Supermarket Challenges & Opportunities

An Executive Briefing for Senior Managers of Supermarket Chains

by
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A tough business is getting tougher. Supermarket chain executives already face enough challenges in the form of low margins, high wages and an uncertain economy. Yet a continuing trend toward consolidation and new competitors in the industry has increased the pressure on most supermarkets. Significantly, the new competitors include well-financed, high-volume, general merchandisers and even pharmacies carrying full lines of grocery items.

But the purpose of this briefing is not to bring you bad news. It is to present an approach to managing that is practiced far too infrequently in supermarkets, but that has worked extremely well for those that have used it. This briefing presents a way of thinking about supermarket operations that differs sharply from "business as usual." Most importantly, this briefing will give you ideas for maximizing profitability and customer satisfaction in this challenging environment.

What's Possible?

Eliminating waste is the path to maximizing productivity, which in turn boosts profitability and customer satisfaction. However, when most people try to maximize productivity, they simply push their people harder, reduce staff or supply new incentives for doing the work in the same old way. Most focus on the workers, rather than the work and work processes. That's too bad, because the largest productivity gains come from focusing on work.

What does "focusing on work" mean? What kind of gains are possible?

Focusing on work means studying, changing and improving the work that goes on throughout the supermarket organization—the distribution centers, the stores and the paths between them and the vendors and customers. Studying, changing and improving work can double, triple or even quadruple pretax profits. Productivity gains of 30 percent and more are usually available through serious fact-finding regarding the work and work processes. The lower a chain's current productivity and profitability, the larger the potential gains. Yet even productive, profitable operations benefit greatly by focusing on work.

<u>Let's Get to Work</u>

For our purposes, work includes the work of people, machines, systems, energy and processes. The goal of studying and improving work is to have all work done in the best possible way and, given that goal, there is always room for improvement.

Imagine one of the work processes in your operation as it is now being performed. This process might be customer checkout, reconciling deliveries, financial reporting or the way dairy items are kept cool. Then, imagine this process being performed perfectly every time: no errors, no problems, no delays, no downtime. Now consider the gap between the two levels of performance—that is the waste.

How much does the gap between current performance and perfect performance cost? In our experience, an average of 20 percent to 40 percent of net revenues at most companies.

Waste is the gap between the way things are and the way they would be if everything were right. This waste takes four forms:

- Waste of Material
- Waste of Time
- Waste of Capital
- Waste of Gross Profit from Lost Sales

For supermarkets, that last item—lost profit due to lost sales and lost opportunities—is the largest. It includes lost sales due to everything from stock outs to poor service to failure to build new stores or renovate and maintain older ones. Eliminating waste of material, time and capital frees up resources for tasks that deliver greater value for the customer and thus increase sales and profits for the chain.

Waste is the difference between
the way things are now and the way they could or should be

<u>What Causes Waste</u>?

Executives in every industry are offended by the accusation that their operations are filled with waste. Supermarket executives are no exception. Most believe that a certain amount of waste "comes with the territory" and that the rest of it is under control. Many also believe that a lot of waste is generated by employee and customer carelessness and dishonesty. Yet our work tells us that while some waste is inherent in the business, the major generators of waste are actually the *systems and work processes put in place by management*.

Example: A mid-size, family-owned chain wanted its baked goods displays to appear full and fresh. The senior managers believed (correctly) that no shopper wants the last corn muffin or cheese Danish. So, they put in place a policy specifying that *no* shelf-bottom should show in the bakery display cases. As a result, unsold baked goods amounted to almost 20 percent of total bakery sales.

In another chain, massive rotisseries ran in every store from an hour after opening to an hour before closing. Each rotisserie was filled with roasters with a shelf life of about two hours. Senior managers were stunned to learn that the stores were literally throwing away almost as many roasters than they were selling and that the employees hated throwing all that food away! This kind of waste occurs in many supermarket chains. That doesn't even include all of the excess energy used to cook the roasters when no one was buying them.

One chain was discarding almost as many
roasted chickens as it was selling.

Although confronting waste can be unpleasant, competitive pressures often force executives to face it down. For instance, over an 18-month period, a supermarket chain in the South saw two larger chains *and* a general merchandiser with grocery operations enter its market. In response, the chain's marketing group created a program promoting Low Prices Everyday. However, management soon realized that they did not have low costs everyday. The mismatch between the pricing strategy and the cost structure undermined the marketing program, not to mention profitability. But by attacking waste aggressively and making widespread process improvements, management found the money to fund these lower prices and stave off the new competitors.

In fact, by attacking waste relentlessly in the areas discussed in this briefing, this chain increased its productivity, as measured by sales per employee, by more than 20 percent in less than two years. Given the competition, management felt they had no other choice—and they were right.

How does all this work in practice?

Laying Waste to Waste

Improving work calls for 1) identifying, 2) quantifying and 3) eliminating specific sources of waste. Each step is essential:

- Waste must be systematically identified because people become so used to seeing it that they just accept it as part of the process. When you identify the waste, you see lots of opportunities for improvement.

- Waste must be quantified, in dollars on an annual basis, because then the trade-off between the costs of the waste (such as discarded food, wasted time or lost gross margin) and its benefits (such as fresh displays) become clear. When you quantify waste, you know what it costs.

- Waste must be eliminated by changes in policies, procedures and systems and in the way people work. When you eliminate waste, you increase the productivity of the operation and the value for the customer.

The following sections detail major sources of waste in supermarket operations, along with more examples of waste that we've encountered.

Waste of Material: Shrink Is Huge

Despite continual efforts to control shrink, it hovers at an average of about 1.5 percent for the industry. Ways of measuring shrink—the difference between what was purchased and what was sold—vary. However, two points are important when we think about shrink.

First, a total, overall shrink figure does not accurately or specifically measure the shrink. It is often a plug figure or "fudge factor" derived by calculating the difference between the amount of goods purchased and the amount sold. Rather than calculate store-by-store or product-by-porduct shrink, some chains <u>simply allocate</u> the total shrink across the stores based on each store's volume. That's a far cry from identifying and quantifying the specific sources of shrink, which is necessary to reduce it.

> *To reduce shrink dramatically, you need accurate measures of specific sources of shrink.*

Second, shrink varies wildly across product categories. This is not news to supermarket executives. But when shrink ranges from less than one percent for certain dry goods up to 10 percent or more for certain types of produce and prepared foods, more precise measures would clearly be useful. Those more precise measures show the true sources and costs of shrink.

For instance, in some areas of the country, supermarkets offer pre-sliced, unpackaged meat and cheese in their deli cases. This helps the supermarket to service deli customers more quickly. Once sliced, these products have a short shelf-life, and many people prefer them sliced to order. Therefore, some of this meat and cheese must be discarded or heavily marked down. When we measured the amount being tossed out at one chain, the total annual figure was approximately $2 million.

We identify shrink in two ways: by interviewing the people doing the work, and by direct measurement. The people doing the work will tell you—if they are asked and if they are granted "amnesty" from consequences—what goes to waste and why. Direct measurement can be even more of an eye-opener. Try maintaining a "waste scale" and a "waste register" in departments such as bakery, deli, fish and produce in a few stores for a few weeks and calculate the dollars lost. Then annualize that figure for your entire chain. Then imagine the effect of reducing that dollar amount by even one-half.

Distribution and maintenance practices were sources of frozen-food shrink in another chain we worked with. First, the drivers from the distribution center would deliver frozen foods late at night when store staff was limited. They would often leave the food in the receiving area where it would thaw and spoil. Second, poorly maintained freezer cases often broke down, causing loss of food.

Improved scheduling and coaching of drivers and store personnel reduced the first source of shrink. Preventive and predictive maintenance addressed the second type. Compressors, motors and other parts have predictable lives, usually measured as mean time to failure. So if the predicted time to failure is 24,000 hours, the part is now replaced at 23,500 hours even if it still works. Writing off the last 2 percent of life is paid back many times over in reduced shrink, stock outs, maintenance overtime and wasted time of employees dealing with the breakdown. Other preventive maintenance, such as lubrication and filter replacement, is also performed on schedule with the goal of reducing shrink.

Material Waste Beyond Shrink

Purchasing practices are another large source of wasted material. A large, privately held chain had for many years purchased its vehicles and related services exclusively from a trusted local vendor on a noncompetitive basis. Most managers knew that this was costing the company several million dollars a year over the prices obtainable through competitive bids. Once the CEO embarked on eliminating waste in his organization, he could no longer ignore the excessive costs associated with this practice. How can store managers push people to make substantial savings when senior managers are allowing millions to be wasted? Fortunately this group of managers appreciated the change and went on to make huge, measurable improvements in reduced costs and improved productivity.

Vendors understand a customer's need to control costs. Worthwhile vendors will work with you to reduce costs by making their processes more efficient. That way, they keep a customer while making their company more competitive. Do vendors like hearing that they must start working harder or differently? No. But over time, they thank customers who help them become more efficient.

Worthwhile vendors will work to *make their processes more efficient.*

Energy used to needlessly run lights, ovens, refrigerators, heating and air conditioning systems and other equipment wastes big money. We have found that virtually every company that has not systematically studied its energy usage can easily reduce its annual energy expenses by 10 to 20 percent or more. To identify waste in this area, review all aspects of energy usage and determine what is actually needed to satisfy customers. Accurate and timely measurement is essential to reduce the waste and keep it gone.

For example, the owners of a chain we studied understood that shoppers enjoy shopping in well-lighted stores. As a result, they designed their stores to include an abundance of lighting fixtures. That proved to be very expensive in both installation and maintenance costs. When they began a program to identify waste, they noticed that the lights often pointed in the wrong direction—for instance, over, rather than at, the cereal display—leaving key areas poorly illuminated. In addition, the level of lighting ("nice and bright") was not clearly specified.

By studying the layout and customer needs and by defining the specifications with the use of light meters, the chain eliminated many of its lighting fixtures, and over $1 million in waste, while actually improving the lighting.

Other energy savings came from turning off warmers when they were empty, turning off exhaust fans when ovens weren't in use, and installing multiple electric meters to monitor usage in specific areas of the store. Constant measurement is the key to keeping the gains.

There are, of course, other sources of wasted material, but shrink, purchasing policies (including relationships with suppliers and supplier selection), food handling and storage procedures, and energy are among the largest in most chains.

Time Actually Is Money

Given the number of people needed to staff a supermarket and their ever-rising compensation, serious efforts to reduce wasted time of employees repay themselves several times over. To locate waste in this area, first study the work and work processes and identify and quantify the time wasted. Especially consider the time employees spend on price changes, out-of-stock situations, receiving merchandise, restocking shelves and check-out. Be sure to include waiting time, time spent doing tasks twice and the time of every person involved.

Next, ask how essential the work is to customer satisfaction. A chain that was famous for its produce believed that constantly reorganizing the displays added a touch of right-from-the-field freshness. But when they measured the hours employees spent on this task and the shrink caused by the extra handling, they soon modified the practice. The waste involved in reorganizing the displays wasn't known until it was quantified in dollars.

Several simple but effective methods enable people to study their own work. For instance, work sampling studies using the Conway Time-Finder are among the sharpest tools for assessing work. In a work sampling study, employees list all the tasks they typically perform. Then they wear a beeper that has a timer set to go off randomly during the day. When the beeper sounds, the employee places a check mark next to the task he or she happens to be performing at that moment. Over the course of the study, employees gather enough data to get a true picture of how their time is spent.

This data reveals a lot about the processes and systems that dictate the ways in which people spend their time. Using this information, management and the employees involved can change the work and work processes so time is spent more productively. The key to success is getting good, accurate data, and the key to that is guaranteeing amnesty from corrective action to the people who report the waste. In addition, although most supermarket chains stand to benefit greatly from systematically improving the work, few have taken the opportunity to do so by taking a truly systematic approach.

Work sampling studies are among the sharpest tools for assessing work.

The full costs associated with hiring and training, particularly as a result of employee turnover, are often underestimated. When a medium-size chain we worked with analyzed the costs and benefits of their HR practices, management took measures that reduced annual turnover by almost 30 percent. The measures included increasing compensation, doing pre-employment checks, improving training and helping people to feel more personally invested in the business.

Store openings and all that they entail also generate wasted time. Meticulous planning and scheduling, along with a few proven floor plans, can reduce the cycle time and man-hours involved in getting a new store up and running. Much can be learned by examining the standardized practices of other organizations. Measures they have taken include purchasing standard equipment to minimize set up and maintenance time and using floor plans and shelf systems that minimize time spent in set up and in reconfiguration over the life of the store.

Capital Ideas

Capital tied up unproductively or longer than necessary is wasted capital. New construction ties up capital, so compressing the time it takes to open a store frees up funds. Other areas to scrutinize include inventory and financial management practices.

Increasing the chain-wide inventory turnover rate can free up millions of dollars in a sizable operation. For instance, a chain we're familiar with carries average total inventory of about $125 million to support sales of $1.5 billion. This chain is working to decrease its inventory to $100 million. If successful, the chain would have $25 million less tied up in inventory and reduced distribution center costs, as well as all of the costs associated with shrink.

The reduction in inventory would free up $25 million for other purposes. With state-of-the-art management, technology and forecasting, that kind of improvement lies within reach for many chains. However, some have been slow to update their systems and methods. Some chains, of course, have invested heavily in real-time systems to support just-in-time inventory practices and have pressed vendors to improve their efficiency. These practices drive costs down throughout the supply chain, and they are one of the reasons that these companies are such formidable competitors.

Regarding financial management practices, we have found that the best-run chains share two characteristics: superior information systems, and openness within the company about goals and performance.

Most senior executives realize that their financial reporting and information systems can generate far more information than managers can use. They need to provide only reports that help managers make decisions, rather than reams of irrelevant data. If the reports do not contain information that is relevant to their jobs, store managers will not take the time to review them.

Well-run supermarket chains share financial information at all levels of management.

Well-managed chains develop budgets, sales projections and cost information, by store and profit center. Then, rather than keep this information restricted to a small cadre of senior executives, they distribute it widely among their managers and supervisors, who have been well trained in how to use it. That way, people at all levels can make decisions that conserve capital, cut costs and build the bottom line. When people have the right information, they can make the right decisions and when people are empowered to make the decisions, they are more fully engaged.

Profits Lost Are Lost Forever

As noted, lost gross profit due to lost sales and lost opportunities represents the biggest waste of all.

Stock-outs generate this kind of waste. Sales are lost when decisions about shelf space are driven by agreements with vendors, rather than customer preferences. Sales are lost when sketchy data is used to calculate purchases for promotions. Sales are lost when the wrong products are ordered or they arrive at the wrong place or at the wrong time. Moreover, the rain checks, restocking, customer complaints, inter-store transfers and rush orders that accompany these situations all generate waste.

More broadly, all waste translates to lost sales and profits because waste does not add value for the customer. The supermarket chains that deliver the most value to customers—in terms of price, quality and service—will be the winners. But it costs money to deliver value, and supermarkets are a high-cost business. Therefore, whoever makes it low-cost is going to win. The stores that reduce costs will, like the Wal-Marts of the world, emerge as the industry leaders in the next five to ten years. Those who don't will, like the KMarts of the world, be the losers.

On the surface, supermarkets will continue to compete on price, quality and service—the things the customer sees. They represent value for the customer, and chains cannot keep customers by downgrading value to achieve low costs. Instead, below the surface, they must cut costs by cutting every bit of waste out of their operations. The money freed up then can go to increase value for the customer, or go to the bottom line.

New competitors like Target and pharmacies like CVS and Walgreens are coming into the market with new formats and they are increasing their focus on taking market share from traditional supermarkets, so the challenges are only going to increase in the years ahead.

Senior managers themselves often pose
the greatest barrier to eliminating waste.

<u>What's Stopping Everyone?</u>

As Pogo famously said, "We have met the enemy and it is us." Paradoxically, and at the risk of alienating readers, it must be said that senior executives themselves often pose the greatest barrier to identifying, quantifying and eliminating waste. As this briefing shows, the waste adds up to tens of millions of dollars. That's why identifying and quantifying waste are so necessary to eliminating it. With the right information, managers can calculate the costs and consider the benefits of the way work gets done. They can weigh the waste and weigh the value to customers. Then they can eliminate what is wasteful and keep what is worthwhile.

Conway Management Company provides consulting and training that enables managers at all levels to manage their businesses more effectively. Established in 1983 by Bill Conway, former CEO of a Fortune 500 company, Conway Management has worked with 500+ organizations in more than 20 industries. Clients learn to eliminate waste, improve all processes and increase their organization's competitiveness, sales and profits.

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