Fresh categories—fruits and vegetables, meat, fish, dairy, and baked goods—typically account for up to 40 percent of grocery chains’ revenues. They are also strong drivers of store traffic and customer loyalty. Fresh food, however, has always been exceedingly complex to manage: prices are volatile, suppliers are fragmented, the products are perishable and sometimes fragile, and replenishment and quality-control processes are laborious. And due to rising consumer demand, retailers are carrying an ever-expanding range of fresh products, many of which have different temperature and handling requirements. In light of these challenges, many grocery chains struggle to achieve satisfactory margin levels in their fresh departments.

But thriving, profitable fresh departments do exist. In our work with retailers in Europe, the Middle East, and Africa over the past three years, we have seen that the most successful fresh-food retailers excel in five critical dimensions: value proposition, merchandising, sourcing and supply chain, store processes, and end-to-end “shrink” reduction and quality management (Exhibit 1). A retailer’s value proposition—how the company positions its fresh department and what makes it distinctive in the eyes of target customers—is an overarching factor that should inform the rest of the retailer’s fresh-food practices and policies.

Retailers that have a strong value proposition and bolster it by implementing best practices in their fresh departments can boost revenues by as
much as 10 percent. The most important dimensions to invest in will vary by retailer, and every company should diagnose its current performance and how far it falls short of best practice to identify where the greatest opportunities for improvement lie. In this article, we zero in on two dimensions that hold high potential but tend to be difficult for retailers to master: sourcing and shrink reduction.

**Smart sourcing**
The cost of goods sold in the fresh department typically amounts to up to a third of the total cost base of a grocery chain. But despite the importance of fresh sourcing, many retailers approach it unsystematically and thus end up paying above-market prices. Typical pitfalls in fresh sourcing include the following:

- buyers who believe their primary responsibility is to secure sufficient supply, and thus spend most of their time processing orders rather than managing suppliers and conducting fact-based negotiations
- limited transparency into the performance and strength of individual suppliers and the supplier base as a whole (many retailers track only one of the following metrics: buying price versus benchmark, margin, availability of products, and quality)
- quality-control processes that rely on a single indicator—for example, evaluating fruits solely on their appearance instead of testing for taste indicators
- lack of a systematic, comprehensive monitoring of the performance of buyers and purchasing units

To uncover opportunities to improve its fresh-food sourcing, a retailer should reevaluate its answers to the following questions: What should we buy? Where should we buy it? And how should we buy it?

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**Exhibit 1**

Excellence in fresh-food retailing has five dimensions.

<table>
<thead>
<tr>
<th>1. Value proposition</th>
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<tbody>
<tr>
<td>Fruits and vegetables</td>
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<tr>
<td>Meat and poultry</td>
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<tr>
<td>Baked goods</td>
</tr>
<tr>
<td>Dairy</td>
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<tr>
<td>Fish</td>
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<td>Cold cuts and cooked meat</td>
</tr>
</tbody>
</table>

| 2. Merchandising      |

| 3. Sourcing and supply chain |
|                            |

| 4. Store processes       |

| 5. End-to-end “shrink” reduction and quality management |
Product specifications: What to buy?
Most retailers know that product specifications in the fresh department should align with the retailer’s value proposition. A retailer competing on price, for instance, should have different product specs from one competing on quality. But few retailers make the effort to figure out which particular fresh products most affect consumer perception. We found that in most countries consumers form their opinions based on only a handful of products. Best-practice retailers conduct consumer research and then refine their product specs based on how much a product influences consumer perception and how their offering stacks up against the competition’s. The idea is to have the most stringent specifications for the products that have the greatest effect on consumer perception.

The most successful retailers also align product specs with the product attributes that consumers value. Often, a retailer’s specs include attributes that don’t matter to consumers and therefore increase costs unnecessarily. For instance, customers shopping for apples may care about the fruit’s color, texture, taste, and shelf life and pay little attention to its size, in which case the diameter of the apple shouldn’t be part of the product specs. Furthermore, to make sure their products embody the attributes that do matter to consumers, leading-edge retailers use scientific but practical tools: to assess a fruit’s taste, for instance, they use pH meters to measure acidity and Brix refractometers to gauge sugar levels.

Sourcing strategy: Where to buy?
A retailer must determine its optimal position in the value chain for each product category. To do so, it must first develop a thorough understanding of the supplier landscape and the economics (that is, the costs and markups) in every part of the value chain. The retailer can then decide on ways to reduce its total costs and improve its negotiating power. Potential actions include cutting out intermediaries that do not add value, allocating activities to specialists (in meat, for instance, the breeding, feeding, slaughtering, deboning, and packaging could all be done by different providers), or achieving various degrees of vertical integration through insourcing.

When defining its sourcing strategy, a retailer should decide on the right number of suppliers as well as the types of relationships it ought to have with suppliers. Every supplier relationship should be based on the product’s supply volatility (in quality or volume) and importance to customer perception. Products with high supply volatility and a strong influence on consumer perception are best sourced primarily through stable—perhaps even exclusive—supplier relationships. Products that are neither volatile nor critical to perception, on the other hand, can be sourced through transactional or even spot-market purchasing, which allows retailers to respond to changes in demand. For most fruits and vegetables, a combination of stable partnerships with joint capacity planning and some spot-market purchasing tends to be most beneficial.

Sourcing process: How to buy?
Leading retailers regularly compare suppliers’ prices against one another and against published market prices. This benchmarking exercise alone, which many retailers don’t do, can uncover significant savings potential: even when buying the same product at the same time, a retailer
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can end up paying markedly different prices by supplier (Exhibit 2). Of course, there are valid reasons for paying above-market prices—supply security, for example, or better product quality—but we’ve found that buyers often can’t explain why they’re paying higher prices.

Price is only one factor in the how-to-buy equation. The most disciplined retailers track not just price but also product quality, timeliness of delivery, and the delivery accuracy of every single order. These supplier “scorecards” give buyers transparency into the performance of suppliers over time and are a critical input into the supplier strategy—for example, suppliers with consistently better quality should be allocated higher volumes at the agreed-on prices.

Retailers should rigorously monitor not just how their suppliers are doing but—just as important—how their own buying staff is performing. To prevent wide variability in buyer performance, clearly defined negotiation rules and guidelines are indispensable. Some retailers provide buyers with a detailed description of the weekly negotiation process, specifying the activities that need to happen on certain days of the week as well as those that must be done daily.

Given that fresh sourcing often entails daily or weekly negotiations, the impact of sourcing initiatives can become evident very fast. A European grocer boosted fresh margins by seven percentage points; a national retailer in the Middle East saw its fresh margins rise by six percentage points.

Exhibit 2

Supplier prices can vary wildly.
percentage points. In both cases, the company captured 50 percent of the improvement potential within ten weeks.

**Shrinking shrinkage**

We define shrink (or shrinkage) as the cash value of products that a retailer has bought but that it neither sold nor has in stock. As retailers well know, there are many components to shrink, including products past their sell-by or expiration dates, damaged goods, theft, and cashier errors. For many retailers, shrink also includes markdown, the cash value of products that were sold at a reduced price.

Some retailers assume that high shrink levels are an unavoidable consequence of ensuring product availability. But leading retailers manage to keep availability high and shrink low. Shrink rates (including markdown) vary widely: 3 to 5 percent of volume in fresh produce at best-practice retailers, 6 to 8 percent among average performers, and 9 to 15 percent at underperforming retailers, due mostly to climate and long-distance transport. Some retailers admit to not knowing what their shrink levels are.

Opportunities to reduce shrink can be found in every part of the supply chain, from the supplier to the warehouse to the store. The highest-value opportunities will vary by retailer. For example, a retailer with a lax in-store culture might want to prioritize the standardization of operating procedures and the introduction of strict markdown policies. On the other hand, a retailer whose stores are in geographic regions with extreme climate conditions may need to concentrate on refining its operating procedures to keep food at the right temperatures from supplier to store. Done right, such initiatives can reduce shrink by as much as 10 percent in the first 10 to 20 weeks and as much as 35 percent over the longer term. Some of the highest-impact initiatives retailers can undertake involve a revamp of ordering processes and reallocation of shelf space.

**Fact-based ordering**

Even at large retailers, fresh departments’ ordering processes tend to be somewhat ad hoc. In the words of one fruits-and-vegetables manager at a major European grocery chain, “The department manager basically orders products based on last week’s sales, without ever checking the current stock levels in the store.” Some fresh-department managers place orders for the next day based on a mix of gut feeling and prior experience. Others are a little more scientific: they use simple algorithms that take into account past sales and safety-stock requirements.

The most sophisticated ordering systems calculate the optimal size of a daily order by using an algorithm that incorporates seven elements: current stock, estimates of the current day’s and the next day’s sales (based in part on the day of the week and store promotions), estimates of the current day’s and the next day’s waste, the stock required for in-store presentation purposes (so that shelves don’t look empty), and a small security buffer in the event of an unforeseen sales spike. Retailers that rely on such an algorithm—and make sure to train their staff to use it—are able to simultaneously reduce shrink, increase availability, and have fresher products in their stores.

**Reallocation of shelf space**

Department managers tend to rely solely on their own judgment—not only in placing orders but also in allocating shelf space. Some managers stock large shelves full of a certain product just
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because they like how it looks, even though the store may sell only a fraction of the display each day. One retail store’s experience is unfortunately all too common: it displayed 12 boxes of green peppers and 4 boxes of eggplants, but two hours before closing time, 10 boxes of green peppers remained untouched while all the eggplant boxes were empty.

A European grocery chain redesigned its space-allocation processes to make them more demand-driven. Shelf space dedicated to slower-selling products was reduced and some fresh items were comeberished with dry items (for example, peelers and juicers next to oranges, or salt and pepper next to tomatoes). Store employees underwent training in shrink-reducing levers: for instance, they were taught that products that mature at different rates—such as carrots and peaches—should not be stocked on the same shelf. These changes helped bring about a 20 percent reduction in shrink levels.

Of course, high performance in fresh-food retailing will last only if it is measured and managed. A performance-management system that incorporates clear key performance indicators, frequent and robust performance dialogues, and reliable tracking tools is critical to sustained success. Instilling a performance culture—not only in the fresh department but across the entire organization—will take time, practice, and consistent attention from leadership, but the payoff will be a revitalized and profitable business in fresh food.

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