OLIVER WYMAN

Retail and Consumer Products

A Retailer's Recipe for Fresher Food and Far Less Shrink

Up to one in seven truckloads of fresh food delivered to supermarkets gets thrown away. That shrink represents a huge cost by itself. But it's just a symptom of deeper problems in grocery aisles everywhere—problems that affect freshness and have a huge impact on the choices that picky customers make. Freshness and shrink, managed together, can add as much as $60 million a year to a $10 billion chain's earnings while growing sales and improving its market positioning. Industry leaders are mastering the new skills needed and starting to pull ahead

Walk into just about any metropolitan supermarket in North America and you'll quickly see superabundance. Fresh peaches piled deep and wide; several varieties of glossy apples; strawberries and lettuce and onions, redolent and seductive to shoppers.

But the succulent arrays hide far less appetizing truths—truths that are becoming more consequential not only for grocers' next-quarter profits but also for their long-term success.

Eye-catching displays often belie the food's actual age, an increasing irritant to shoppers who treasure freshness yet find their purchases spoiling all too quickly. And few see the grocers' side of the freshness story: the trash bins full of baked goods, fruit, seafood, and flowers at or near their expiration dates or rejected by customers.

Up to one in seven of the truckloads of perishables delivered to a store will be thrown out. That's a huge shrink cost even before factoring in the costs of getting the goods to the stores, handling and stacking them, and then culling and paying for their disposal.

But those costs pale in comparison to the costs of losing customers who care about freshness. New studies by Oliver Wyman show that more than four-fifths of customers have seen bad produce on display in their grocery stores. Nearly 60 percent have found goods they bought at the supermarket unsatisfactory when they got home—and nearly two-thirds have changed their shopping behavior as a result, with few complaining to store management.

High shrink and poor freshness are two sides of the same problem. They share the same causes and as such they need to be tackled together. Yet little is being done about this problem. To be sure, grocery executives apply effort to improving cold storage and making other moves that tweak food freshness.

But to most managers, shrink is an unavoidable consequence of the need to offer abundance. In practice, supermarkets tolerate shrink and tinker with freshness. They don't actively manage either, let alone manage both in an integrated fashion. It is nobody's problem and everybody's problem—no single person is accountable for freshness and shrink. And although there are some numbers to chart shrink rates, there are often none that properly quantify freshness.

Freshness and shrink together represent the most under-managed lever in groceries.

Arguably, freshness and shrink together represent the most under-managed lever in the grocery business. For a $10 billion-a-year retailer, that lever can liberate as much as $60 million annually in pure additional profits. If retailers' shareholders were to know that—and to see how shrink reduction can make or break profitability in perishables—retail executives would be far more likely to look at the problem anew.

If shareholders were also to find that many of the most easily spoiled foods could be as much as three days fresher with minimal capital investment, and with concomitant cuts in shrink, management's priorities would look quite different.

Oliver Wyman's studies show that a few grocers are winning recognition for the freshness of their food. Others are achieving quite low shrink levels. Moreover, the handful of companies now tackling the problems in tandem are starting to see huge opportunities not only for profitable growth but also for expanded market share. Their managers deeply understand the interplay between the two factors—and they are actively beginning to formulate plans and assign resources to manage both together. In doing so, they are rapidly opening up a lead over their competitors—a gap that won't be easy to close.

This white paper dissects the problem and offers an integrated solution, beginning with the prevailing approach to freshness and revealing what leading practitioners are doing now to map new strategies for managing the underlying challenges without making major capital investments.

The Freshness Forcing Factor

Many elements make up a grocery store's offer to consumers: the choice and quality of what it sells, the store shopping experience, and its levels of customer service. But those elements aren't equally weighted. Freshness in the perishables departments is one of the strongest levers for driving consumer satisfaction, and it is gaining clout as consumers emphasize healthy eating.

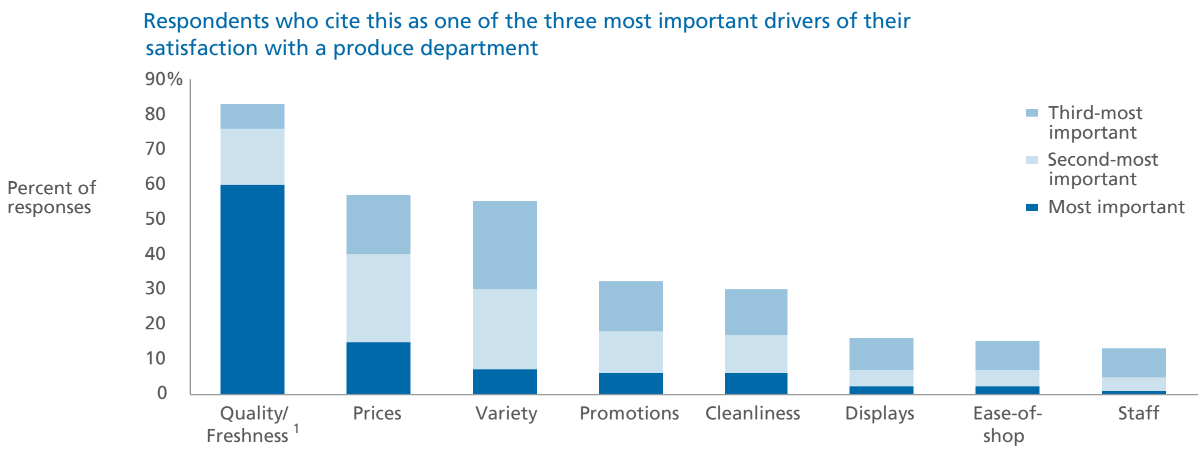
Oliver Wyman's recent survey of the U.S. market reveals that freshness is the most important driver of customer satisfaction with a store's produce, as shown in Exhibit 1. Our survey confirms that it is also critical to growing sales and market share. Not only does freshness actively drive customers into stores and hike perishables sales, it also boosts volume across the rest of the store.

Customers who are satisfied with freshness will spend over a third more in the produce department of their primary store compared to those who are not satisfied. At the same time, customers will spend 8 percent more of their total grocery spend with the retailers whose produce they are pleased with—that is, 8 percent more than the shoppers who aren't happy with that store's produce. The shoppers who come back for the plump nectarines and fresh deli products will fill their baskets with other fresh foods at that store and with more goods from other aisles.

Everyone in the grocery business likes to think that they're masters of freshness. The latest polls by the Food Marketing Institute show that nearly all retailers are emphasizing perishable products such as meat, produce, prepared foods, and deli and bakery items, with nearly 85 percent focusing on natural and organic products.

Still, the issue is consistently underestimated and underplayed. Grocers are failing to live up to customers' expectations. In fact, they dig deeper holes for themselves because their marketing teams so aggressively lay claim to superior freshness and trumpet their efforts to stay ahead of customers' freshness concerns. Despite the retailers' promises, customers continue to be disappointed. With a few notable exceptions—Wegmans being the standout—consumers give a lukewarm verdict on the quality of what's on display in the produce departments (Exhibit 2).

Exhibit 1 **The importance of freshness**



[1] Respondents were asked about "quality" here, but they overwhelmingly indicated that they view "quality" and "freshness" interchangeably.
Source: March 2007 online survey conducted by Oliver Wyman and Ipsos Interactive.

Our survey exposes the seriousness of the problem. More than four-fifths of consumers have noticed bad produce on display where they shop, and 58 percent have found goods they purchased unsatisfactory when they brought it home. It has been enough to make nearly two-thirds of those customers change their shopping behavior—many choosing to buy less produce at that store and a few taking all their grocery business elsewhere. But most retail managers were oblivious to those responses because only 17 percent of the shoppers annoyed by the poor freshness of their purchases say they complained to the store about it.

The Link to Shrink

Perishables shrink is effectively the smoking gun. Most shrink in perishables is caused by product reaching the end of its shelf life. High shrink means that a lot of product will be on the shelves just before it needs to be thrown away.

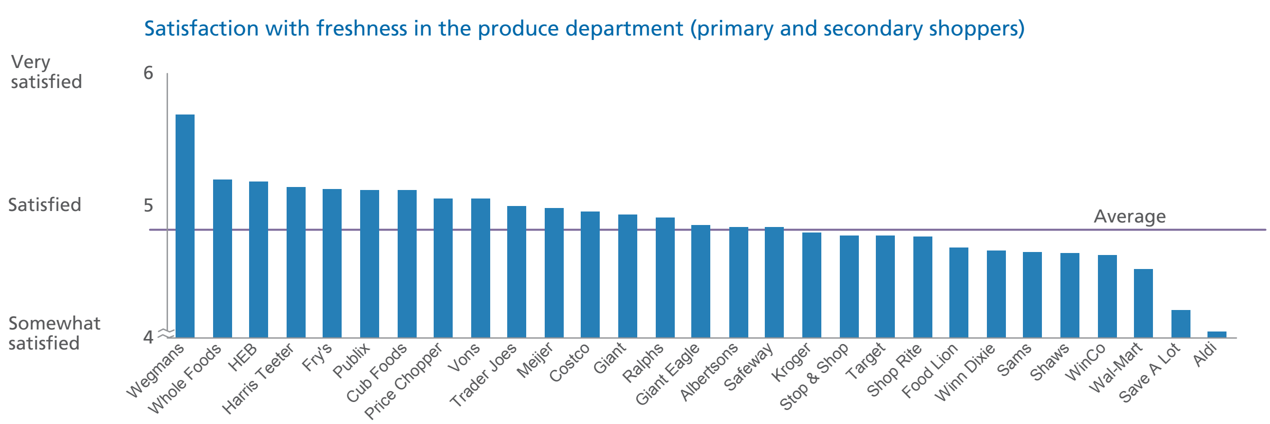
Shrink is clearly identified in retailers' financial documents. At least one leading U.S. grocery chain has made public disclosures of shrink problems that have reduced its gross profits in recent years. But the problem is that shrink, as most retailers view it, is synonymous with loss prevention, with remedies focused on addressing various forms of theft by shoppers, employees, suppliers, and service contractors. While loss prevention is clearly an important area of opportunity for retailers as a whole, the real opportunity lies elsewhere for supermarkets that sell perishables.

Further industry research shows that shrink caused by spoilage in perishables can be 10 times greater than shrink in non-perishables, which is largely caused by theft, damage, and accounting errors. While perishables make up about 30 percent of total store sales, they can be responsible for up to 80 percent of total store shrink.

There are several allied causes for concern. First, perishables shrink is not easing up—even though it might seem easy to think that tight business metrics, sophisticated management processes, rigorous business disciplines, and advanced IT systems would be making it easier to control. Second, retail executives still have not fully grasped that shrink reflects dissatisfied consumers who reject products on display.

Shrink and freshness are inextricably linked. The fresher the food, the less will be left on the shelves to be culled and thrown out the next morning. Everything that boosts freshness drives automatic shrink benefits and "managing down" the levels of perishables shrink is, if executed properly, itself a lever for improving freshness.

Exhibit 2 **Few grocers excel at freshness**



Note: Only stores with more than 30 respondents are included.
Source: March 2007 online survey conducted by Oliver Wyman and Ipsos Interactive.

Tackling the Problem

At its heart, the freshness/shrink quandary is an inventory management issue. But that does not place it at the door of the supply chain manager. Perishables inventories are directly influenced by many different functions in stores and along the supply chain. By default, store operations managers "own" shrink since the store is where the shrink happens. But many influences can cause shrink. The procurement department, for example, has a big impact because of the quantities it commits to buy and the delivery schedules it negotiates with vendors. And merchandising teams wield influence as they build planograms, set display standards, or design promotions programs.

To set change in motion, executives must take a cohesive, cross-department approach that brings those perspectives together, altering the business strategy, adjusting the operating model, and leading to new business processes and organizational structures. The approach is no short-term fix, but it need not take years to yield results.

What's useful first is a short exercise that requires no big capital outlay or resource drain—a diagnostic project that begins to untangle the complexities, captures data, and gains insights into what limits freshness and drives shrink. In a few weeks, retail managers can find out where shrink is really happening and what is causing it, and then craft an agenda and a set of initiatives to deliver the savings identified. The diagnosis will quickly pinpoint the many issues that are common to most grocers. It will also point to the custom approaches to implementation that are necessary because Retailer A's business processes or organization structure are very different from those of Retailer B. Here are the steps to make it work.

1. Build a formidable fact base.

Emotions and opinions are the tools of the

Why Is the Freshness/Shrink Problem So Intractable?

Shrink and freshness problems are becoming more acute. There is no shortage of reasons why. Here are four of the most pressing:

- **Misaligned views.** Many retailers believe it's a supply chain problem only. They continue to think and act in terms of continued investments in fresh-produce distribution centers and in cold-chain software implementations without considering the impact of merchandising and store operations. There are mismatched perspectives at an executive level, too: While the CEO may emphasize freshness as a strategic imperative, the CFO may be concerned about the cost of shrink at a tactical level.

- **Few or incomplete metrics.** What cannot be measured is hard to fix. That is all too true in the grocery sector, where there is little or no data on freshness other than generalized data about shipment times or the time that produce waits in refrigerated distribution centers. Moreover, the metrics on shrink are generic at best; they include theft by customers and employees. To date, there are few true cross-industry or cross-sector statistics with which retail executives can benchmark their companies' performance.

- **Complacency.** In perishables, retail managers have an enduring sense that there will always be some level of shrink, which encourages a "good enough" syndrome. Among some managers, there's a more pernicious idea—that shrink reduction is actually dangerous. Managers weaned on the concept of growing sales by displaying abundant amounts of product—the "pile 'em high, watch 'em fly" doctrine—then worry about hurting sales if shrink efforts go too far; their deepest fear is that they will see empty shelves. In practice, the reverse can be true: The "pile 'em high" mentality can actually hurt sales when produce at the bottom of the piles is damaged.

- **Complexity.** Many reasons account for why shrink happens, and many levers can be pulled to correct it. It's a merchandising issue as much as it's a logistics, procurement, or store issue. By the same token, there is no unified view of the causes of poor freshness and shrink. Every functional area of the business interacts with freshness and shrink—and nobody has overall ownership of it.

entrenched. They help to maintain the *status quo* in the retail grocery business, where there are almost no hard metrics on freshness and few shrink statistics that are detailed enough.

To get around the emotions and the finger-pointing that can follow when change is called for, it's crucial to spend a few weeks developing a robust base of facts. Most companies lack key base-level data—basic inventory listed by item, day, and store. But they often have much more data on hand than they think. By gathering and assimilating data from every relevant area—from the warehouse, the point-of-sale systems, from procurement, and so on—it is possible to rapidly build up a quantitative, cross-company picture that no single executive probably ever has seen.

It is also vital to work with the right set of facts. One recent diagnostic initiative that Oliver Wyman undertook with a leading North American grocer proves the point. The grocer, with more than 500 stores nationwide, tracked shrink data store by store, with each store's shrink number compared to its division average. The resulting targets were not credible to store managers and their teams; for some stores, the numbers seemed unrealistic and therefore unachievable, and for others they were too easy. The targets were largely ignored.

A preliminary evaluation revealed that the company was not using the right comparables to gauge its stores' shrink performance. Examining the operations in detail, Oliver Wyman confirmed striking variations in freshness and shrink performance between the company's stores, even within a region. Some stores were located in environments and markets that made it much more difficult for them to control shrink. Indeed, a rigorous analysis revealed that over half of the variation in shrink stemmed from structural drivers outside the stores' control. By controlling the variables and regrouping the retailer's stores by similar structural factors instead of by geography, it was possible to demonstrate meaningful comparisons of shrink performance. Now that they can play on a level field, the company's store managers have shrink targets that are both fair and achievable. As a result, they are working hard to bring their shrink numbers down.

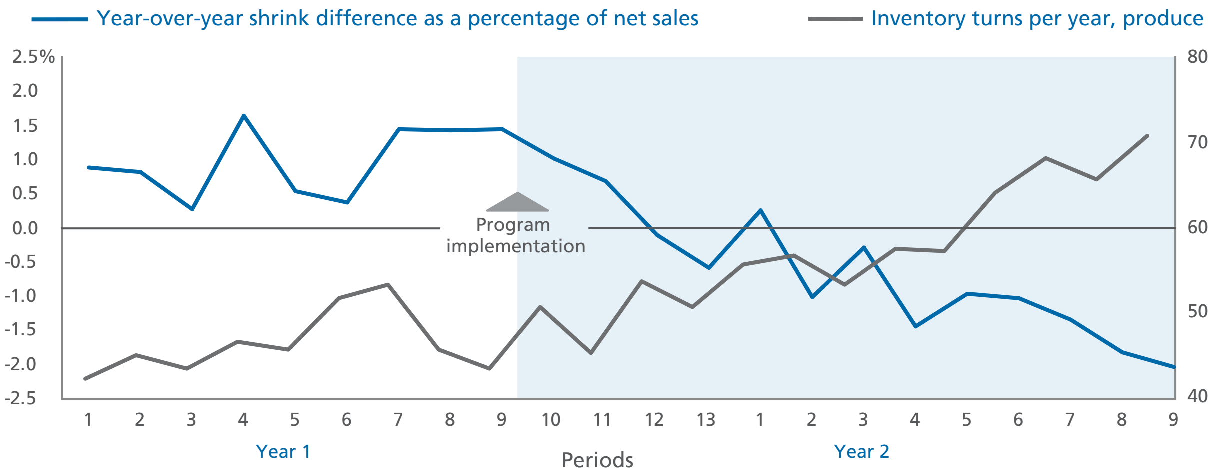
> A rapid, cross-department diagnostic can pinpoint where the problems lie.

2. Get ready to shock.
When played back to senior executives, the fact base can shock. In one case, the CEO was astounded to learn that so much fresh food ended up being thrown away. It's common for executives whose marketing campaigns center on freshness to be alarmed by inconvenient truths—for instance, how highly perishable mushrooms often sat for up to three days on the shelf due to over-sized displays, or how a slow-selling variety of tomato had higher shrink than sales. At the very least, grocery leaders learn that it's not enough in perishables to be good on average; it's what the worst 20 percent of product looks or feels like that matters. Long shelf-life apples may benefit from studies of the average; peaches and strawberries certainly do not.

3. Get rapid agreement on the problem.
With the data on the table, the CEO can now call a high-stakes meeting with the executive team. Several weeks into the diagnostic, the findings are presented. These facts get every executive vice president to acknowledge that there is a problem, and that he or she owns a part of it. The door is open for candid discussion about roles, resources, and schedules for implementation of a new approach.

4. Craft the agenda, map out change.
Subsequent executive meetings start to chart everything that has to be transformed in order to crack the problem. Every company's plan will be different. To what extent does Grocer A's procurement department make use of shoppers' transaction data to determine the best possible

Exhibit 3 **One supermarket chain has seen big improvements in shrink to date**



forecast on which to base their buying decisions? Should Grocer B limit the variety and quantities of food on display in the name of freshness—at risk of some stock-outs or tarnishing its reputation for high display standards? At this stage, it is important to capture as many potential improvement paths as possible and to quickly winnow them to a set of probable change initiatives. Further analysis, backed perhaps by a short round of primary research, can help determine the necessary change initiatives and the resources needed to set them in motion.

The diagnostic mentioned earlier led to the grocer listing several shrink-reduction initiatives across six key areas of opportunity, spearheaded by a series of quick wins that saved $10 million within a year. The cumulative efforts are expected to build to more than $100 million in annual benefits within three years. At the same time, there was a measurable increase in the freshness of the product and with customers' satisfaction with freshness. None of the initiatives is sufficient alone; it's clear that most of the savings must come from addressing a variety of fundamental business practices. The grocer is now working on many of the programs—and starting to see dramatic performance improvements across the board, as shown in Exhibit 3 on the next page.

5. Name a "chief freshness officer."
With a plan in place and freshness/shrink objectives woven into the business strategy, it is time to appoint a respected senior executive who will own the initiative and drive it hard. At this point, the issue goes from being nobody's problem to being somebody's problem and is becoming part of the organization's cultural fabric.

The "chief freshness officer" (not an actual title) will be a semi-permanent role that crosses functions, but with a probable bias toward operations. With a dotted-line report to the CEO, the new leader will have the rank and the personal authority to make change happen quickly and at scale. He or she will be personally accountable for tens of millions of dollars in shrink-reduction savings and sales increases spurred by freshness, with a meaningful annual bonus for hitting predetermined freshness and shrink targets.

Reporting to this new business leader will be a team of senior managers with backgrounds in everything from merchandising to operations and procurement. The team will be highly focused and dedicated to driving shrink down and freshness up.

6. Pick the right metrics and tools.

Previously, even the best-intentioned of retailers may not have tackled freshness or shrink because they lacked the right tools. But when the company sets hard targets, develops metrics, and allocates resources, things begin to happen.

Metrics are pivotal for change to happen on a broad scale and in sustained ways. A sound diagnostic exercise serves as a good kick-off point: It will quickly yield more granular shrink data than the retailer's managers have had before. It will also create metrics for freshness based on days of foodstuffs on hand—statistics that before long will become almost as important as sales and gross figures. The diagnostic will show why it is so important to "de-average" the data—to pay attention not only to median or mean figures but to the "20 percent worst" statistics that represent the spoiled or aging products that customers really notice.

Just as importantly, the metrics will form the basis of new performance incentives for key employees. For instance, each store manager will be given a shrink target rather than being measured only on sales and gross margin: Hit the target and the manager will see a fatter annual bonus.

As the freshness/shrink team thinks through the metrics that will best meet the new objectives, its leaders will draft support from all over the company. For example, they'll borrow from the

The New Life of the Produce Manager

A useful way to envision the new approach is to see it through the eyes of a produce manager. The name is fictitious, but the types of changes to the manager's job are not:

The past six months have meant big adjustments for Jack Mendoza. As produce manager at the Burbank store of one of North America's largest supermarket chains, he has another workshop on product freshness this Tuesday afternoon. On Friday at 10:30 a.m., he will receive the now-weekly review of the new metrics on the freshness of his store's fresh fruits and vegetables. He also has had to brush up on his math to get to grips with the flurry of data that now helps drive his decisions.

A 22-year veteran of the grocery business, Mendoza had always been proud of the way his department looked. Symmetrical pyramids of colorful vegetables and fruit nestled among weathered wood and rustic baskets signaled "farm-fresh" food to shoppers and drew compliments from visiting district managers. His focus had been on having plenty of product on the shelves at all times. And he had always worked hard to make sure that his team felt the same way about their work.

But the numbers that Mendoza's store manager had shared were a shock. He knew how much spoiled produce was being thrown away daily and he'd seen firsthand that customers were getting much choosier. But he'd had no idea that shrink weighed so heavily on the company's profits, or that freshness had such far-reaching implications for overall market share.

So it was no big surprise when, along with colleagues from the company's other stores in the region, he'd had to attend the first workshop on freshness. His counterpart at the Glendale store had plenty of complaints about "management fads," but it was clear to Mendoza that this was one initiative that was permanent. After all, here were the first hard numbers he'd seen to show the extent of shrink's influence on freshness—and vice versa.

Besides, Mendoza took the new freshness standards as something of a personal mountain to climb: He soaked up the training in latest planogram use and display-level best practices, shared much of what he learned with his team, put what he learned to work, and saw shrink levels start to fall in a matter of weeks. He saw that he wasn't the only one working on the issue: Improvements in the produce coming from the warehouse clearly reflected the outcome of the concerted efforts of the store's buying teams.

This Friday's review holds no terrors for the produce manager. In fact, it will be the fourth time this week that Mendoza and his store manager have swapped information about the company's freshness/shrink program. And since he began tuning his daily ordering and replenishment with input from the new automated forecasting system, he has solid numbers with which to defend his actions. With about three months before year's end—bonus time—Mendoza now knows he's on track for a nice extra paycheck that recognizes his efforts to cut shrink and improve freshness.

Dedicate a team of senior managers that uses "de-averaged" data to create new performance incentives.

expertise of the Finance group to develop a metrics reporting structure and the proper accountability processes. They will enlist the IT department to provide the software tools that can automate key freshness/shrink business processes, capture and analyze data, and build reports for senior management. And Human Resources will be tasked with assembling the right mix of incentives and crafting appropriate workshops and training programs.

Within a few months of the start of the initiative, the benefits will begin to show up. The needle starts moving on the financials. Freshness and shrink will become part of the conversations among department heads, and there will be palpable pride in the outcomes. Shoppers entering one of the company's stores will start noticing fresher product on offer, and third-party tracking studies will echo their observations. Before long, the new freshness leader should be able to present a strong series of quick wins to the CEO.

Reworking Next Week's Agenda

Here is the uncomfortable truth about the supermarket industry today: Fresh products can be much fresher—and "good enough" shrink isn't.

Retail executives have a remarkable opportunity for differentiation and revenue growth: They can significantly improve freshness in their perishables sections and cut shrink as a consequence. By taking a cohesive approach to freshness and shrink, they can not only avert many of the truckloads of produce that are junked daily but they can do much to burnish their stores' reputations for freshness and thus bring customers back week after week.

Imagine for a moment that next Monday's management meeting is instead a meeting with agitated shareholders. They have questions about stressed profit margins, about growth in same-store sales, and about the likelihood of an acquisition bid by your smaller and more profitable rival. How are you going to answer when they ask what you're doing to slash persistent costs such as shrink? Or when they want to know what you're doing to help generate more traffic and higher share of customers' spend?

Some retail executives can answer easily already. We're seeing early benefits at the few retailers that are starting to tackle the twin challenges of boosting freshness and corralling shrink. But in many corners of the industry, we still see surprising indifference to the issue. Perishables management has to become a priority on every retail CEO's strategic agenda. It is every bit as important to long-term success as that corporate brand overhaul or the new-store investment plan.

Shareholders may not yet be pressing for freshness statistics, but as the retail pioneers' initiatives start getting attention, those questions will come.❖

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About Oliver Wyman

Oliver Wyman's Retail Practice has a 20-year track record of helping clients deliver high-impact performance improvements. We combine deep industry knowledge with clear insight into what it takes to succeed in retail. Our proprietary, state-of-the-art analytical tools and techniques provide an unrivalled understanding of how to create shareholder value, and we work closely with clients to develop practical, real-world solutions that make this happen.

Oliver Wyman is an international management consulting firm with more than 2,900 professionals in over 40 cities around the globe.

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