Lesson 3.1 – Food Retail Structure

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After this lesson students will be able to

- Recognize the ongoing shifts in food retail structure and the major source of their bargaining power with respect to other agents in the food supply chains.

- Assess the factors driving differences in retail structure across national context and the consequences of these differences in terms of consumers' well-being.

Factors determining the evolution of food retailing

Changes in Consumption trends: the general structure of demand and the amount of goods consumed → increased attention for variety and (recently) health;

Due to changes in:

1) Consumer behavior: consumer decisions as to which of their wants they wish to satisfy and how, when, where → most obvious: demand for convenience;
2) Shopping behavior: consumers have become more demanding and therefore retailers pay more attention to store design, ambience, service, quality etc…

Demographic Changes

1) Population grows but growth rate has slowed down in developed countries;

2) Shift in age composition – decline in birth rate, coupled with a reduction in child mortality causes aging population (in most cases affluent);

3) Socio-demographic and lifestyle changes – later age of marriage, resulting in radically different number and structure of households → more, but smaller, households.

Three Key Trends of the last few decades

1) Decentralization of retail operation; growth of larger stores resulting in changes of location strategy → logistic advantages in the distribution of fresh products.

2) Differentiation of the types of store formats characterizing food retailing – in terms of scale, design, technique and approach → market segmentation more accurate, increased efficiency for larger stores;

3) Food retailers have increased their size and power; changes in the structure along the supply chain.

Decentralization

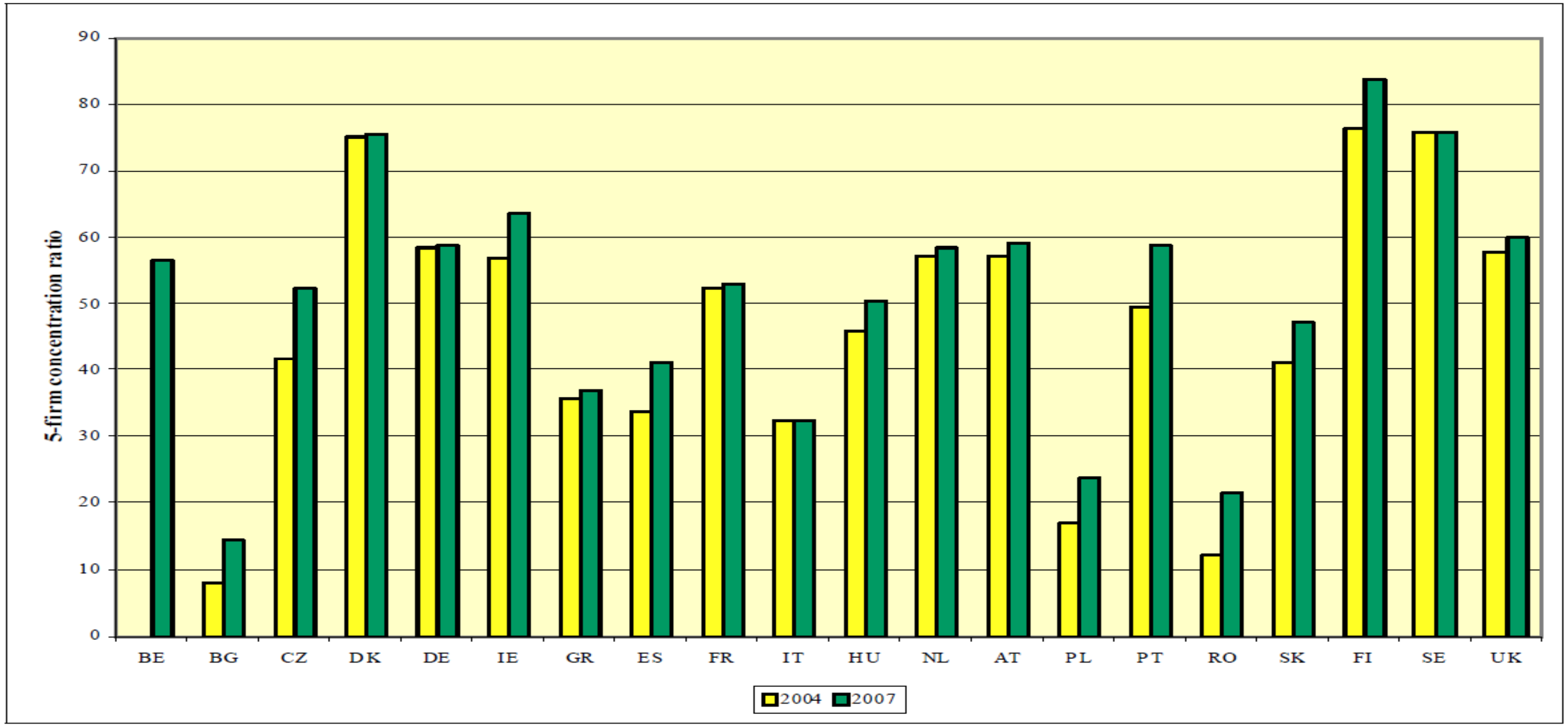
1) Growth of affluent and mobile population in suburban areas in contrast to a declining less affluent and less mobile town and city center population;

2) Development of strong corporate chains with fewer ties to a locality with more willingness (and need) to move shops to areas of demand and opportunity;

3) Changes in methods of selling, calling for larger stores and associated parking – necessity for larger spaces.

- Reduction in food access for less mobile (economically or physically) population;
- Land-use planners have been increasingly concerned with this phenomenon.

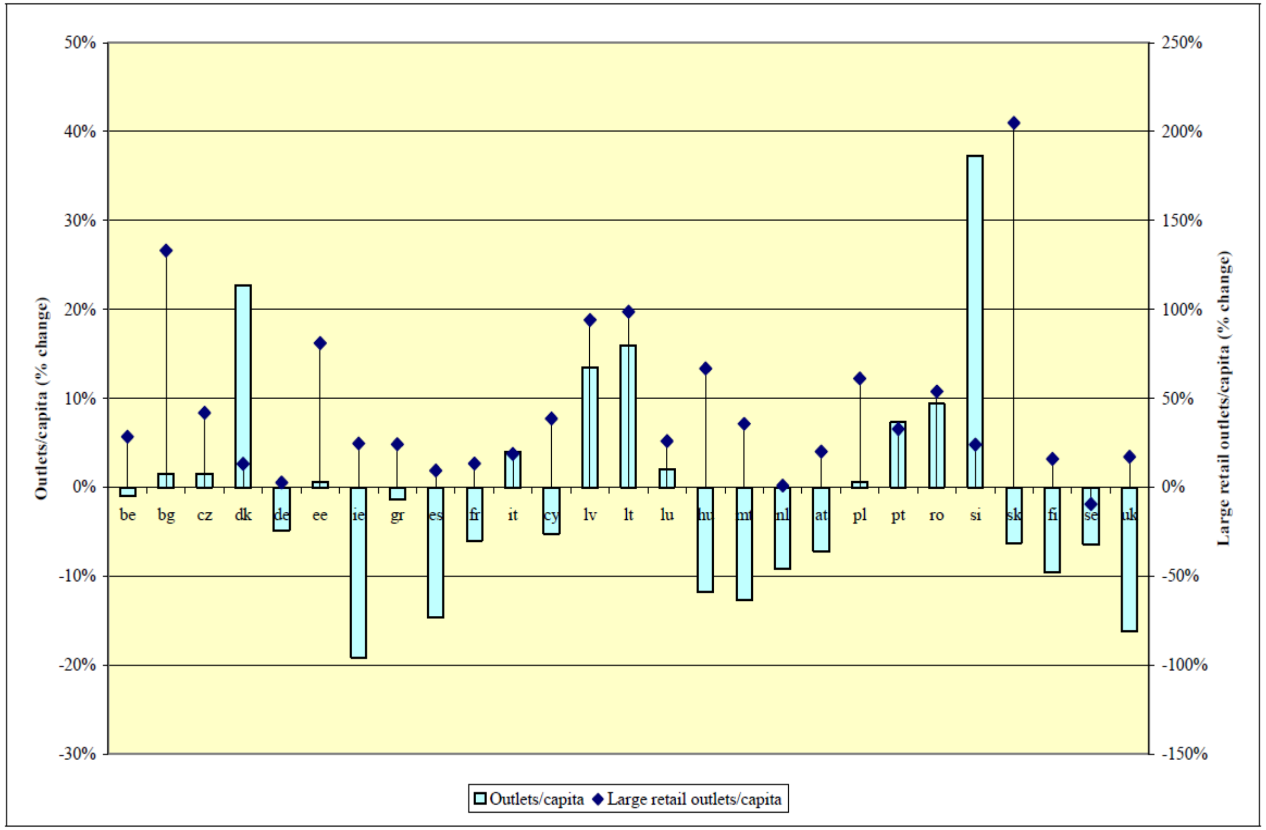
Figure 13: Combined market share of the five largest retailer chains (2007) and change (2004-2007)



Note: There are no data for CY, EE, LT, LV, LU, MT and SI. Market shares are based on turnover and include non-food items sold by retailers.

Source: Bukeviciute et al.(2009) "The functioning of the food supply chain and its effect on food prices in the European Union"

Figure 14: Change in number of outlets per capita, 2002-2007



Note: Large retail outlets include hypermarkets, supermarkets and discounters.
Source: Euromonitor International

Source: Bukeviciute et al.(2009) "The functioning of the food supply chain and its effect on food prices in the European Union"

Retail Strategy

A retailer develops a marketing strategy based on the firm's goals and strategic plans

Two fundamental steps:

- ➢ Selecting a target market
- ➢ Developing a retailing mix to satisfy the chosen target market

➔ **Develop a retail image**: Consumers' perceptions of a store and the shopping experience it provides

Retail Mix


Merchandising
(assortment)
Store
Atmospherics
Service
Target Market
Promotion
Location
Price

Store Image Strategy + Service + Assortment

These factors are decided simultaneously!!!!

1) Food retailers choose the assortment of product they carry strategically.

2) Food stores differentiate themselves by means of services provided (along with assortments / image etc..) to invest in services to attract consumers with lower price sensitive in the stores

- More investments necessary to deliver more features (and higher quality products) to soften competition in price and attract less price-sensitive consumers (Bonanno and Lopez, 2009).

- Modern food retailers offer bundles of physical products and services (Betancourt, 2006), assuming the features of differentiated products.

- Food stores are *ranked* in function of services/quality of the products offered + consumers heterogeneity → both endogenously sort themselves according to their respective store-features and preferences.

Location Strategy

Demand-side factors

Supply-side factors

Location Strategy

Demand-side factors

Supply-side factors

- *Market size*
- *Income*
- *Taste heterogeneity*
- *Poverty rate*
- *Population and income* ***growth***

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Supply-side factors

- *Fixed Cost - cost of land/rent/buildings ;*
- *Cost of labor (and other variable costs);*
- *Presence of subsidy/tax breaks;*
- *Sourcing, sorting and distribution costs*:
- *Competition – presence of other stores*
  - (+) Complements; (–) Substitutes;
- *Ease of delivery/replenishment of stocks;*
- *Infrastructure*
- *Other factors*:
  - Local/state-level tax regimes,
  - Labor laws / minimum wages
  - Zoning Law / Other regulations
  - Crime rates,

- Assume only two types of stores can exist:
  - small stores that provide quality via variable cost (little service, mostly assortment);
  - “high quality” (large) stores requiring investments in fixed costs to provide additional quality / services to consumers.

- Food stores location and quality are an outcome of a three-stage game.

- Ellickson (2006, 2007) application of Sutton’s Endogenous Fixed Cost theory (Sutton 1991) to food retailing.
  - ***First Stage***: stores decide whether or not to *enter* market *j*
  - ***Second Stage***: firms that have entered choose quality (store-type is endogenous);
  - ***Third Stage:*** firms compete à la Cournot.

- Entry of low quality stores occurs as long as there is demand to be satisfied; small stores can saturate a market and fill every niche

- For "high quality" (large) stores, the number of stores will depend on market size, investment costs and the relative costliness of investing in quality vs. satisfying quality-valuing consumers.
  - The number of stores WILLNOT increase indefinitely with market size: retailers will choose to increase "quality" and grow larger.
  - Even if demand would grow to infinity, the number of stores will plateau

Bottom line: Food Retailing is a **NATURAL OLIGOPOLY**

Bargaining Power

Bargaining Power

What is a bargaining situation?

- two or more players (individuals, organizations, firms at different levels of the food chain etc...) can engage in a (mutually beneficial) exchange but have conflicting interests over *how* the exchange should take place.

- The players have a common interest that the exchange takes place, but have different ideas on how that should happen.

Bargaining Power

- The more patient (or the less impatient) a player is, the more bargaining power he/she will have.

- In individual's negotiation, poverty (in this case the measure of the necessity to obtain a positive amount from trade) leads to more impatience → less bargaining power

- The risk of a breakdown impacts bargaining power. The more risk averse a player is, the lower his/her bargaining power

- In some bargaining situations a player may have some information others do not have. The presence of asymmetric information may lead to inefficient outcomes

Bargaining Power

- In some bargaining situation players may have outside options as well as inside options
  - Consider a married couple always arguing....
    - “definitive” outside option: divorce
    - inside option: staying married but unhappy

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  - Consider a married couple always arguing....
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- A player's outside option increases her bargaining power *if and only if* it is sufficiently attractive. If the option is not attractive enough it will have no effect on the outcome
  - The presence of an attractive outside option constitutes a *Credible Threat*: Credible threats shift bargaining power in favour of one player

Why Do Retailers Have Bargaining Power?

- Retailers represent the main interface between manufacturers and consumers.

- They carry hundreds of different products in their shelves, they can "take their time" and establish negotiations with multiple suppliers.
  - Small suppliers may have "urgency" to place their products in the market (they need cash, solvency)

- De-listing (product eliminated from the shelves), can be a credible treat.

- NOTE: policymakers worry about "unbalance of power," or situation where one agent has significantly more power than another.

Waterbed Effect

Differential buyer power may lead to a "waterbed effect" where

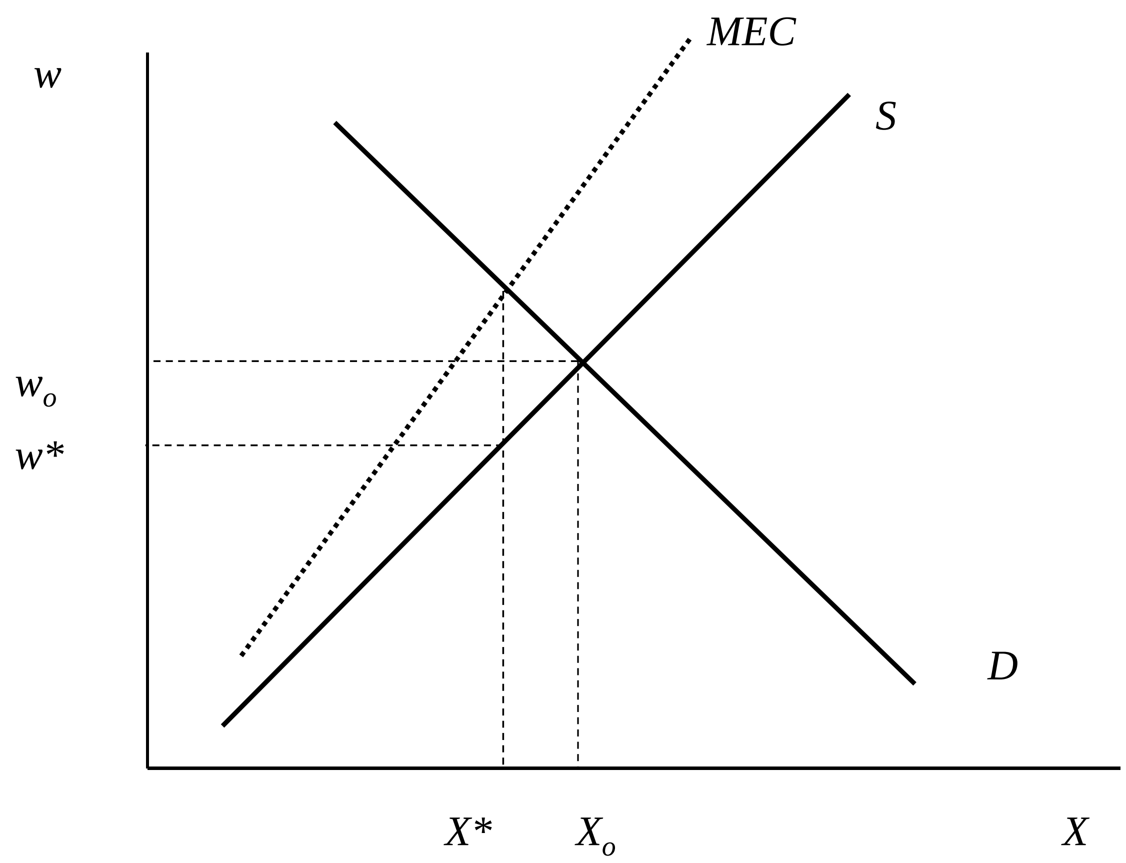
"*… better supply terms for powerful buyers can lead to a worsening of the terms of supply for smaller or otherwise-less-powerful buyers, which might then have an adverse consequence for consumers if downstream competition is lessened.*"*

Suppliers whose profits have been "squeezed" out by large, powerful retailers, may have to recover lost profits from other, smaller retailers.

*Dobson and Inderst, 2008 "The Waterbed Effect: where Buying Power and Selling Power Come together" Wisconsin Law Review. Vol 331. Page 333

Careful: bargaining power is conceptually different than market power!

Monopsony



The buyer has the power to decide how many units of the input to buy so that its price equals marginal expenditure

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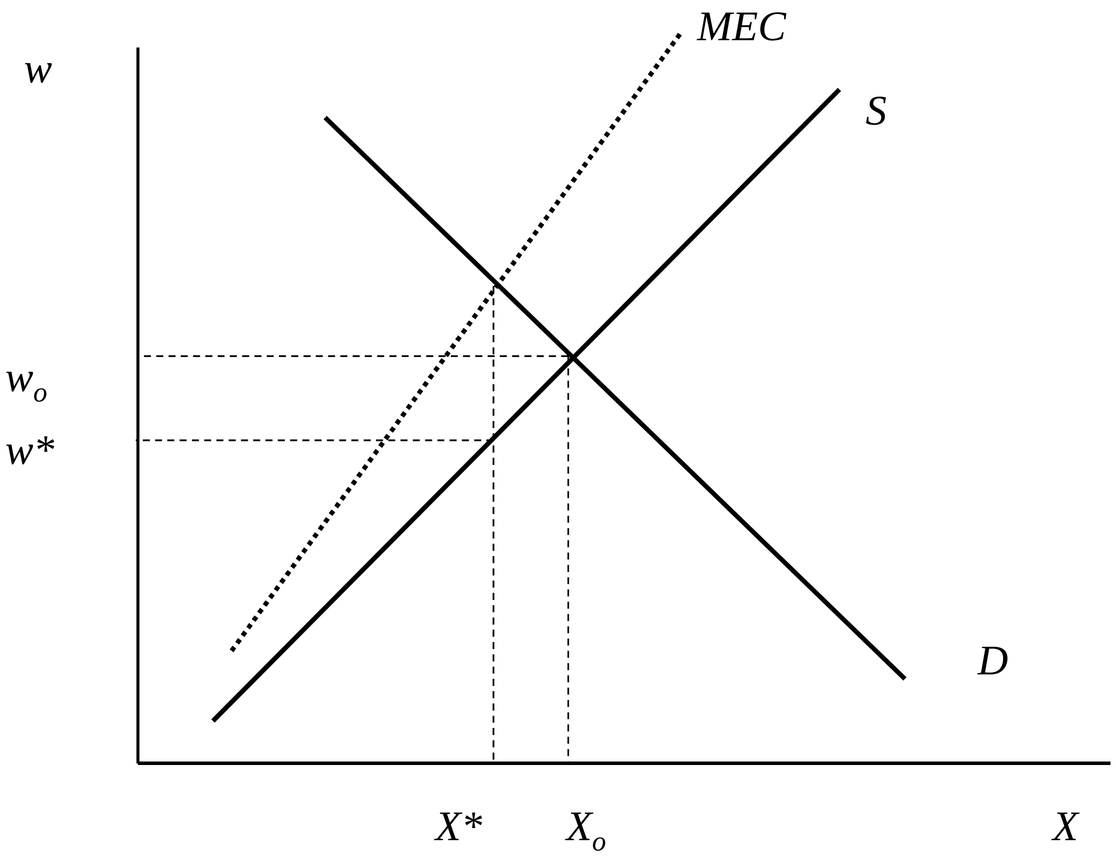


The buyer has the power to decide how many units of the input to buy so that its price equals marginal expenditure

Note: the marginal cost is not the supply curve but the marginal expenditure curve [*MEC*]

Private Labels

Private Labels

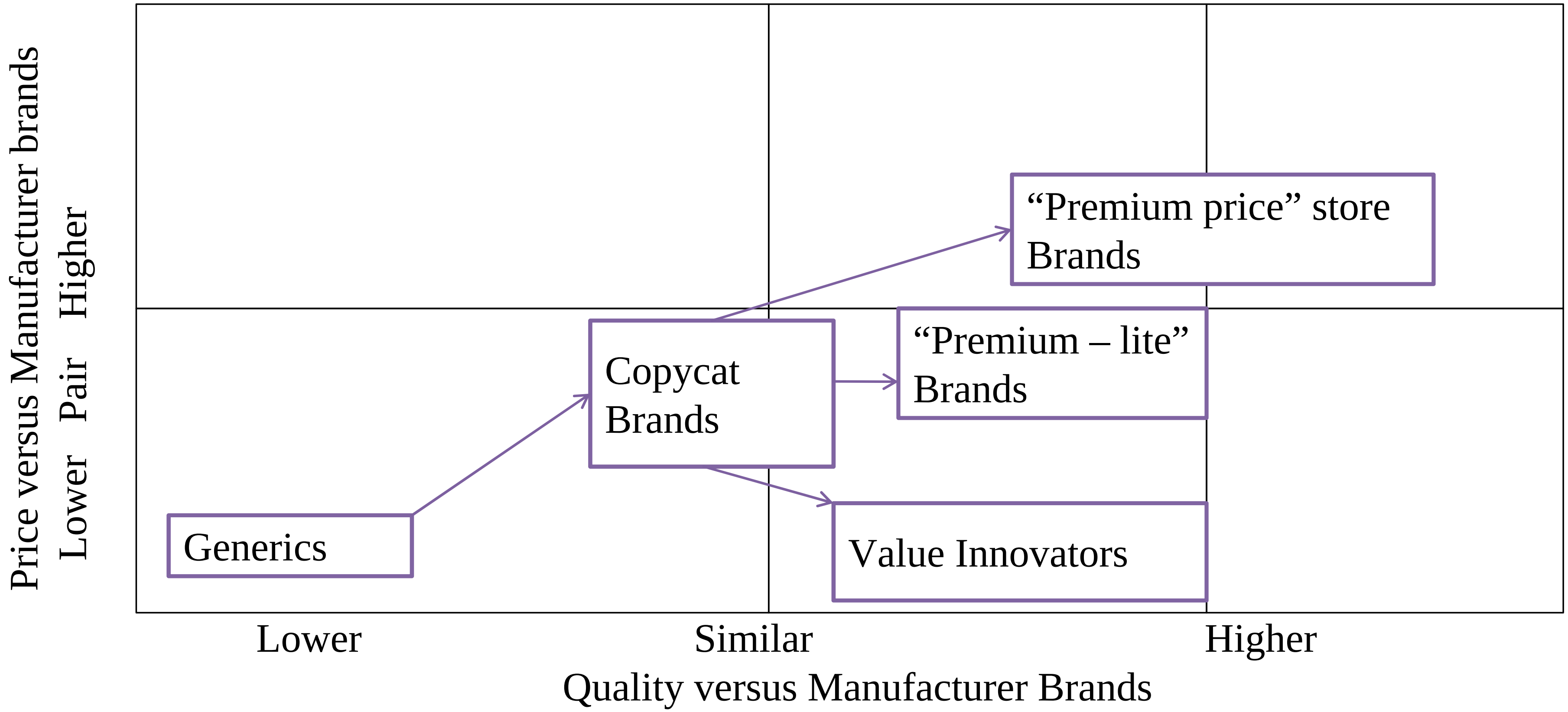
Private Labels (or Private Brands) are Brands owned by wholesalers or retailers.

Brands owned by a manufacturer (or a producer) are referred to as Manufacturer or National Brands.

There are many types of PLs – some are:

- Generic Private Labels
- Copycat Brands
- Premium Store Brands
- Value Innovators

Private Labels Evolution



Source: Recreated from Kumar and Steenkamp (2007) Private Label Strategy

Do Retailers Benefit From Private Labels?

1) Higher margins – high performances;
   - ❑ Lower prices BUT lower marketing cost;
   - ❑ High volumes;
2) Affirm store/chain image;
3) Store/chain loyalty though brand loyalty.

<u>IMPORTANT</u>

Historically, motivation 1) was the main determinant for the creation and introduction of PLs. In the modern competitive environment 2) and 3) are more important.

What does this imply?

PLs Diffusion

- PL performance and share strongest in commodity categories.
  - Among food products: Canned vegetables, sugar & substitutes and other non perishables; refrigerated products (milk, fresh eggs).
  - Some Supermarket chains sell almost exclusively PLs milk

- PL share is the lowest among categories where

1) top brands invest heavily in marketing (ex: soda, candy, gum, beer)
2) high-level of innovation occurs (esx: detergents, deodorant, cosmetics)

PLs Diffusion

Price Gap with Manufacturer brands		
Low (< 30%)	Snacks and confectionery Cosmetics Baby food Alcoholic beverages	Paper, plastic and wraps Refrigerated Foods Frozen Foods Shelf-stable foods
High (> 30%)	Home care Non-alcoholic beverages Personal care	Pet food Health care Diapers Feminine hygiene
	Low (< 12 %)	High (> 12%)
	PL shares	

Source: Kumar and Steenkamp (2007) Private Label Strategy

Diffusion of PLs in Europe

Value Share of PLs

	Belgium	France	Germany	Italy	Netherland	Spain	UK
Dairy	48,7	-	41,5	-	30,5	21,2	67,0
Frozen Foods	59,8	40,9	46,4	21,0	25,7	46,3	46,3
Dry Foods	44,9	29,5	41,6	12,8	19,9	32,4	43,4
Bakery	25,7	14,0	28,3	-	14,2	16,3	18,8
Soft Drinks	39,8	19,8	23,1	11,5	11,9	18,1	47,1
Alcoholic Beverages	23,4	18,3	23,4	3,7	14,8	19,6	29,6
Pet Food	49,8	-	46,8	24,6	24,4	41,5	16,3

Source: PLMA Yearbook –2001

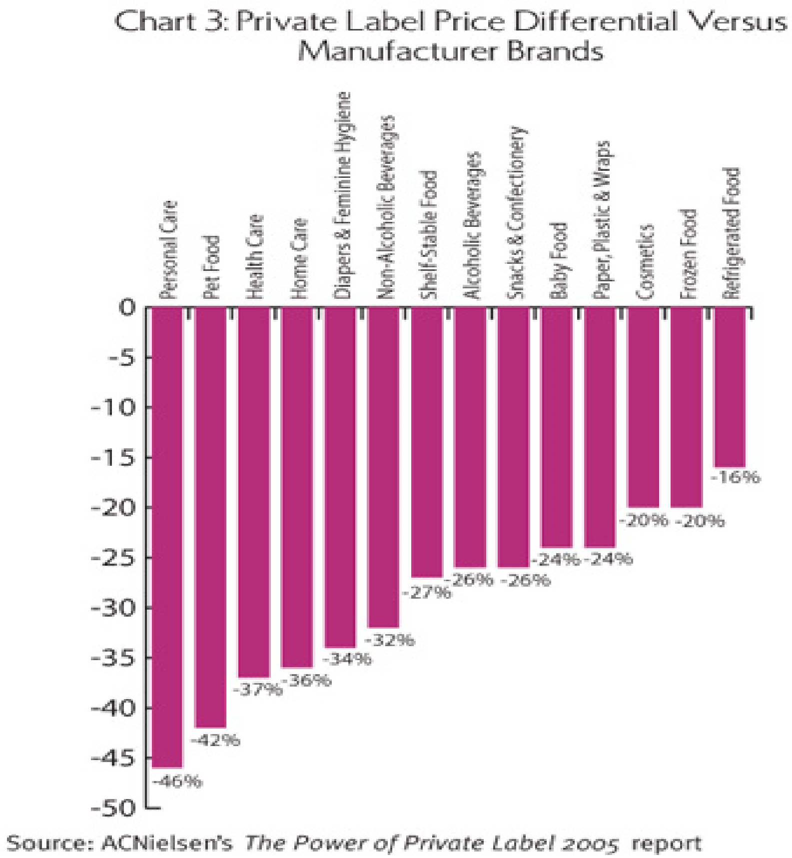
Market share of top four producers (CR4), retailers' private labels, craft production and no-label products in Europe, 2001

Products	CR4 (%)	Private label (%)	Craft production (%)	No-label products
Chewing-gum	75,8	1,6		
Savoury biscuits	68,5	20,1		
Articifial sweeteners	66,0	12,6		
Soft drinks	64,0	15,7		
Ice cream	58,3	14,7	11,2	
Dairy spreads	56,3	8,8		
Melted cheese	54,3	12,6		
Sweet biscuits	47,9	22,4	0,3	
Sugar	41,7	15,9		
Dry pasta	38,2	23,7	2,4	
Sugar confectionery	35,1	14,7	0,1	0,2
Frozen prepared meat	31,2	19,7	1,1	
Natural cheese	30,1	16,7	1,0	1,8
Delicatessen	26,1	20,4	15,1	13,4
Butter	26,5	21,2	3,1	
Flour	25,6	32,1	9,7	
Beef	19,4	15,2	69,1	
Poultry	18,1	14,8	31,9	
Pork	14,0	10,3	69,6	
Bread	12,1	22,7	53,6	

Notes: Craft production is defined as direct sales from producer to consumer (e.g. bakeries, delicatessen). No-label products are low-cost generic products sold without any branding. Countries covered are the EU15, Switzerland and Norway.
Source: 'Food for Thought' database (2003), reproduced in Palpacuer and Tozanli (2008)

Source: Bukeviciute et al.(2009) "The functioning of the food supply chain and its effect on food prices in the European Union" Page 11

What About Prices?



- Are PLs prices ALWAYS lower?

Not really….

- Premium PLs [organic, PDO products]
  - Some retailers do not sell manufacturer brands in certain categories
  - In other cases the PLs may have higher quality than MBs

Pros and Cons of Producing Private Labels

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- More sales
- Fully exploit underutilized production capacity
- Have stronger/better ties with retail chains
- Access to different consumers
- Less risk to be “dropped”
- Have (direct or indirect) access to marketing information
- Focus on production and less on marketing can be an advantage for small companies
- More flexibility in handling input quality fluctuations

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- Sales cannibalization (if Dual Branding is in place)
- Manufacturers have little (if any) control over price
- Performances of manufacturer brands may be put in jeopardy
- Retailers have high level of control over quality and volumes
- Less flexibility in making marketing decisions
- Diversion of R&D resources

Take-home messages

- Increased consolidation leads to larger, differentiated stores, providing more services (quality / variety) and able to exercise market power with respect to their suppliers

- A fringe od smaller stores which differentiate themselves in quality (horizontally) also emerges.

- Production of PLs can also result in increased competition (lower prices) beneficial for consumers, but it may lead to additional market power for retailers