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Power shifts in the Australian agrifood supply chain

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Dr David McKinna

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Abstract



Over the past two years, the oligopsony of Australia's big two supermarkets has been put under the spotlight. Woolworths was the dominant retailer, powering ahead of Coles which was lost in the haze of a dysfunctional management team and a poor business model. With the arrival of Coles' new team from the UK, the sleeping tiger has leapt into battle to recover years of lost time. The Coles recovery strategy and Woolworths defensive response has thrown agrifood supply chains into disarray. Milk at \$1 per litre, the banning of hormone growth promotants and the phasing out of caged egg production are examples of the power of supermarkets to restructure

entire industries and redefine the economics of the Australian food sector. The farmers' share of the food dollar continues to decline. Processor and value-adder margins are now below the levels needed to fund reinvestment to ensure the sustainability of these businesses. At the same time, the regulators have been reluctant to confront the issue because, fundamentally, lower grocery prices are good for consumers. Although there can be little doubt of the power and impact of the two major retailers, there are signs that new contenders are encroaching on their space. ALDI is making its presence felt and Costco has plans for further inroads into the Australian market. Both offer a totally different shopping experience. On a smaller scale, farmers markets, specialty retailers and on-line direct businesses are giving the big boys something to think about.

Although the Australian agrifood industry is far more developed than any of its neighbours in the Asia Pacific region, it is still evolving significantly and quickly. The defining trend has been the shift in market power and therefore income along the supply chain, initially from farmers to processors and more lately from processors to supermarkets. This shift is already resulting in significant structural readjustment and will have long-term economic and social consequences.

The stages of the power shift

The family farm era: 1960s and 1970s

The 1960s and 1970s were the halcyon days for Australian farmers. In the post-war era, global demand for food was booming and, with the Australian dollar at a moderate level, exports were competitive. Farm-gate prices generally delivered strong returns, albeit with the occasional seasonal hiccup. The vast majority of agrifood products were sold through grower-owned cooperatives or statutory



marketing authorities — the latter commonly with single desk and pricing powers which favoured grower returns.

The processors peak: 1980s and 1990s

The late 1970s and early 1980s saw market power moving convincingly towards food processors. Farm cooperatives were forced to become corporatised because of their inability to raise capital under the provisions of the various Cooperatives Acts. Consequently, cooperatives were forced to open up their share registers to outside investors. One by one, the larger ones became takeover targets. Today, virtually all of these are wholly owned by multi-national food companies whose primary aim is to maximise shareholder returns at the expense of farm-gate returns.

At the same time, statutory marketing authorities were phased out because of their political incorrectness; one of the last being the Australian Wheat Board. In conjunction with their new-found bargaining power, the large food companies were able to leverage their power brands to achieve both premium pricing as well as high profits. As a consequence, the processors were investing heavily in Australia for future growth.

The supermarkets strengthen: 2000s

Over the last ten years, there has been a further shift in power up the supply chain away from food processors to supermarkets. This has reached a crescendo in the last 18 months with the arrival of the new management team at Coles. Coles and Woolworths now control around 70% of the packaged food market. This gives these two retailers tremendous oligopsony power and dominant bargaining power with suppliers.



Coles and Woolworths account for a very large part of most food processors' businesses — up to 70% in some cases. Any loss of distribution in Coles and Woolworths would dramatically decrease the volume output through their factories, impacting on efficiency, economies of scale and overhead recovery.

The latest shift in market power reached a new level with Wesfarmers' purchase of Coles and the appointment of the new management team that was charged with catching-up on Woolworths' leadership position. The Coles turnaround strategy has included store refurbishment, dramatic price discounts and the refocusing of the private label program. But most of all, Coles have leveraged their market power to negotiate deep price reductions. The other supermarkets were forced to do the same to defend their positions further — driving down the profits of food processors.

The renaissance of private label

Apart from buying market power, supermarkets have another tool at their disposal — private label strategy. Private label (products sold under supermarkets' own house brands) has been around for at least 30 years but has

only recently started to be embraced by Australian shoppers because of a history of inconsistent quality, poor packaging and lack of marketing. Australian retailers have revamped their private label offer to the point where, increasingly, shoppers see them as being as good as the proprietary brands but at a far cheaper price.



Private label now accounts for approximately 25% of all groceries sales and will reach 30% within two years. In the UK, private label accounts for up to 70% of sales in some chain stores. However, private label dramatically erodes the profitability of food processors on three fronts.

1. It takes market share from their own brands, which impacts on factory volume and therefore impacts on costs.
2. It devalues the category. Processors have to reduce prices and offer promotional discounts to defend their market share.
3. When processors produce private label products, the profit margins are usually much less than for their own branded product.

Increasingly, private label product is being imported, largely because of the strong Australian dollar.

Supermarkets are flexing their muscle in other ways than price

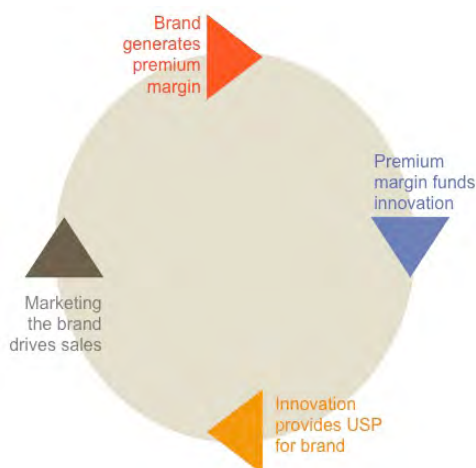
Supermarkets have not only used their market power to reduce high prices but also to drive changes in the way food is produced. Coles, for example, has introduced hormone growth promotant (HGP)-free beef and will phase out cage-laid eggs in its private label, which accounts for 70% of egg sales. This will have a significant impact on both production costs and profitability.

The importance of branding to drive category and industry development

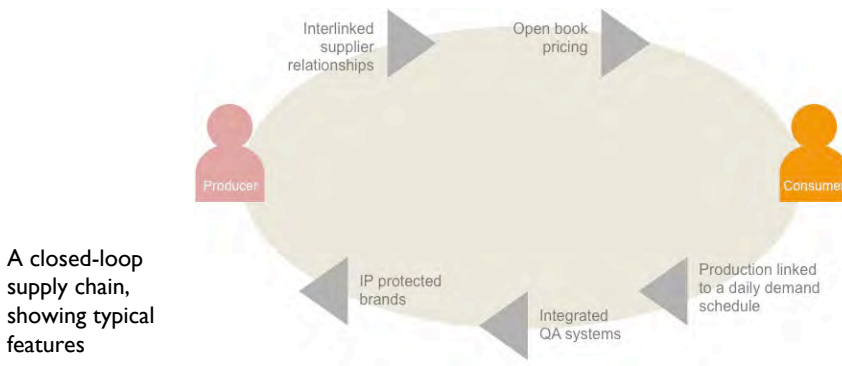
Strong proprietary brands play a major role in industry development and category growth. Consumers, historically, have been prepared to pay a premium for their trusted brand on the basis that it delivers value to them above other

competitors. This premium price allows processors to reinvest to create new products.

Investment in innovation and new product development creates products with a point of difference which marketers call 'a unique selling proposition' (USP). This 'unique selling proposition' then becomes the basis of a brand message directed towards consumers that builds the strength of the brand and so the cycle continues. The erosion of the premium pricing



Supermarkets: Good, Bad or Ugly?



of proprietary brands means that the investment needed to build the category growth is curtailed.

Closed-loop supply chains

An important part of the evolution of supermarkets has been the creation of so-called closed-loop supply chains whereby food moves from paddock to the plate through a series of integrated links.

Closed-loop supply chains are initiated by supermarkets in order to improve product quality and consistency, to lower and stabilise cost and improve scheduling.

A secondary impact of closed-loop supply chains is the emergence of corporate farms. Closed-loop supply chains lend themselves to very large, efficient farms, typically spread geographically to allow seasonal, year-round production and reduce climatic risk. Typically, such farms have outside investors. Because of their size and scale economies, together with their ability to invest in cutting-edge technology and management systems, corporate farms generally have a significantly lower cost of production.

This dramatic structural adjustment in rural Australia cannot be totally blamed on the bargaining power of supermarkets (although they do play a major role). There are other factors at play including:

- the strong Australian dollar,
- the low level of consumer confidence that is dampening demand for higher-priced items,
- Australia's high labour costs and inflexible labour laws relative to our competitors,
- higher freight costs, poor road and rail infrastructure and generally high compliance costs.

The threat to the family farm

These large, highly efficient farms are, in turn, putting pressure on the family farms which generally have a higher cost of production. Smaller family farms cannot compete. As a consequence, in many industries such as potatoes, there

has been a dramatic reduction in the number of potato growers — with three or four growers having the lion's share of the Australian fresh potato market.

The social fall-out of the structural adjustment

The redistribution of wealth along the supply chain is having dramatic impact on the Australian farming sector. In particular, the victims of such redistribution are the country and regional communities where most of the food factories are located. In the past three months, there have been a number of announcements regarding the closing down of major food factories in regional areas and the movement of their operations overseas. The closure of a dairy factory, for example, means that farmers no longer have an outlet for their milk. This comes at a cost to many direct jobs, leading to dramatic economic flow-on effects for local communities. With the loss of a major industry, small regional areas die a slow death because of the inability to sustain social infrastructure such as schools, hospitals, banks, supermarkets, and so on.

Who are the winners and losers from all of this?

Obviously, the structural adjustment creates winners and losers. In the short term, consumers are winning through cheaper prices — it cannot be denied that \$1 for a litre of milk is not a bad deal. However, in the longer term, consumers will probably be worse off because the range of choice will be limited. Potentially, products could be de-engineered to meet the lower price points demanded by supermarkets and a much smaller range of Australian-grown products will be available. Supermarkets do not reap all of the benefits, because they pass on some of the savings to shoppers. As witnessed already, family farms and regional communities will certainly continue to suffer.

Lessons to be learned from the Australian experience

Effective competition policy is central to providing an equitable and competitive retail market environment. The market power enjoyed by Australia's two big supermarkets is as a result of previous rulings by the Australian competition regulator, which allowed the chain of mergers over the past 20 or so years that has led to the oligopoly. Once the genie is out of the bottle, it is hard to put it back in. Emerging countries have the opportunity not to make these mistakes.

Dr David McKinna is recognised as a preeminent Australian opinion maker on agrifood issues. His views on the sector are regularly sought by media. David has been the quiet achiever behind some of Australia's best known agrifood case studies. He has spent much of his career as principal of global strategy consultancy McKINNA et al. In addition to work in agrifood, McKINNA et al has a history of strategic trouble-shooting in sectors as diverse as banking, education, 'fast-moving consumer goods', retail, home improvement and public governance. The consultancy has a global project portfolio, focusing on corporate strategy and export market development and is actively engaged in most established and emerging markets of the world.

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