Private Label Moves to the Next Level in Canada

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The purpose of this paper is to examine the current and future role of private label grocery products in Canada. It is expected that by better understanding the future role of private label, Canadian grocers and food manufacturers can more advantageously position their firms and product lines for profitable growth.

Rumours of the demise of private label in Canada are greatly exaggerated. Private label share, category penetration and scope is as great as ever and appears to be growing. What is changing, however, is the role and function of private label (alternatively referred to as store brands) in the Canadian grocery sector.

The private label business consists of two categories: "premium" private label such as President's Choice or Our Complements, and "generic" such as No Name and Smart Choice. Generic products are typically more basic in nature and are true price fighters, developed as a value offering in commodity categories such as flour, cake mixes or tea bags. Premium private labels tend to exist in categories where a store's product developers can add value and have access to cooperative manufacturers. Examples are frozen entrees, cookies and coffee. There are still some categories such as frozen french fries where the sheer brand power and technology of the manufacturer (in this case McCains) makes the development of private label products almost impossible.

Generic and premium private labels rarely co-exist in the same category - not more than 15% of grocery categories have both. In these cases generics are generally priced 10% to 15% below the "premium" label and 30% to 40% below the national brand. As a rule of thumb, each generic item always delivers a "net-cent-profit" equal to or greater than the "premium" label, and always greater than the national brand.

Private label brands thrive in highly consolidated grocery markets. The combination of scale players and limited competition makes the development of private labels much easier. The volume that comes with scale drives lower costs; the limited competitive set takes the emphasis off price competition, which is typically the battlefield of national brands.[1]

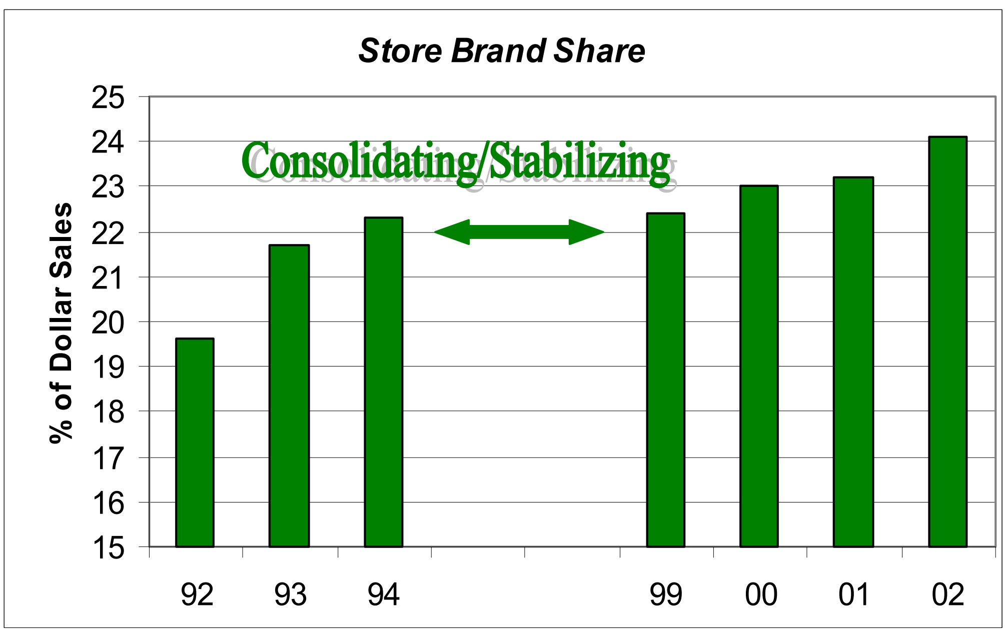
Is it in the Maturity Phase or Not?

On the surface, there were reasons to suggest that the growth in private label in Canada had run its course. The following are some of the arguments that support this:

[1] Investor's Guide to the Canadian Grocery Industry, April 9 by Perry Caicco of National Bank Financial.

- Canadian private label share of total grocery sales is among the highest in the world. According to data from ACNielsen, Canada ranks either third or fourth in private label shares between North American and European nations. Only Belgium, England and Switzerland have had higher private label shares. As a result, there are reasons to suggest that there is not a great deal of growth potential left for private label.
- The household penetration rate in Canada is essentially 100% with consumers buying nearly every shopping trip. While there are several strata of devoted or uninterested store brand buyers, in a general sense, there are no untapped consumers yet to win over.
- Private label growth rates were consolidating in the mid to late 1990's.
- Almost every category in the store now has a private label presence. Other than the fresh department, there are few unexploited areas of the store in which private label can grow.
- As of the late 1990's, every major retailer had developed a reasonably competitive private label offering.

Considering those factors, it is easy to see why store brands might have reached the mature stage of their development. Looking beneath the superficial evidence and the historical data, however, reveals that store brands have, in-fact, not reached the mature stage. Instead they have moved up to the next plateau. The graph below, using AC Nielsen Canadian data, shows that while private label share may have slowed in the mid-to-late 1990's, it has picked up again in the last two years. The data for 2002 is preliminary but indications are that share will increase to at least 23.5% of Canadian grocery sales, the highest on record. IT LOOKS LIKE MORE THAN 24%



In fact, this next plateau that Canadian private label has moved to is based on the strength of the past and the consolidation of the role and function of the products.

In the past, store brands proved their importance to retailers for two main reasons:

1. Private label provides better margins for retailers than do most national brands. This is because costs of private label tend to be lower due to lower marketing, overhead and logistical costs. Even with their lower retail prices, private label provides better margins.
2. Private label provides leverage to grocers relative to manufacturers. Private label provides grocery category managers with enhanced knowledge about product costs. It also provides grocers with a replacement for second and third tier brands (sometimes even first tier brands). This coupled with the grocer's point of purchase knowledge leads is a powerful combination.

This knowledge also led to a third key to the importance of private label: destination products. By the late 1980's and early 1990's, increased understanding of costs and consumer demands lead to the enhancement of private label quality. Better quality closed the loop on the consumer's perception of the value of private label. Furthermore, unique, high quality products that can only be purchased at one grocer meant that private label could become a draw in and of itself. Private label could become a destination product. In the best cases, private label became a customer loyalty program.

As a result of the two or three key private label strengths, grocers learned the proper balance between national brands and private label. They learned about the value of brands and the consumer equity that the brands in the category held. For example, grocers learned that tier two and tier three brands had little or no consumer equity. Those brands could be swept away without a loss of consumer demand. Not only that, but the loss of those brands resulted in an increase in the margins afforded by their private label replacements. The categories were clarified and simplified for both consumers and retailers.

In summary, from the grocer's perspective, store brands have helped them control their own destiny. They have also helped them develop a better consumer focus and delivery.

Private label also made manufacturers better. National brand manufacturers were forced to keep costs and prices in line with private label. In addition, private label also forced top national brand manufacturers to stay ahead of the game with improvements in technology and quality. In this regard, there is a strong argument to be made that the leverage retailers gained from store brands has been passed along to consumers.

There is another point with regard to manufacturers that is different today than just 5 years ago. That is the fact that manufacturers accept private label as an equal partner in the category. The battle over whether there will be private label is over. Manufacturers understand the role of private label and are willing to work in partnership to grow the category.

There is a final, often forgotten point pertaining to the manufacturing sector as it related to store brands. Much has been written and spoken about the loss of national brand shelf space and product lines as a result of private label. The reality is, however, that the volumes and sales of weak second and third tier brands have been replaced by the manufacturing capacity of private label manufacturers. A thriving private label manufacturing sector has simply replaced the lagging national brands.

The Cost of Entry

Today private label is simply the cost of entry into the retail business. Consumers expect a strong two-tier store brand program in complement with a national brand. Furthermore, it is necessary from a price competition perspective. Grocers all have private label for either offensive or defensive (reactionary) reasons. In the offensive sense, private label is there to generate sales and margins. As noted above, in the case of the most successful programs, private label could be considered a loyalty program. Conversely, from a defensive or reactionary perspective, private label is there for price competition reasons but has little equity.

In North America, there is an argument to be made that of the major grocers, only Loblaws has been using private label strategically or offensively. That is, only Loblaw is using it as the means to differentiate their stores from their competitors. All others have used private label as a margin enhancer, not as a chain store differentiator. Further to that point, it is noted that private label manufacturers in Canada have tried to sell the concept of "Premium Private Label" to their US customers, typically to no avail.

With regard to Loblaw, the company uses President's Choice and No Name as their own brands, which means that they have to be innovating constantly - like any national brand. Other chains seem content to come up with me-too's. To do what Loblaw's does, you need the same development infrastructure as any nationally branded company - R&D, QC, Marketing, etc.- and this is costly.

The next plateau that Canadian retailers are moving to is based on all the lessons learned from the past. Retailers have learned what works and what does not. For example:

- Retailers will spend less time and effort on the exotic private label lines and spend more time on the higher volume demand drivers.
- Untapped areas such as fresh and general merchandise will be growth areas.
- Retailers will focus effort on the tier two store brands to ensure a more complementary, rational relationship between the private label offerings.
- Depending on the category and the economics, retailers will seek to reduce the quality and the price differential between private label and national brand.

That last point, with regard to price, however, will be cautiously monitored. Private label share is a key performance measure. If that share erodes, grocers know that many other factors will be eroding with it. Grocers will not risk that in order to take a short-term price hike.

Within that context, however, there is some differentiation occurring between retailers. There is no question that there continues to be a price differential between nationally branded and store branded, even with President's Choice. Although PC's pricing is lower than the leading national brand, it is usually closer to the latter than is the case with other premium private labels and the national brand. In other words, PC has built more consumer equity than other private label programs.

In addition, in the past there were usually readily identifiable categories that were subject to private label penetration. Those were the categories that were technologically simple and had high volume. Salad dressing and soft drinks are good examples. Other categories such as diapers and detergents were technologically challenging and/or dominated by very powerful brands.

In dominant Canadian supermarket chains, private label could grow to 35% of dry grocer sales, or 23% of all Canadian food sales through grocery stores. The big upside for private label in Canada is in these areas:

- Quebec remains largely underdeveloped regarding private label.
- Perishables, particularly as categories shift to value added (marinated meats, semi-processed produce, unique bakery items, marinated or smoked fish).
- General merchandise, especially in lower ticket “consumable” areas such as housewares, seasonal and table lines, and drugstore merchandise.
- The continued growth of the discount box stores, which are highly levered to private label.
- The discovery of private label by first-generation Canadians - 60% of all new Canadians are Asian whom, in our experience, have been reluctant to experiment with private label.
- Continued pressure from national brand suppliers for price increases, which may simply result in loss of shelf space to private label brands.[2]

Basically in the past, private label took all the low hanging fruit. Current and future efforts will see stronger penetration in the more challenging categories. Further to that point, while there are many examples of where private label has led the markets in the area of new products or merchandising, for the most part, private label has been a follower. That is, private label copies the national brand.

In the future, there will be more examples of private label leadership, and not just in the exotic or sometimes quirky areas of the past. Leadership will occur in the product lines that are most in demand and in the areas that are the strongest growth. Furthermore, the lag time between national brands and private label introductions will be shorted. The enhanced knowledge that grocers have with regard to technology, marketing and finance will help them lower the hurdle rate of products. That is, the critical mass of volume will be lower and lower due to increased knowledge on the part of grocers.

In summary, store brands are stronger than ever and are going to get stronger. Each different retailer and the associated banners will drive private label in their own way and for their own reasons, either defensive or offensive. Within that context, however, the store brands will be better than ever from both a product and strategic perspective.

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[2] Investor’s Guide to the Canadian Grocery Industry, April 9 by Perry Caicco of National Bank Financial.