Recipe for success for sourcing in the food industry

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Transforming the way food companies specify, source, and manage the supply of raw materials can help them cut costs, meet changing consumer preferences, and manage risks.

Over the past decade, profits in the food industry have fallen in the face of significant headwinds. Increasing competition, especially from private-label players and discounters, as well as more value-conscious purchasing from consumers, are putting downward pressure on prices. And the race to keep up with new trends and changing dietary preferences is driving up demand volatility, portfolio complexity, and development costs. Raw-material prices, meanwhile, which account for 60 to 80 percent of direct material costs and 30 to 40 percent of total costs, have become 35 to 50 percent more volatile over the past decade. At the same time, currency fluctuations have compounded volatility among regions, affecting the global operations of major food companies.

In this challenging environment, food players are being forced to rethink the way they select, specify, source, and manage their ingredients. The best of them are doing this using a holistic approach that can reveal innovative ways to reduce total costs or unlock hidden value in the raw-material supply chain (exhibit). This approach has allowed food companies to save 2 to 6 percent on the cost of direct materials and 8 to 22 percent on the cost of conversion. That makes it one of the most effective levers that food companies have in their tool kit: for every 1 percent improvement in direct material cost, companies can improve their net margin by 200 to 300 basis points. Let’s look at a few high-impact examples.
Leading food companies are taking a holistic approach to the sourcing, specification and management of their ingredients.

**Questions**
- How do I drive right mix of global and regional suppliers?
- How can I use clean sheets or “should cost” models to drive down margins?
- Are there any opportunities in contract terms—eg, freight, payment terms, delivery time, quality?
- Are there opportunities for price design?

**Tools**
- Best-in-class requests for proposal (RFPs)
- Permanent RFPs
- Procure-to-pay (P2P) software (to avoid value leakage)
- Global sourcing models
- Clean-sheet-based negotiations

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**Questions**
- What is value added at each step of physical supply chain?
- What are key factors influencing my decision to make or buy? When does vertical integration make sense?
- How should I structure relationship with other players (eg, co-investment, tolling)?

**Tools**
- Value-chain analysis
- Make vs buy analysis

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**Questions**
- What buying strategy should company follow (eg, rules-based coverage, expertise-based coverage)?
- What is right level of risk exposure for these commodities?
- How can company manage and evaluate returns against nonmarket price risks such as credit, counterparty, quality, quantity?

**Tools**
- Value-at-risk (VAR) assessment and management
- Operations management for nonmarket risk

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**Questions**
- How can I optimize specifications to reduce total cost of ownership or approach price/quality trade-off?
- How transparent will changes in specifications be to consumers?
- How switchable are my ingredients?
- How can I build flexible formulas, avoiding packaging changes?
- How do I engage food quality/safety and build right business case?

**Tools**
- Design to value
- Specification optimization
Developing the supply base

In the past two years, commodity prices have fallen steeply. To benefit from these drops in a timely fashion, however, companies need the mechanisms to identify and size savings opportunities, as well as a flexible procurement process to capture them quickly.

An increasing number of food-industry players are making use of clean-sheet cost-modeling techniques. Clean-sheet techniques allow a buyer to build up a comprehensive picture of the cost drivers of existing and potential suppliers. That insight helps them build efficient requests for quotation (RFQs) and to determine the most effective negotiation and go-to-market strategies, optimizing factors such as the award term and the degree to which prices will be indexed to underlying commodity costs. The approach can also suggest opportunities for the unbundling of certain components from a supplier’s offering, if they can be delivered more efficiently elsewhere.

Companies also need a deep understanding of underlying commodity cost structures, including crop yields, farm production costs, and logistics costs. New analysis tools are helping here, allowing the evaluation of multiple potential sourcing scenarios—down to the level of individual farms—while enabling optimization on a global scale to drive efficient decision making.

One major multinational food company has implemented an inflation-tracking mechanism across all its major spend categories. This tool gives it direct feedback on how its sourcing efforts are performing against market movements and allows it to react faster to changes in underlying price trends.

Food players must also ensure that the short-term performance of their ingredient supply base isn’t coming at the expense of its long-term health. Leading companies take action to ensure the sustainability of future supply. One major coffee buyer worked with growers in Kenya, for example, to develop an alternative source of long-term supply and to create competitive pressure in its supplier base. Another company partnered with rice growers two seasons before it made its purchases to ensure they planted rice paddy and not another crop such as corn.

Finding and securing these sources of value requires food companies to change the way they conduct their procurement activities. That in turn requires new skills, tools, and processes. The best companies are now taking a systematic approach to developing these capabilities. They may do this by taking on staff from industries,
such as automotive and high tech, that pioneered the use of advanced sourcing techniques, and by developing skills in house. By starting their advanced sourcing efforts in the categories where they spend the most, leading companies have secured rapid savings, while simultaneously refining the processes and skills they can go on to apply across their product portfolios. In our experience, the use of these techniques will deliver average cost savings of 8 to 10 percent. Moreover, they also improved availability and customer value perception—which together typically yield a 5 to 12 percent sales impact across multiple product categories.

Managing risk
Underlying much best-in-class materials supply management in the food industry is a smarter approach to risk. Price volatility in many major food commodities has been significant in the recent past. Volatility in wheat, rice, corn, and cocoa prices rose by between 50 and 80 percent from 2008 to 2014, for example. Leading companies protect themselves from the impact of these fluctuations in three ways. First, they improve their forecasting abilities, by analyzing the links between prices and external factors (such as weather, currencies, the wider economy, and demand elsewhere) and by monitoring key influences closely. Second, they use these forecasts to inform their use of financial tools to hedge against future price fluctuations. Finally, they make changes to their products and supply chains to reduce the impact of volatility. This might include the use of flexible specifications to manage short-term fluctuations, for example, or vertical integration through the purchase of farmland to secure longer-term supply. One company secured privileged access to quality products by entering into joint ventures with certain dairy producers, for example.

Optimizing specifications
Design-to-value techniques help companies to understand exactly which features of their products matter most to consumers. For food players, careful assessments of consumer tastes and preferences can often create opportunities for significant savings through changes to specifications or the substitution of lower-cost ingredients. They can also increase product value and sales through value-added processes and ingredients. One major food company was able to replace eggs with a mixture of vegetarian ingredients that replicated a similar taste and flavor, for example. The new formulation had no effect on the color, texture, or taste of its product, but it did reduce overall costs and had the added advantage of making the product kosher. Similarly, companies have successfully exploited growing consumer interest in the potential health benefits of certain food types (for instance, natural
products and those free of genetically modified organisms, antibiotics, hormones, and artificial ingredients) to develop successful new product lines that drive growth in mature categories.

A flexible approach can also help companies reduce their exposure to commodity-price volatility. One cheese maker, for example, developed a flexible formulation strategy to build alternative recipes for each product. Adapting its systems to allow switching between recipes was a crucial part of this strategy; doing so meant the company could change the recipe in accordance with the relative price and availability of ingredients or in response to the preferences of different consumer groups. Such flexibility has also allowed companies to minimize downside from currency volatility, letting them adapt their supply chains quickly and efficiently to source from the best-cost country at any time.

**Understanding the value chain**

Rather than just accepting what ingredients do cost, leading food players invest time and effort to find out what they *should* cost. They do this by looking beyond their direct suppliers and building up their understanding of the role of different players across the whole value chain from field to factory, the true costs of the services each provides, and the options available.

When one company analyzed the value chain for its processed-nuts product, it found that a key group of intermediaries had a disproportionate effect on both price and availability. Rather than just buying from downstream producers, as it had before, the company started negotiating separately with the intermediaries to achieve both better prices and improved supply security.

In another case, a major bakery analyzed the value chain for gluten and starch produced from different sources (wheat and corn) and different regions (Europe and North America). Since starch and gluten are products of the same process, understanding the value of the starch to producers helped the company pick the best source of gluten in each market.

Understanding their suppliers’ underlying costs doesn’t just help food companies to negotiate lower prices—such knowledge also helps them to find collaborative ways to deliver value, for example, by changing product specifications or delivery requirements to reduce the overall cost of supply.
As they evaluate the best course of action and define their strategies, food manufacturers should consider a few questions:

- Does your organization truly understand the structure of its supply chains from farm to factory, as well as the underlying cost drivers?
- Are you doing all you can to capitalize on the current low-price environment in commodities?
- Are you ready to respond to steep or prolonged changes in supply-market dynamics, such as future rises in energy or commodity prices?

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The McKinsey Food Institute aims to help food manufacturers optimize the total value of their raw-materials-specification and production processes using proven, proprietary databases and tools. To find out more about our approach, contact Agustin_Gutierrez@McKinsey.com or Ludovic_Meilhac@McKinsey.com.