5. Grocery retail

Determinants of prices in the retail sector

GROCERY RETAIL – OVERVIEW

Background

This section of the report provides an overview and analysis of the determinants of food pricing in the grocery retail sector.

Grocery food retailing takes place in a number of retail formats with a small number of publicly listed supermarket chains, wholesaler controlled chains and international operators entering the Australian market. These compete with over 30,000 specialty food businesses ranging from single shopfronts to multiple franchise operators.

The Australian grocery retail market is characterised by a relatively small market, large distances and low growth in population. This requires economies of scale for national retailers to deliver food and other grocery items to consumers across that market in a consistent manner.

Major retailers compete with other investment options for access to investor capital. They strive to achieve critical mass of infrastructure, business and profit growth while delivering suitable returns on investment to their shareholders in a small consumer market. The retail sector is among the least profitable sectors.

The increasing concentration is not only an issue in the retail sector as several branded food categories are dominated by a limited number of largely internationally controlled brands and manufacturers. Australia cannot hope to stay immune from these pressures. They have been a major result of the changes in food retailing internationally, as retailers seek to achieve better economies of scale and asset utilisation in order to provide consumers with a better service offering.

It is important to consider that price is not the only means by which retail outlets compete. Consumers consider a range of factors when purchasing food and grocery products. These include price, store location, product range and quality, queuing time, opening hours and access to car parking. For stores such as supermarkets, price plays an important part in this mix.

However, smaller stores often compete on the basis of convenience, with many consumers prepared to pay higher prices for hassle-free shopping. This creates a nexus between price and convenience that underpins competition across competing retail outlets despite price differentials. Consumers increasingly have the opportunity to weigh a range of price and convenience factors when deciding the type of food products they purchase and the retail outlet from which those products are bought.

Concentration of retail

In the preceding section of the report there were several instances noted where major chain retailers have been increasing their market share in the retail food sector over recent years.

Australia has a concentrated grocery retail sector but not relative to countries, like the Netherlands, or regions, like California or Florida in the United States, with similar populations.

In measuring shares of the retail food market, the major retailers contend that the definition of the 'food market' is much wider than grocery retail and that the major chains hold less than 50 per cent of the food-liquor-groceries market. Industry analysts vary in their recognition of the relevant dimensions of the market and some see it differently, preferring a definition based on the mode and format of grocery retail as distinct from other forms of food sale. Concentration is horizontal as well as vertical, with greater integration leading to cost savings in logistics and inventory investment.

Our purpose in preparing this section of the document was not to enter or inflame the debate about which is the correct way to describe and quantify the market share of major grocery retailers. We wish however to make note of the significant trends over time towards major retailers taking a greater share of the grocery food retail market, as is relevant to this study.

Grocery retail – developments

There are a number of key developments in the food retail sector which are important in any analysis of the role that food retailers play in determining prices.

Customer intimacy

Successful retailers focus on the importance of intimacy with the customer – the customer is the greatest asset that a retailer has, not the store itself. Investments in display, storage and technology are made with a strong sense of purpose to enhance the durability of the connection with the customer.

Beyond the consistent me-too approach that characterises the behaviour of the Australian majors, the micro-strategies adopted by different groups towards greater customer intimacy are diverse and complex, built around core themes that promote care for food safety, freshness, variety and price consciousness. Loyalty programs have aimed at achieving repeat visitation.

Category management

Retailers focus on category management strategies in order to generate shopper enthusiasm for a product category. In this way, the retailer can mine the overall retail sales value potential of the product line by effective use of shelf space, promotional support and price competition where necessary.

Leverage

Recent innovations in Australian retail have followed trends in the European Union and the United States where retailers have sought to expand their retail offer into areas such as liquor, fuel, newsagency, pharmacy and other segments previously the domain of specialty businesses. This has altered the effective wholesale market shares in the grocery food market in certain areas and changed the dynamics for suppliers to certain food sectors.

The fuel strategy has the added purpose of enhancing the customer loyalty to each retailer – whilst points of difference remain with different retail offerings.

Points of difference

Retailers compete on many planes for the loyalty of the consumer. Whilst 'sales', 'specials' and 'lowest prices across the store' are common marketing tools used by all retailers, each also strives for a non-price point of difference based on a combination of service, quality goods, convenience, range and so on. The consumer ultimately makes the shopping decision on these variables. Major chain retailers offer the convenience of a one-stop shop for all food and grocery lines and hence their consumer appeal. Food retailers each seek to offer a fresh product image – illustrated by Woolworths being the 'Fresh Food People'.

For new international entrants such as Aldi, their point of difference is being a low cost, limited range retail outlet characterised by a cheaper supply chain and low store-operating costs.

Convenience retailers offer local convenience in shopping for emergency lines or smaller volume shopping needs without the fuss of a major shopping mission – though there is aggressive competition from the majors in this area backed with faster checkouts and front of store access to newsagency lines.

Supply chain management

Over the years, the major chain retailers have adopted different strategies as to how to manage logistics through their businesses from point of delivery to back of store.

Both major retailers in the Australian industry have announced efforts to take control of the logistics costs from the supplier's factory gate into the back of the retail store, through respective central warehousing systems. These innovations are planned to take significant costs out of the value chain – mostly the costs incurred by suppliers and their distributors in the delivery of orders direct to store and in the cartage from supermarket warehouse to store. Major retailers have indicated that they will seek a sharing of cost savings with suppliers.

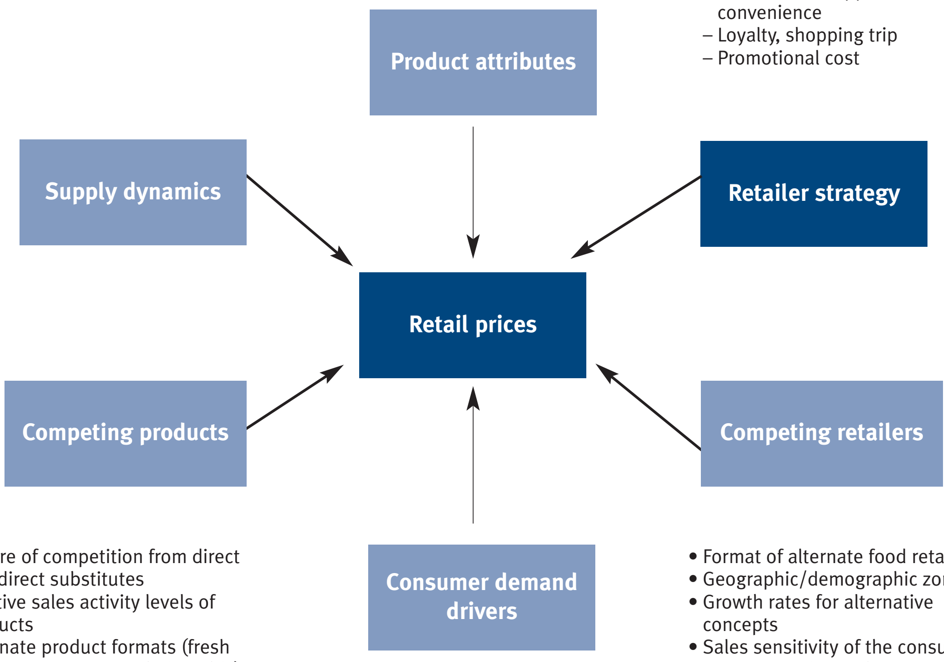
Figure 123. **Grocery retail – what determines prices?**

There is a set of factors that determine prices of food in the grocery retail sector, at retail and wholesale points. These concepts are discussed in the following pages.

- Industry structure – concentrated versus fragmented
- Seasonality of availability
- Supply chain efficiency
- Information volatility and quality
- Transparency of cost structures
- Rate of supply industry adjustment
- Supplier support

- Pack sizes and features
- Perishability and shelf life
- Seasonality of product availability

- Business factors
  - Overall return on investment and EBIT contribution
  - Place in price/quality perception
  - Product range/sales margin mix needs
  - Store format
- Category factors
  - Destination, support or convenience
  - Loyalty, shopping trip
  - Promotional cost



- Nature of competition from direct or indirect substitutes
- Relative sales activity levels of products
- Alternate product formats (fresh versus frozen versus shelf-stable)

- Format of alternate food retailing
- Geographic/demographic zones
- Growth rates for alternative concepts
- Sales sensitivity of the consumer to price, quality and image

- Effectiveness of advertising and promotion
  - Extent of brand loyalty and brand attributes
- Consumer product awareness
- Consumption trends (how people are eating)
- Shopping trends and characteristics (frequency and convenience)

GROCERY RETAIL – WHAT DETERMINES PRICES

Retailer strategy

Target margins

A key driver of prices that are set at wholesale and retail are the target returns sought by the retailer in order to cover the costs of doing business. For major retailers in the Australian market, business margins (or EBIT over sales) are 3–4 per cent after coverage of the costs of doing business, which is estimated by majors in Australia at 23 per cent.

Target product margins are therefore in the order of an average of 26-27 per cent across the retail product range but tend to be higher for fresh produce. This is because of high spoilage rates and stringent regulations on the sale of fresh produce as well as what is referred to in the trade as shrinkage (waste), which can be as high as 10 per cent for some fresh produce.

Figure 124. **Target returns**

EBIT target → Category target → Product target

The role that the individual category plays in meeting that overall target will vary from time to time given the conditions affecting the consumer demand in that category and supply conditions. Within the category itself, products will also play different roles from time to time in contributing to returns.

The level of that margin will be influenced by:

- competitive constraints in the market;
- the overall contribution (in absolute dollar terms) made by a product;
- the volume of sales turnover;
- the use of shelf space in making the sale – which includes the rate of turnover;
- the costs involved in managing the category in the retail store (for example, fresh food is labour intensive and involves significant additional capital costs such as refrigeration);
- the state of the supply industry; and
- consumer sensitivity to the retail price and value proposition.

Individual product target margins vary from time to time and will vary between fresh products, proprietary branded lines and private label lines.

The role of the category

In keeping with category management strategies, certain product categories and key product lines will play important roles in the overall business of the store. They are:

- destination products – a must buy product that, due to its essential or staple nature, draws customers to shop at a store;
- support products – carried to support a category or to provide a complete range within a category or within the wider store, provided they justify their shelf space; and
- convenience products – typically less frequent purchases ranged to support the one-stop location.

As noted at left, the target contribution, treatment in price positioning, product location and promotion will differ in each case.

Terms

Trade terms are an important part of the return equation for a major retailer. The level of trade terms makes a significant contribution to the net earnings of a major retailer. Again, this is a practice that is not unique to this market. The business of grocery retail is effectively financed using suppliers to provide the substantial working capital needs of the major retail business.

Over time the cost of terms (in terms of the rate per dollar) has increased across food categories, as retailers have sought greater funding and promotional support to drive increased volumes through their expanding businesses. For example, suppliers devote marketing funds to point-of-sale activities. The ability of retailers through their performance to earn a greater share of the manufacturers' available terms is crucial to being competitive with their market offer.

Use of the private label

The private label is now a major tool in the category management strategy of all major retailers, including the major groups in the Australian industry. The private label is used primarily to provide a price-competitive weapon that is essentially used in key commodity lines. There are however some different uses in the positioning of the private label between the major chains.

The private label is there to provide the customer with an option and to provide preferred suppliers with volume sales outlets. It is used by many small suppliers to gain a national market for their products and improve scale production capability and reduce overhead costs. The private label is used selectively to add to a category performance for the retailer.

The approach will vary according to:

- perceived consumer loyalty to major supplier proprietary brands;
- categories where strong potential exists to capture market share for the retailer (such as, eggs, packaged milk) as they are commodity products with low consumer involvement or excitement; and
- scope to assist with cost reduction in some products where adjustment is occurring.

Private label products are exclusive to each retailer and provide a chance to build loyalty and trust.

The pricing strategy used for private label products varies from category to category, though these products are generally priced below proprietary branded equivalent items which in many cases are of little or no difference in product quality. The role of private label lines in category management is a case by case situation and sweeping assertions regarding the tactics used with such lines run the risk of being oversimplistic.

Specials versus every day low prices

Retailers use price as the major competitive weapon. It has conventionally been used to drive market share maintenance and growth in a category through periodic discounting or 'specialling' which is funded through price support by the supplier and retailer according to a promotional program.

Major retailers have recently moved to a strategy of consistent lower prices on key lines – each retailer promoting the concept to the consumer as a different theme but essentially the concepts are the same.

Woolworths promotes 'every day low prices' while Coles refers to 'save everyday' on the same principles. Under these approaches prices have been 'rolled back' to provide lower retail prices whilst maintaining a target margin to the retailer in line with plan. Whilst this has reduced prices available to the supplier and their cost of doing business (which the supplier offers to the retail buyer), it also provides reliable sales volumes of commodity lines.

The role of food service

In 2001, the food service sector represented 31 per cent of food sales in the Australian market. It is projected to slowly grow to 35 per cent by the end of the decade (BIS Shrapnel 2002). Data further suggests that food service is growing at a faster rate than total grocery food sales with the expansion of the quick service restaurant format, the growth in the hospitality sector and the development of large integrated food service distributors to specifically service the needs of food outlets. Total food service grew by 31 per cent in the five years to 2001 (BIS Shrapnel 2002).

The consumer trend towards eating out of the home places pressure on major food retailers in achieving growth in food sales from their retail formats and will continue to cause their category managers to seek products which increase the convenience appeal to customers.

The five external factors that determine prices *(refer figure 123)*

Supply dynamics

The nature of product supply will have a major impact on pricing over time. As noted, pricing will be influenced by the seasonality of availability in fresh product lines, though major retailers attempt to smooth costs by sourcing from suppliers capable of delivering year-round supply. This approach extends to products which are affected by international trade – suppliers holding large quantities of commodity lines in times of export downturn may offer lower prices to move volumes through retail as part of a promotional program (such is the case with block cheese).

Retail buyers will have greater ability to influence buying prices in fragmented industries than in those that are concentrated. In fragmented sectors, commodity conditions prevail.

The nature and quality of information will have a bearing on pricing. Where there is room to move, transparency on the true costs of products will have a bearing on the contribution that is sought towards category targets.

Product attributes

The nature of the product itself will dictate the costs of handling and the requirements of display and in-store servicing. Higher product margins will be sought on higher cost lines such as fresh fruit and vegetables, where shrinkage, labour and capital costs require greater gross margins to cover these investments.

The effect of competing products

Competition for individual products may come inside the store from directly competing lines (for example, meat lines within red meats or between chicken and red meat cuts, or to shift buying patterns to private label from proprietary brands), from different formats (frozen versus fresh vegetables, semi-prepared packaging versus conventional basic product) or from product substitutes (pasta versus rice versus other sources of carbohydrates).

The retailer will take account of the contribution of each product to the category and store targets when setting prices.

The existence of competing retailers and different formats

Major chain retailers compete with a myriad of independent chains and specialty food retailers in buying and selling. Supermarkets use their one-stop shopping, convenience and low prices to attract the consumer at all points and negotiate the best buying prices from suppliers.

Work presented to the Senate by the Australian Competition and Consumer Commission regarding prices paid to suppliers by retailers showed that there were two levels of terms accessible by retailers and wholesalers. The commission noted that whilst the major chains did achieve better deals more often than the independent wholesalers, they did not always receive higher terms from the same suppliers. This indicates the market at work with suppliers varying their deals where they achieved best performance for the terms paid, whether the buyers were independent wholesalers or major chain retailers.

At a category level, retail products are increasingly competing with the growth in food service demand.

Consumer demand factors

All retailers are acutely aware that the consumer is very fickle in their shopping decisions and choices as to where to shop. Out-of-step pricing, poor quality of offer or service and empty shelf space each influence the choice of shopping destination.

Over time, the consumer preference for convenience and the frequency and purpose of shopping trips are changing. The shift towards a greater demand for products that reduce cooking times and simplify preparation from scratch has seen substantial product innovation and altered price sensitivity compared to the base product. This provides retailer and supplier with opportunities to improve the spread of returns (although how each shares in the make up of returns may differ greatly).

GROCERY RETAIL – RETAILER PRACTICES

The table below provides examples of how the determinants of retail prices vary, based on the factors outlined above. Retailer strategy (one of the six factors identified in figure 123) is a constant factor in each case.

	External factors					
	Supply	Product features	Competing products	Consumer demand	Competing retailers	Comment on key determinants
Packaged milk, 2 litre	★★★	★★		★★★	★★★	Milk is a destination product, located at the rear of stores for logistics access.
Block cheese	★★★	★		★★★		Cheese demand is maintained by a policy of regular discounting.
Beef steak	★★★	★★★	★★★★	★★★	★★★	Pricing of competing meat products.
Pork cuts	★★	★★★	★★★★	★★★	★★	
Fresh oranges	★★★★	★★	★★★	★★	★★★	
Frozen potatoes			★★★	★★		
Orange juice	★★★		★★★	★★		
Cage eggs, 700g	★★★★	★★★		★★	★★★★	The dynamics of egg production and supply, and the activities of competing retailers.
Packet rice	★★★		★★	★★		
Packet sugar	★★			★★★		A staple product which sees declining consumption.

(number of stars represents strength of influence)

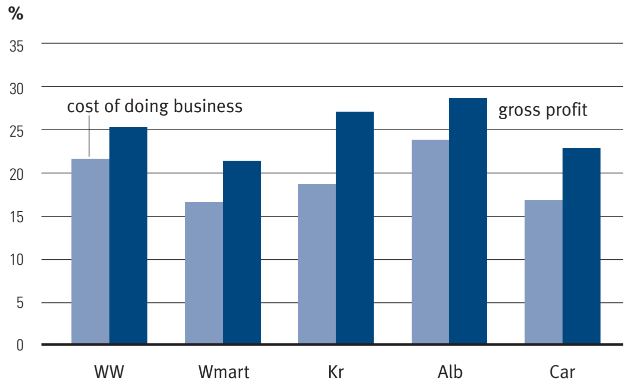
GROCERY RETAIL – PERFORMANCE OF GROCERY RETAILERS

Making comparisons

We have compared the performance of Australian major retailers to major public listed international groups, using a number of retail and financial key performance indicators.

Figure 125. **Costs of doing business and gross profit, three years, % of sales**

Our chains operate with higher costs and target margins than other majors due to the nature of this retail market.



Abbreviations

WW	Woolworths
Wmart	Wal-Mart – a United States supermarket chain
Wmart Int	Wal-Mart operations outside the United States
Kr	Kroger – a United States supermarket chain
Alb	Albertsons – a United States supermarket chain
Car	Carrefour – a French hypermarket and supermarket chain
CML	Coles Myer

Figure 126. **Days in stock**

Coles do not report their investment in stocks but Woolworths is performing better than other majors in this indicator.

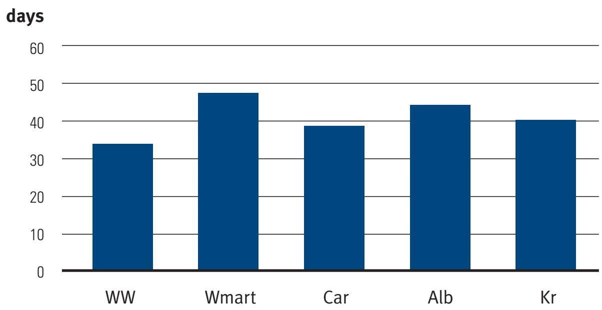
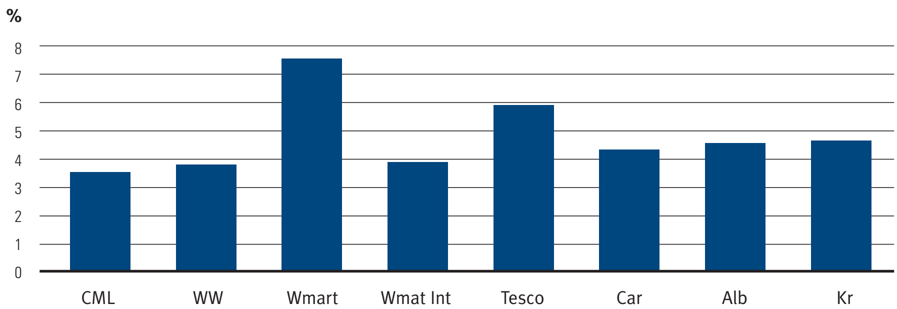


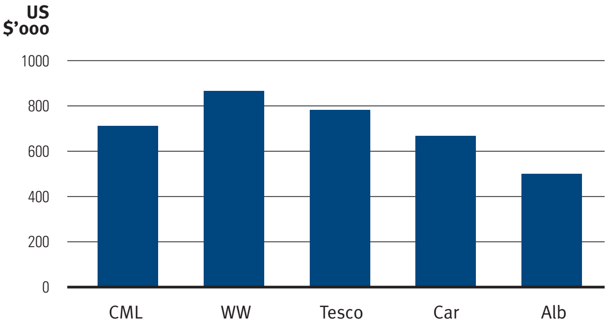
Figure 127. **Earnings before interest and tax, last three years, % of sales**

Australian retailers operate on lower overall margins than most major European Union and United States retailers.



Australian retailers are operating competitively in terms of the productivity of floor space despite the lower population concentration. These numbers vary however due to relative currency values.

Figure 128. **Sales per annum per square foot, US$'000**



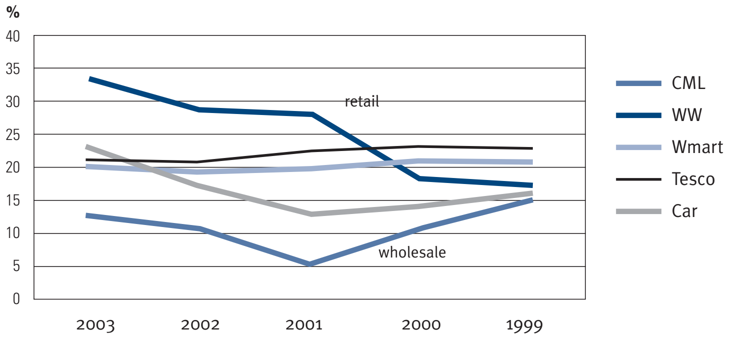
Sources: Whitehall Associates' analysis of financial statements

Financial performance of listed companies

The financial performance of retailers as major listed companies varies due to a number of factors:

- the geographic mix of business;
- the portfolio of retail operations included in the group;
- the strategy and philosophy regarding use of capital in the group – whether property ownership is a critical business requirement; and
- the importance of goals regarding shareholder wealth.

Figure 129. **Return on equity employed, %**



Source: Whitehall Associates' analysis of financial statements