

# What's Driving Food Distribution -- Forces for Change

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This morning, we were given expert insights about the state of the food industry, both from the view of the manufacturer and the distributor/retailer. We heard about the challenges facing the industry, and how the participants intend to respond. We were also told about many of the important changes taking place in the food system and their implications for its members. This afternoon, I would like to add my perspective, from a vantage point outside the industry, but still very close to it. As a food retailing analyst for USDA, my perspective is somewhat different from those industry members. Our concerns stem from the need for informed public policy, which involves relevant economic information, research, and analyses. This afternoon, I would like to share with you some insights into the complexities of the food distribution and retailing industries. These insights take the form of three observations, and identification of the driving forces behind them.

The title of my presentation, "What's Driving Food Distribution -- Forces for Change," requires that I sort out cause and effect -- not so easy a task, but hopefully it will help others to better understand the important developments taking place today, and to better understand their implications for tomorrow.

Observation: Food Retailers and Distributors are aiming to reduce both internal and external costs through ECR and Other Means. Efforts to reduce internal (within-company) costs are a guiding principle throughout the industry. New technology, innovation, and better use of resources have produced a continuing stream of internal cost savings. But as the marginal returns to internal costs reduction efforts have diminished, and new sources of competition have emerged in recent years, the industry has looked to additional efficiency gains through external cost reductions.

External costs are those costs that result when food retailers and wholesalers interact with other participants in the marketing and distribution channels. These include upstream entities such as brokers and agents, manufacturers, and even commodity suppliers. Retailers must also interact with downstream entities, namely consumers.

Rising external costs and inefficiencies have prompted the food industry to make major changes to improve coordination among the various entities of the food system, through mutually agreeable methods that produce benefits for all involved. The term Efficient Consumer Response, or ECR, was coined a few years ago to capture the principles of reducing external transaction inefficiencies. One of the overriding principles of ECR is to end adversarial relationships between upstream and downstream entities and to work together to seek mutually beneficial means to reduce their respective transaction costs. Means to achieve this goal are being developed, tested, and adapted in the food industry. For example, better inventory management, such as continuous replenishment, cross-docking, and more uniform supplier pricing policies can discourage stockpiling by wholesalers and retailers. The manufacturer can achieve savings through long-term production planning and reduction of promotion costs. Retailers can benefit through reduced cost of goods, and through reduced inventory requirements. Procurement coordination and streamlining can lead to automated ordering, such as the use of Electronic Data Interchange (EDI), that reduces paperwork, ordering errors, and related transactions costs between entities.

Adoption of these new external efficiencies also has implications for retailers and consumers. As the importance of promotions and deal purchasing between suppliers and retailers is diminished, cost savings to suppliers could, in theory, be passed on to wholesalers and retailers. Retailers would have greater pricing flexibility resulting from lower cost of goods from suppliers that have

adopted ECR principles. The effect can benefit consumers in the form of consistently lower and uniform pricing practices. This approach has come to be known as Every Day Low Pricing, or "EDLP" to the trade.

**Driving Forces:** The forces driving retailers' efforts to reduce internal and external costs are many and varied. The recession of 1990-91 and the subsequent slow growth rates and low inflation levels since then have limited retailers' ability to raise prices in response to cost increases. This period of slow sales growth largely dispelled the myth that food is a recession-proof industry. The consumer's food dollar is one of the largest spending categories that is not a fixed expenditure in the short term, unlike mortgage and installment payments. Consumers apparently took control of their food spending to an unprecedented degree in the early 1990's, giving rise to growth of the non-traditional sources of retail grocery products. These outlets include the warehouse clubstores, and mass and discount mass merchandisers. The growth of non-traditional food retailers selling grocery products has engaged many food retailers in unexpected heightened competition, adding to pricing and cost reduction pressures.

At the same time, slow and below-normal industry real growth rates coupled with low inflation levels has heightened price competition between food retailers. As a result, cost reduction--in order to protect store profit margins--has become an added priority. Pricing is relied on to stimulate sales growth, where under more inflationary times, it had served to maintain store margins.

**Observation:** Non-traditional grocery retailers have grown considerably in recent years, providing an additional source of competition. The introduction of food and nonfood grocery products on a large scale by non-traditional retailers has had a major competitive impact on food retailers, most industry members would agree. The non-traditional retailers are meeting the needs consumer segments that were either not identified or thought to be marginal in importance by traditional food retailers.

Warehouse club stores primarily serve consumers who buy in bulk or large quantities in order to achieve greater savings. These retailers gave consumers an added image of exclusiveness

by calling their outlets a "Club" and charging a membership fee.

Although warehouse supermarkets offered a similar no-frills orientation, the club stores had also identified small business needs for bulk and larger package sizes on a cash and carry basis. The club stores also offered products that had not been previously made available to the public. Although consolidation has reduced the number of clubstore retailers, growth rates are still very good, according to forecasts by William Degen. In response, many supermarket operators have added bulk and institutional package sizes to their offerings. But warehouse clubs still surpass in the variety of non-food categories, especially general merchandise and consumer durables.

Mass merchandisers and discounters such as Wal-Mart, Kmart, and Target, have extended their product lines to include an increasing array of food and non-food grocery products in a new supercenter format, which includes a largely self-contained supermarket within the larger store.

Depending on the format, the percent of sales in direct competition with traditional food retailers can be as much as 30 percent. Mass merchandisers and discounters bring their knowledge of procurement efficiencies, coupled with buying power as a result of large sales volume to the retail grocery products marketplace.

**Driving Forces:** But what are the driving forces behind this development? The motivation differs somewhat, depending upon the type of non-traditional retailer. Both mass merchandisers and warehouse club stores are pursuing locational and product mix strategies in a quest for greater sales volume. Mass merchandisers have developed their supercenter format in low cost, low-density, rural areas where large-scale competitors were previously nonexistent. They also required a very large trading area, which depended upon a super-low price image coupled with unprecedented product variety. These factors generated high growth rates in recent years, giving grocery retailers much consternation. The traditional food retailing industry's concern is evident when we look at the sales of grocery products by warehouse club stores' and mass merchandisers' sales of grocery-related products, courtesy of James Degen & Company consultants (Figure 1). Together, these two formats registered \$29.3 billion

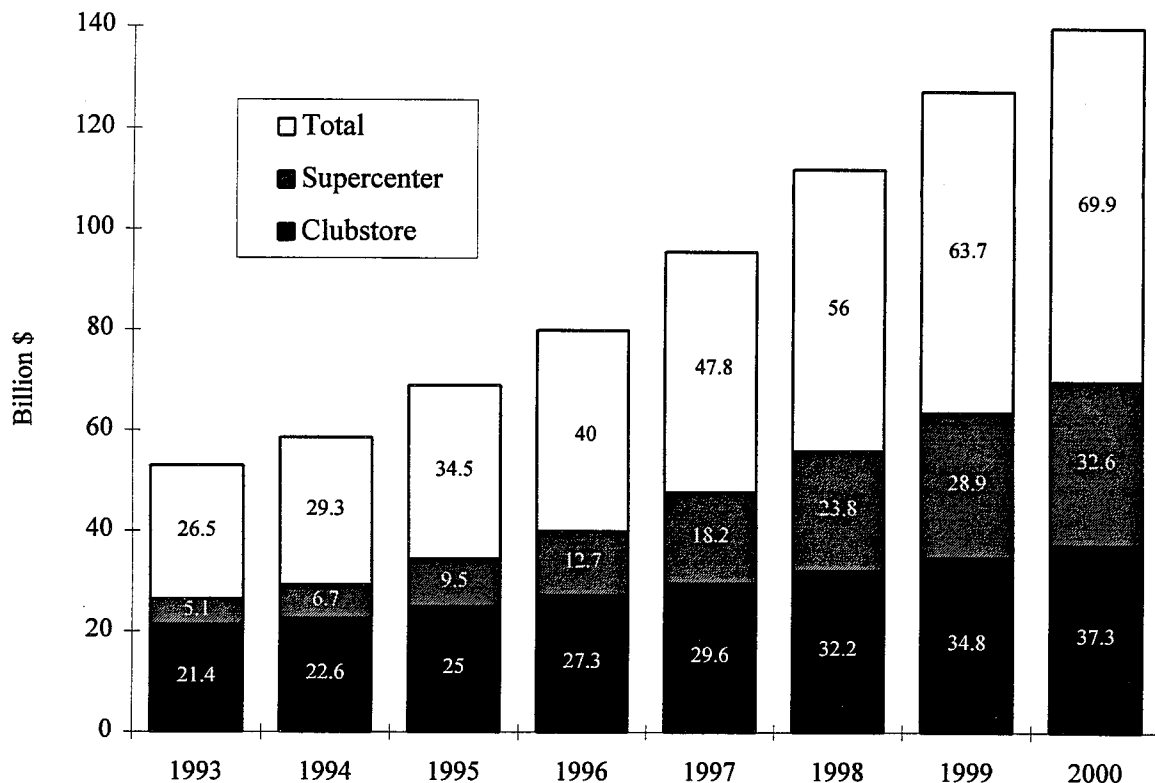
in sales in 1994, up from \$26.5 billion in 1993. As we can see from Figure 1, Club stores currently account for a major share of non-traditional grocery sales. But as the number of mass merchandiser supercenters are opened, their growth will take precedence. Supercenter formats, such as those currently operated by Wal-Mart, Kmart, and Target, will see sales jump from an estimated of \$6.7 billion in 1994 to \$32.6 billion in 2000. The combined grocery products sales of these non-traditional retailers is forecasted to reach almost \$70 billion in 2000--amounting to about 14 percent of total grocery products sales. (Note: Foodstore sales projection to \$441 billion in 2000, with total grocery products sales of \$511 billion.)

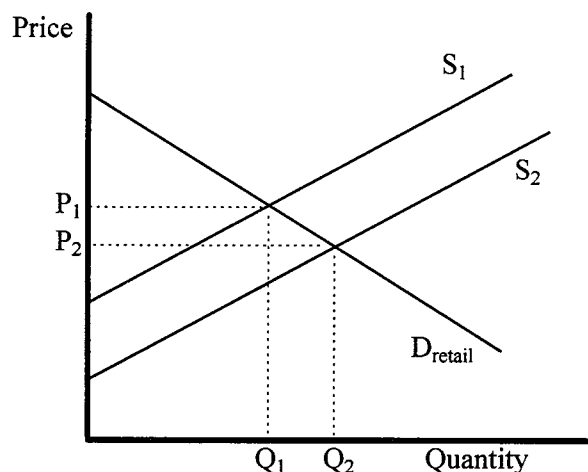
However, the likelihood of sustained growth rates at these high levels can be called into question, as rural locations become saturated, requir-

ing mass merchandisers and discounters to enter metropolitan area markets. There they will find established traditional grocery retailers already in abundance, occupying the most desirable locations, and protective of their market shares.

One of the likely outcomes of these developments is illustrated in Figure 2. We see grocery products supply and demand curves represented in a typical functional form. With the growth of non-traditional retailers selling grocery products, the industry supply curve has shifted outward, from S1 to S2. But consumer demand for retail grocery products remains largely unchanged. The result is a new equilibrium, in which total quantity has increased from Q1 to Q2. But average price has fallen, from P1 to P2. The Wal-Mart slogan "watch out for falling prices" seems highly relevant for the entire industry as well.

**Figure 1. Grocery Products Sales by Non-traditional Retailers.**



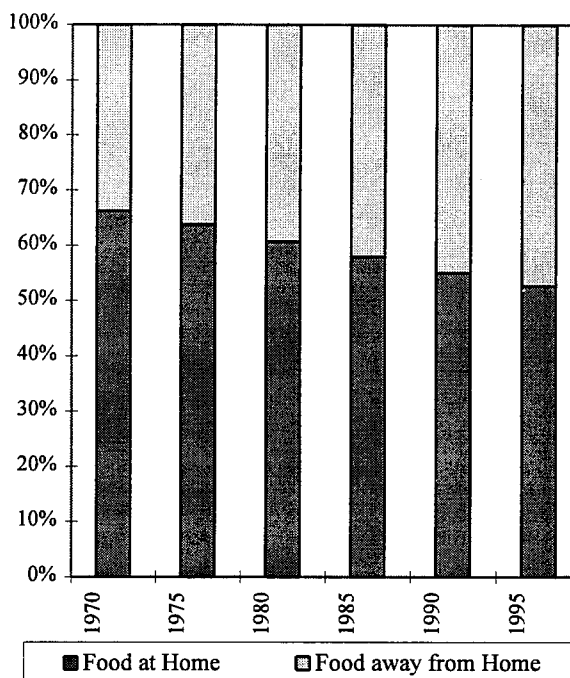
**Figure 2. "Watch Out for Falling Prices."**

Observation: A growing proportion of the consumers' food dollar is devoted to the foodservice industry. The long-term trend in the allocation of the consumers' food dollar has favored the food-away-from-home sector, which consists of commercial eating and drinking places, and institutional food service, such as food served in employee cafeterias, hospitals, and schools. Meanwhile, food-at-home spending in retail outlets such as foodstores and other retail outlets selling packaged food have not enjoyed comparable growth rates. In Figure 3, we see total per capita food spending divided between the two principal sectors. In 1970, consumers devoted on average about 66.0 percent of their food dollar to food-at-home purchases, mostly in foodstores. The remaining 34.0 percent was spent for meals and snacks, primarily food service outlets. By 1995, the share of the consumer's food dollar spent in foodstores and other retail outlets had fallen to less than 53.0 percent of the total.

This phenomenon is fairly well understood in the food industry. However, the causes and consequences of this long-term trend may not be fully appreciated.

**Driving Forces:** Although natural population growth has provided sales growth for both the food-at-home and food-away-from-home sectors, consumers have exhibited a strong preference for convenience both in food preparation and consumption. Traditional gender roles, especially among women, have been displaced by their

greater workforce participation. Time resources for food preparation have become limited. Dual-income households are more likely to depend on food preparation outside the home. Rising household incomes have accompanied the expansion of the foodservice industry, and analysis has shown that growth in personal disposable income is highly correlated with growth in food-away-from-home spending.

**Figure 3. Share of Food Expenditures.**

The foodservice industry has responded to the resulting preference for greater convenience in food preparation in a variety of formats, ranging from full service restaurants, to fast-food carryout outlets. Food retailers must realize that the preference for convenience in food preparation is here to stay. Although many food retailers view their business as serving primarily food-at-home consumption, greater convenience through value-added products, such as prepared foods, has been well received by consumers. Although a number of food retailers offer prepared foods that rival those of a high quality food service operator, the industry broadly speaking, does not measure up to the variety and quality found in the food

service industry. Retailers have yet to offer complete prepared meals, although many in the industry view this as the next challenge.

Another food retailer innovation that offers time-saving benefits is home shopping and delivery services. Combined with ease of preparation,

retailers can offer greater convenience at lower costs compared with food service operators. By responding to these driving forces for change, food retailers can begin to make gains in their quest for the consumer's food dollar.