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What is the Impact of Manufacturer Consolidation on the Grocer Sector?

A Special Report

Kevin Grier, Senior Market Analyst

The wave of massive mergers and acquisitions in the food manufacturing industry, including the Unilever purchase of Bestfoods and the Phillip Morris purchase of Nabisco were driven by a variety of reasons. Slow growth, the need to generate greater earnings, economies of scale are just a few. Ironically another reason for the mergers in the manufacturing sector is the wave of mergers that took place in the grocery sector over the last two years. Manufacturers needed to get bigger in order to deal with larger buyers.

Manufacturer consolidation in the food industry is going to serve up a multitude of new challenges to Canadian grocery retailers. It will be prudent for Canadian food manufacturers to be aware of these challenges. By being aware of the grocer's challenges and concerns, a manufacturer can both help to solve these issues or alternatively, can take advantage of the situation.

None of those challenges is more important than the effect of being shuffled into a manufacturer's global deck of customers. The shuffling of the deck will determine the outcome of each Canadian retailer's position for prioritizing of issues and opportunities. Manufacturing consolidation will increase the size of market that a retailer competes in to get an expected level of service from manufacturers.

The newly consolidated manufacturers will be taking a close look at their regional policies and business practices. It is likely that current regional policies and practices will be globalized by the manufacturers as they look to maximize the synergies of their purchases. Retailers for years have tried to sway the marketing efforts of the likes of the tobacco companies, as well as Proctor & Gamble and Nabisco. From their perspective they see little result for their efforts. Retail grocers are already expecting that the situation will now be more difficult given the much larger size of these new global manufacturers.

Despite those expectations, manufacturer business plans are not going to be set up to intentionally lose out on micro-economic opportunities. Nevertheless, as with every budget or plan there is rounding off. That may be the first threat to satisfying the needs of the Canadian grocer and the ultimate decision maker, the consumer. Smart retailers will be looking to meet early and often with these consolidated manufacturers to be close to any changes. These grocers will be seeking to have the opportunity for input to preserve regional disparities that are small yet important.

Category management will be further threatened by this trend towards manufacturer consolidation. That is because meaningful category management requires an action plan that is general enough at the top level and yet workable in all markets. To some degree many models are information overloaded or not designed to be managed at store level for interpretation and execution.

Canadian grocers are not yet able to provide excellent mass execution of a general strategy like Walmart. Thus with larger global manufacturers at the other end of the table, category management could become even more disjointed between the strategy and the execution.

Another huge issue is going to be control label or retail brand product. Most large national brand manufacturers never really went after this business. Furthermore, what little control label that they did have was typically by default rather than due to aggressive pursuit of the manufacturing opportunity. The fact that manufacturers are now even larger should make them less willing to pursue this business.

It can also be argued that these consolidated manufacturers will see their new power as an opportunity to slow control label sales. It is well known that as a result of the growth of control label, retailers and manufactures have become silent competitors. They compete with each other through national brands versus private label while still trying to partner-up around procurement issues. These relationships have evolved into secret agendas for both parties. This in turn is likely the primary reason for the slow progress of meaningful advancements with ECR initiatives. Thus, it should not be surprising that these consolidated manufacturers will not operate with the best intentions of continued retailer brand growth.

Choking Out Private Label

Private label strength in the market and its product quality is typically compared to the national (now global) brand. Profitability of private label versus the national brand is a specific measure. It is this point of measure that will become clouded for both manufacturers and retailers. This will result from the fact that manufacturer marketing managers will now manage much larger portfolios of products. As a consequence, the economic models of manufacturing profit can be altered to the point where key national brands may never be knocked off (ie. duplicated in form of a private label product) to the same extent as in the past.

With the consolidation of manufacturers, the product portfolios for the marketing departments has increased significantly. More brands and skus are contributing to their bottom line. In the past, some manufacturers in key categories adjusted the economic requirements on selected brands to slow the growth of the competitive retailer private label brand. This practice was limited by just how much pain the manufacturer's profit line could take and by what additional profit the other skus and brands could contribute. Leading grocers assert that P&G, Nabisco, Kraft, and Coke have relied heavily on this mixing ability.

The premise now with consolidation, is that with a larger portfolio of products and with fewer competitors, and the need to show early positives in these new organizations, key brands and skus will be and can be, protected like never before. In other words, now more than ever, the grocer has to consider the bigger manufacturer's ability to fund a profit from a portfolio of hundreds of other brands.

Lets examine this concept further. As noted, the strength of a retailer brand is how it performs when compared to the key-off national brand. It is also measured against how it performs in the category. One point of measure is profitability as defined by the average retail price less the average dead net procurement cost of the item. The retail price assigned to the retailer brand is determined by the retail price on the key-off national brand. In most cases, the retailer brand is much lower than the key brand. The ability to generate the needed category profit is then a procurement cost differential. That is, the retailer brand has to be at least that much lower in cost as related to the national brand to

generate the same net cents profit as the national brand. Of course, the same profit should be a minimal expectation of the retailer brand.

So if profit is a point of measure, then one strategy by a manufacturer is to take that away from the retailer private label brand. This can be accomplished a few ways. One less likely and perhaps too public (but it has been done before) is to fund a price war on the key national brand between retail/grocer competitors. The result can be severely depressed retails on the control label item reducing its ability to generate tonnage and/or profit.

Another approach as noted above is to utilize the expanded balance of the manufacturer's portfolio of products to fund cost declines on the key national brand. That will result in squeezing the control label point of difference. One primary reason for a retailer brand is that the brand generates a greater profit opportunity than found with national brands. If this is taken away then there will be a reduction in the core control label listing bases. Manufacturer marketing managers will find it hard to resist this tactic.

Consolidated manufacturers could also have an impact on the availability of technology and the cost of product development. As consolidated entities, these manufacturers will have an increased ability to now affect competitive costing and sourcing of retail brands. This could choke out many core retail brands.

How is all of this possible? One way to economically challenge the control label brand is at its sourcing. Much like a retail buying group which can procure a product at a lower cost because of the size of the purchase order, these larger manufactures can dominate the availability of low cost raw materials to the extent the smaller manufacture cannot. This has happened in the past with many raw materials so it will not be a new trend. Nevertheless, in this regard, consolidation provides a much larger opportunity to negatively affect the core economics of control label.

There is also product formulae and raw materials that can be better managed by the larger international manufacturing groups. These can be effectively out of reach by retailers. The result could be inferior retail brands that do not meet consumer expectations.

The same would hold true for product innovations. In the past a retailer could partner up with a number two or three brand and put a strategy together to take on the number one brand as they shared common goals. Sometimes this partnership may have involved the actual manufacturing of the retailer's private label brand. This in turn would aid the economics of the partnered manufacturers's brand. Now these much larger consolidated manufacturers will be able to limit the availability of that opportunity. They may also make any such opportunity much more costly for the retailer and partnered national brand manufacturer. Furthermore and quite simply, with fewer manufacturers, grocery procurement staff will be less able to generate a need with one of them to build the retail brand (and often the manufacturer's own brand) as they try to partner up against more dominant national brands.

For example, the ability now of Kraft to mix back a profit or manage a product cost has been greatly increased by its new product portfolio if nothing else. So grocers are going to be asking themselves: Just who do I partner up with in the cheese category that will result in a meaningful impact against Kraft with cheese?

Streamlining Operations

The cloud attached to the point of measure then becomes one of finding the truth: the true costs, ingredients and margins for comparison to the key national brand.

For those retailers that are less concerned about regional listing bases and satisfying every consumer, these consolidations will benefit them through further sku rationalization. With sku rationalization comes efficiencies that both retailer and manufacturer will be naturally attracted to.

The rationalization of variety versus duplication will take place, and is taking place now, in all manufacturing companies. P&G, Campbell, Heinz, Nabisco, and Kraft, to mention a few, have been actively globalizing their brands and formulations. As these organizations purchase others, the trend will continue. In fact, the trend is partially being fuelled by large retailers asking for the same as they too search for the synergies of fewer skus.

With consolidation of these groups and growing access to new more global markets, manufacturers will challenge themselves to create single skus that work over large markets, if not globally. The new economics of this may force regional de-listings. At first the duplications, due to size, flavour and performance, will be challenged by some retailers. At present full service retailers in Canada feel obligated to carry all these duplications and varieties due to consumer pressure. When the manufacturers rationalize, the more global listing base and new economics of manufacturing will mean that the likelihood of maintaining wide distribution of these peripheral skus is not high.

As a caveat, it should be noted that while consolidation is very visible and closely watched by governments, consumers and purchasing agents around the world, it may not be the dominant threat to the business as usual model. The new formation of manufacturing strategic alliances or B2B partnerships will likely have a more profound affect on present day procurement practices in retail not to mention the actual cost of goods that are offered.

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