The new reality for grocery suppliers in Australia

As private labels flourish, competition for shelf space increases and pricing options dwindle, local and multinational suppliers need to adjust their strategies by following seven important rules

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In a country with one of the world's most concentrated grocery landscapes—with Coles and Woolworths accounting for almost two-thirds of grocery retail sales—fast-moving consumer goods (FMCG) suppliers have long felt they were highly dependent upon the two major retailers that sell their goods. But for many suppliers, these challenges have increased dramatically in the past two years, to the point where management teams must fundamentally reshape strategy for a new reality in the grocery channel. Today's world is characterised by lower prices, growth in private label and increasing sophistication on the part of retailers in allocating shelf space.

These changes have taken their toll on local and multinational suppliers. In response, the Australian Food and Grocery Council has campaigned for the appointment of a supermarket ombudsman to oversee the relationship between the supermarkets and suppliers, as well as legislation to limit the amount of shelf space that supermarkets can allocate to private label. But all signs point to an even more challenging environment in the future. Woolworths has been particularly transparent about its approach, and its strategy, released publicly in November 2011, makes for sobering reading. The company called for everything from improved buying terms to doubling the penetration of its own brands to removal of "substitutable" products from supermarket shelves. Coles is likewise raising the bar for its suppliers. What FMCG executive wouldn't find cause for concern?

Learning to make the most of the new reality begins by understanding its origins in the pricing strategies of the grocers and many suppliers. The same basket of groceries can be 50% more expensive in Australia than in the UK. While high rent, labour costs and other factors contribute to higher grocery prices, price inflation was also a key source of growth for the industry. In recent years Woolworths consolidated its place as one of the world's most profitable major grocers, with gross margins in excess of 25%. And many suppliers relied on annual price rises to boost their profitability (see sidebar on page 7, "Some of the pain is self-inflicted"). Such prices created a path for low-cost competitors like Aldi and Costco to attract bargain-seeking consumers, and Coles began to use price as a differentiator, with such moves as its "Down, Down" campaign and $1 milk/$1 bread promotions.

While both grocers are reducing prices, Coles' strategy has been more successful; the retailer's comparable sales growth surpassed that of Woolworths for 12 consecutive quarters. A recent Bain & Company survey of more than 1,000 grocery consumers in January 2012 showed that price perceptions have moved in the past 12 months, with Coles perceived to offer lower prices than Woolworths in many supermarket categories. Aldi remained the winner in the price perception battle *(see Figure 1)*.

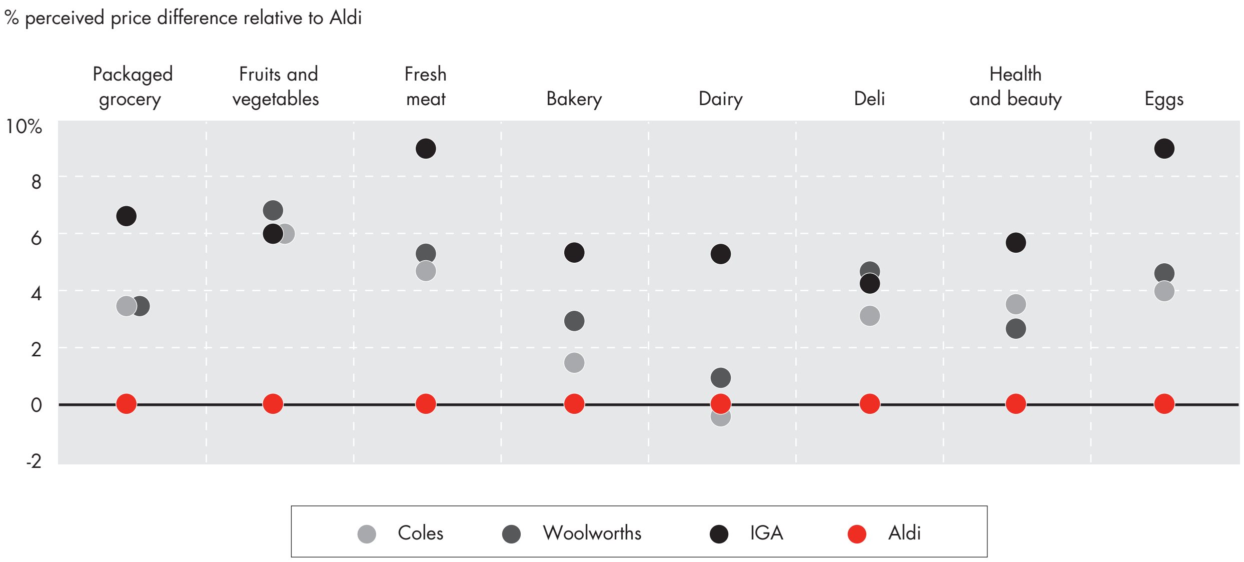
Complicating the situation is the fact that private labels are now a core part of most consumers' shopping repertoires. Our survey found that in most grocery categories, seven of 10 consumers now purchase a mix of private labels and brands or only private labels. Health and beauty, soft drinks and confectionary remain brand driven and are notable exceptions *(see Figure 2)*. In this environment, increasing prices to fuel profit growth will be less viable for major retailers and FMCG companies.

Simply put, suppliers now face three choices. They can decide to live with lower growth and lower margins. They can take a short-term approach to running the business, cutting back on investment to hit margin targets. Or they can use the changed environment to their advantage—as an opportunity to transform their operations and approach in a way that can help them not only adapt but also outperform their competitors. From our experience working with consumer products clients in Australia and around the world, we've identified the seven most important rules for winning in Australia's new reality.

Rule 1: Play the right game

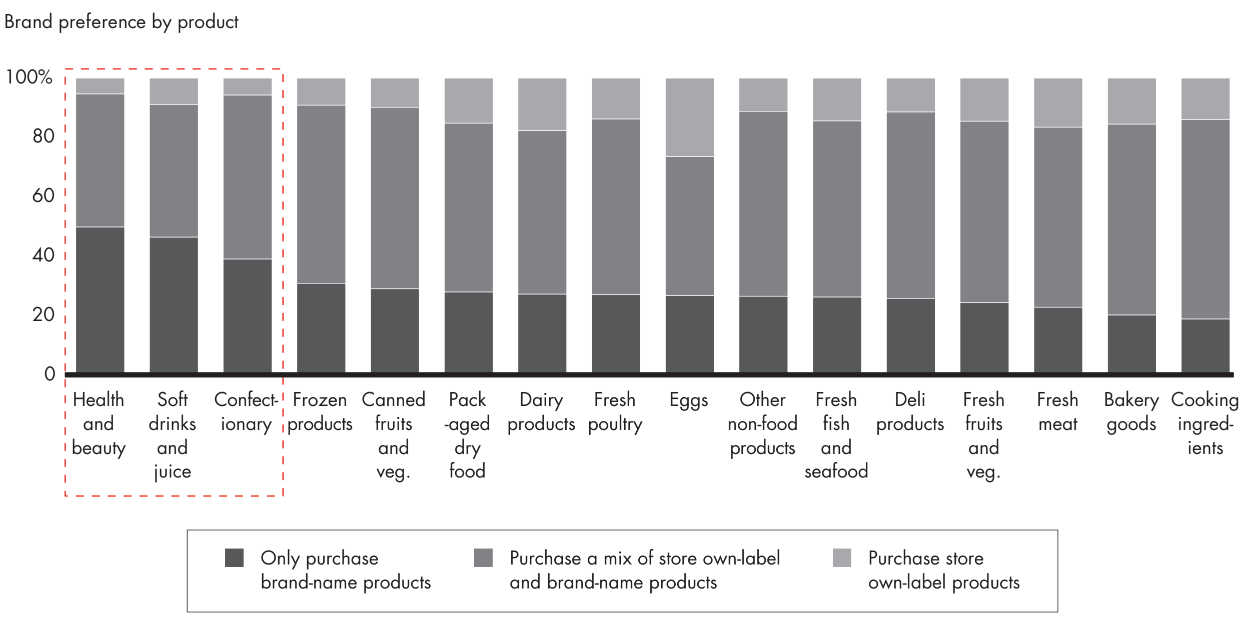
Since it was introduced in 1997 in *Harvard Business Review*, Bain & Company's High Road-Low Road

Figure 1: Aldi is perceived as cheapest across most categories



Note: Survey question: "Of the grocers you frequent, in your opinion how does pricing compare for these departments?" Options are: cheapest, <5% higher than cheapest, 5-10% more than cheapest, 10-20% more than cheapest, 20-30% more than cheapest, 30%+ more than cheapest. Created a weighted average based on number of responses in each bucket, and indexed to Aldi
Source: 2012 Bain Australian Consumer Grocery Survey, n=1,080

Figure 2: Private label is already established in most repertoires, even in brand-driven categories



Note: Only includes respondents who shop the category. Survey question: "Describe your brand preferences for the following product categories."
Source: 2012 Bain Australian Consumer Grocery Survey, n=1,080

approach has helped countless companies determine the best strategy for their brands. After studying hundreds of product categories, our research concluded that while scale determines returns in most industries, in consumer products the nature of the category—whether it is a premium category or a value one—matters even more. For example, a market share follower in a premium category typically earns higher margins than a leader in a value category. The approach has endured after two decades of massive industry changes, including retailer consolidation and the invasion of private labels. As those trends continue, it's now more important than ever for companies to know where they play (whether they compete in a premium category like beer or a value category like fresh milk) and where they stand (whether they're a market share leader or follower) to determine the right path forward. The strategies are completely different.

A High Road player—a leader in a premium category—needs to invest in brands, innovate and constantly trade consumers up. That is the approach that has sustained Gillette for years in razor blades, and it's how Kraft plans to continue to boost its market share in chocolate. For example, its Cadbury brand is at a five-year market share high in Australia, thanks to a program of aggressive investment in innovation. The company boosted its rate of innovation from about 7% of total revenue to about 11%, and the trajectory is continuing. In premium categories like chocolate, the company is more concerned about growing the category than battling private labels.

In less premium categories, suppliers with scale advantages and lower cost positions tend to win. But even in value-driven categories, it is sometimes possible to create premium niche brands. Consider how milk processor A2 rose above the private-label milk wars that began with Coles' A$1 a litre campaign. A2 differentiated its product from the heavily discounted generic milk by promoting its health benefits. Appealing to health-conscious milk consumers has paid off handsomely. Sales grew by 31% since the price wars began on Australia Day 2011, according to independent sales tracker Aztec (see Bain Brief "High Road-Low Road, revisited: New life in value categories").

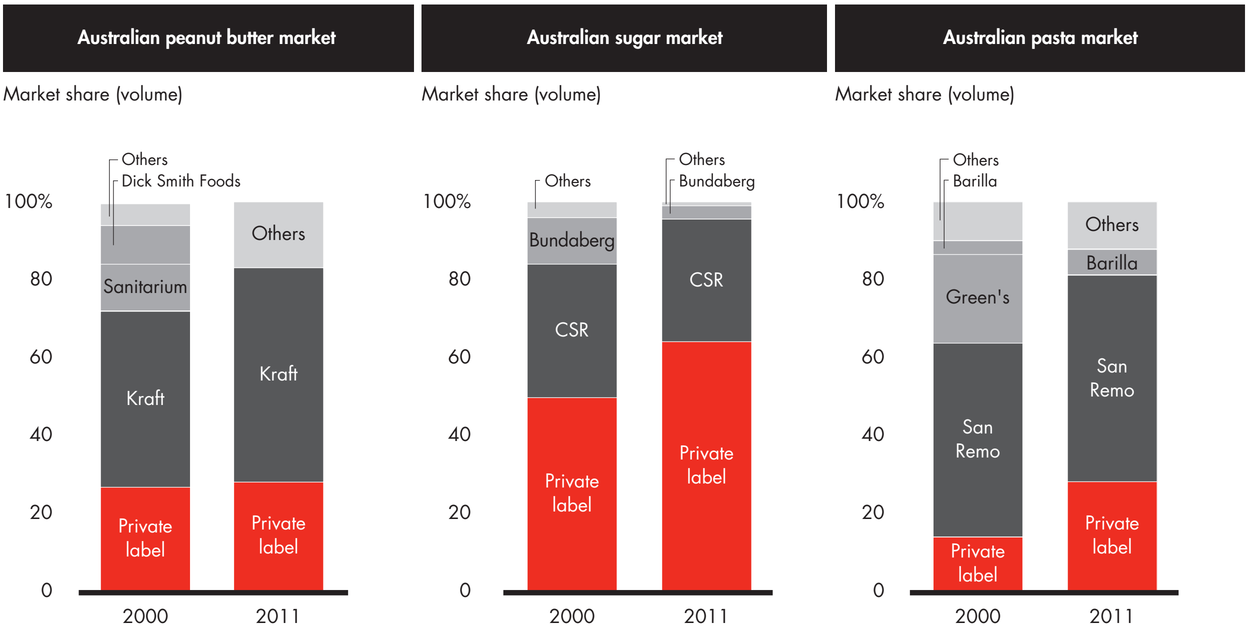
Rule 2: Win the battle for the shelf

As grocery stores stock more fresh produce and high-margin general merchandise like stationery and apparel, they will need to limit the share of shelf space for packaged groceries. And, of course, grocers are devoting more real estate to private labels in most categories. In the years ahead, this competition for shelf space will create a growing challenge for suppliers—there simply won't be space for all of the brands and products that are currently displayed. Consider Coles' decision to stop selling Greenseas tuna but to maintain the John West brand. The de-listing of brands in core grocery categories will play out more frequently as the major grocers begin effectively to act on the wealth of basket- and shopper-level data that their loyalty programs produce. Products that command shopper loyalty will hold their place, but products with readily available substitutes are at risk.

Instead of ignoring the looming challenge of maintaining multiple products, suppliers need to start thinking like retailers. How will the category evolve? How quickly will private label grow? Will this category evolve to be more premium, or more value driven? From the retailer's perspective, what is the right number of brands in the category?

Experience shows that the No. 1 brand has an opportunity to consolidate its leadership of the category as private label grows (*see Figure 3*). For the No. 2 and No. 3 brands in a category, working proactively with

Figure 3: The pain will not be shared equally



Source: *Retail World*

the retailer is often essential for survival. Look for opportunities to help the retailer achieve its strategy. Use shopper data to review your product portfolio, and your competitors'. Understand which lines may be substitutable, and be ready to make tough decisions. The fact is, not all of these products will have a place on the shelf of the future.

But also take note of how winning companies use these trends to their advantage. For example, one major supplier created a low-end brand exclusively for its largest customer. As a result, the supplier has strengthened its relationships with its customer, as well as its market share of the category, even as the overall number of brands in the category has been reduced. For suppliers with strong brands that are proactive, collaborative and nimble, the shelf of the future presents as many opportunities as it does challenges (see Bain Brief "Deciding to fight or play in the private-label arena").

Rule 3: Be lowest cost

The best suppliers constantly strive for efficiency, and this has never been more important than it is today. Low-cost suppliers have more funds to invest in marketing and innovation—and if necessary, into more generous trading arrangements with the retailers. When prices are stable or falling, high-cost suppliers are always at risk.

Suppliers must start by understanding their cost position compared with their competitors, not just domestic competitors, but also overseas suppliers that could supply Australian grocers. If there is a cost gap, now is the time to take action. Many suppliers will need structurally to reduce costs by rationalising facilities and supply chains, or by moving production offshore. For example, Heinz has announced that it is shifting production of sauces, beetroot and some meal products from facilities in Girgarre, Brisbane and Wagga Wagga to its facility in Hastings, New Zealand. In other industries, particularly where excess production capacity or duplicated supply chain infrastructure exists, suppliers may be able to work together to share costs.

There's also a real opportunity to reduce complexity. Most suppliers now have a long tail of unproductive products. For many, the distribution of volume is even more skewed than the "80/20 rule" suggests, with 10% to 15% of products accounting for 80% or more of volume. The best suppliers are proactively rationalising their assortment, combining shopper insights on which products are substitutable, with a perspective on how the shelf of the future will evolve. They understand which groups of products contribute to high manufacturing and supply chain costs. One beverage manufacturer found that a cross-functional complexity reduction exercise was far more effective than approaches it had used in the past, which simply focused on eliminating the tail of low-volume products. Instead, the manufacturer was able to eliminate clusters of products that collectively boosted costs. As a result, the company generated significant savings in manufacturing and procurement, as well as improved sales from increasing shelf space for its best lines.

Rule 4: Don't count on price rises—but move net price up

As private labels grow and the major grocers battle for perceived superiority on value for money, it will be harder than ever to negotiate price increases with the major retailers. But there's ample opportunity to boost profits by improving net prices—the weighted average prices a supplier realises across its product portfolio, after accounting for discounts, rebates and other trade spending.

The best suppliers are boosting net prices in two ways. First, they look for opportunities to improve the premium nature of the category in which they compete. Companies introduce a range of new—and more expensive—premium products that encourage consumers to trade up. It's a move that helps retailers as well as suppliers. For example, it would be hard to find a more commoditised product than salt. Yet Cerebos was able to command a price premium on its Saxa brand by introducing such innovations as salt crystals and cooking salt. The effort not only lifted margins but also helped the company grow. Sales of Saxa rock salt—a premium variant that's used in home salt grinders—grew by 25% between 2000 and 2011, compared with the 1% growth rate of standard table salt.

In sugar, another commodity product, Sugar Australia's CSR brand has taken a multi-pronged and sophisticated revenue management approach. It involves innovation, encouraging trade-ups to such premium versions as healthy sugar and investing in promotions featuring celebrities like the often-shirtless Olympic swimmer Eamon Sullivan. The strategy has helped CSR grow its market share by 8 percentage points in the 2005–2011 period, while private label's share dropped by 4 points. Similarly, McCain increased market share by around 3 percentage points by introducing a host of premium versions of its frozen pizza, everything from a group meal version that sells at a 300% premium over private labels to a single snack version that sells at a 22% price premium.

Second, the best suppliers are investing in more sophisticated pricing strategies to grow net price without necessarily moving list prices up. Many suppliers still use simplistic models for price elasticity, failing to set prices strategically relative to the right benchmark products. Perhaps no company operating in Australia can match Coca-Cola Amatil for the sophistication of its revenue management. The company rigorously researches its options—for example, understanding that a consumer in a convenience store may opt for a higher-priced bottle if a can is unavailable—and then strives to ensure the right products are in the right packs in each channel. The bottler constantly hones its pack-price architecture. On a per litre basis, that means Coca-Cola sells at very different prices in different channels, from single 375-ml cans at a price of A$7.20/litre in convenience stores to 30-packs of the same size cans in supermarkets for A$1.78/litre, for example.

At the same time, leading companies optimise trade spending, often the biggest and least-understood item on the P&L. Optimisation starts by diving into the data to understand what's really going on when you fund discounts. Almost every food company in Australia uses software products to track the return it makes on promotional spending. But in most cases these analyses fail properly to account for "flows" of volume when products are promoted and can dramatically under- or over-state the true return on investment. These flows may be positive when a lower price helps boost consumption of the product or steal share from a competitor. But the flows can be negative when a lower price results in "pantry loading" or cannibalisation of sales from other brands within the supplier's own portfolio. To understand such flows more actively, one company combined consumer panel data with cross-elasticity analysis of supermarket scan data. That way, it was able to overhaul its pricing and promotional calendar, enabling it to increase margins and boost share simultaneously.

Rule 5: Make collaboration "just what we do"

Many suppliers still rely primarily on a single touchpoint with the retailers that sell their goods. A member of the salesforce interacts with the retailer's buyer. But imagine the many benefits of enabling multiple touchpoints: an FMCG's finance, supply chain or marketing representative talking to his or her counterparts at the retailer. Not only would it strengthen the supplier-retailer relationship, but it also would generate a continuous flow of insights that could be used to benefit both parties. For example, a supply chain manager may realise that if his or her company slightly altered its packaging, it would be easier for the retailer to handle the product in their stores. Or marketing managers could suggest co-branded marketing opportunities. Such strategic collaboration can create a win-win, reducing the cost to serve, improving product mix or growing a category.

The concept of multi-point engagement with retailers has been around for decades, and most Australian suppliers implement this to some extent. For example, many suppliers have embedded "vendor replenishment planners" that sit alongside retailers' buying teams. There also are a handful of examples of suppliers working collaboratively with retailers on major one-off category development projects. But few Australian suppliers have fully realised the potential of a collaborative engagement model.

One global food manufacturer is implementing a sophisticated retailer collaboration program in its Australian business. Under this program the supplier and retailer work together to identify and capture specific opportunities to create mutual value, whether by growing the supplier's category in the retailer's stores or by improving efficiency through joint planning or shared distribution and integrated logistics management. What differentiates this supplier's collaboration program is that it has become a capability within the business and a platform for ongoing dialogue with the retailer, rather than a one-off effort.

Ultimately, suppliers should embed win-win thinking in their customer investment frameworks, creating performance-based trading terms, where customers "earn" additional trade spending by delivering outcomes that create value for both parties.

Some of the pain is self-inflicted

Sure, the new reality for FMCGs is tough, but many suppliers manage their businesses in a way that actually contributes to the challenging environment. In our experience, companies typically take five missteps.

Too much price. In some categories suppliers aggressively use price growth to grow the bottom line, often ceding control of their categories to new low-price entrants.

Too much cost. Some suppliers have cost structures that make them vulnerable to smaller, leaner competitors with lower overhead structures. Multinational FMCG suppliers are particularly at risk because they carry overhead cost allocations from global and regional support structures.

Becoming complacent. Suppliers tend to look at their category in a way that is defined by market research agencies, but which may not relate to how shoppers think about the categories. As a result they may hold onto their position within the narrowly defined subcategory, but miss broader trends that erode their business.

Setting unrealistic targets. Too often, FMCGs set unrealistic top- and bottom-line growth targets, a misstep that leads them to manage their businesses for the short term. In order to hit a profit target, many management teams are forced to cut back on brand marketing and are tempted to increase prices. And if the price increases lead to unexpected volume losses, suppliers are forced to "deal back" prices by running increasingly deep and frequent promotions. Each of these actions makes it even more difficult for the supplier in the future.

Not managing the "system." In many categories, suppliers fail to manage the different retail channels as a system. They make a series of one-off decisions in response to retailer requests. For example, a supplier may concede margin at the request of a major retailer. A competitor replicates the move. Another supplier demands margin concessions. Each of these moves is predictable in hindsight, but few suppliers consider the implications.

Rule 6: Drive growth outside the majors

For most FMCG suppliers, Woolworths and Coles will remain top-priority customers for the foreseeable future. But there are also opportunities to grow outside of the two major retailers, and a more diverse mix of distribution channels is often favourable for suppliers. For example, one reason Australia's major brewers remain highly profitable is that they invest heavily to market to pubs, clubs, restaurants and convenience stores—the world beyond the two leading supermarkets. For other suppliers, diversifying will mean focusing on grocers other than Woolworths and Coles, such as Metcash and Costco. Some may develop exclusive brands or private labels for sale through Aldi. Aldi has opened 25 stores a year since entering Australia in 2001 and plans to open its 300th store in the country by the end of 2012.

The effort to diversify can take many forms. Many food suppliers have an untapped opportunity to grow into the food service channel. But while food service in Australia is a A$16 billion industry, many suppliers fail to give it the focus it deserves. The reason? For one thing, it is a broad mix of subchannels, covering everything from fast-food restaurants to hotels, restaurants and cafes to institutions such as schools and hospitals. Succeeding in food service often requires different pack sizes or product formulations and different salesforce capabilities. For example, some suppliers employ chefs who work collaboratively with restaurant kitchens to design menus. The opportunities can be significant for companies that invest appropriately. Nestlé, the largest food manufacturer globally, devotes an entire division to its food service business and generated US$5.8 billion of revenue globally in the channel in 2010.

Even direct-to-consumer sales are a possibility. In China, where counterfeit products are common, direct purchasing from the manufacturer gives consumers confidence in product quality. That's one of the reasons why online sales of infant formula in China are growing nearly 15 times the rate of sales through traditional channels. In developed markets, most efforts to sell directly to consumers online have so far focused on unique products as part of larger strategies to engage consumers using digital media. For example, in the US, Heinz released a new variety of ketchup exclusively through its Facebook page, and in the UK it allowed Facebook fans to send personalised "Get Well Soon" cans of Heinz soup to their friends and family.

As the retail landscape continues to consolidate and technology evolves, suppliers will intensify their efforts to test innovative new business models. Wine producers have used subscription-based wine clubs to sell directly to consumers for many years. In the US, Amazon.com now offers a "subscribe and save" service on frequently purchased categories such as laundry supplies, coffee pods and baby-care products, with regular free delivery on a specified schedule.

Rule 7: Be ready for the call

Despite their best efforts, many suppliers still will receive a dreaded call from retailers, informing them that their products are at risk of being de-listed. The past two years have witnessed at least three highly visible relationship challenges: a contract dispute between Nestlé and Coles; Coca-Cola Amatil's refusal to accept better trade terms sought by Woolworths, leading to a two-month standoff; and Foster's pulling key beer brands from grocers after learning of a plan to sell them below cost.

Being ready for the call means being realistic about what you can achieve in any given relationship, recognising the balance of power between supplier and retailer. In each category, pre-emptively model the downside risk, the actions you could take to mitigate that risk and how your customers and competitors might react in different situations. Only by understanding your "plan B" can you be properly prepared for the negotiation.

Whether your company sells tuna or tissues, carrot juice or cleanser, mastering these seven rules will be critical for success. Australia's retail landscape is becoming less and less hospitable for under-prepared suppliers. But for suppliers best prepared for the new reality, opportunities for sustained profits and growth will continue to emerge.

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