

# Food for thought

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## Redefining the Own-Label Market: the Battle for Shelf Space

*This extract from Retail & Consumer Outlook - Australia 2005 and Beyond\* shows how Australian grocery retailers are looking to own-label growth to boost margins in a mature market, and how much of this growth will be driven by the development of new premium own-label ranges - with a major impact on their suppliers.*

*We think the themes and issues addressed will also resonate with companies in other country markets, whether their competitive landscape has already been affected by significant growth in own-label products, or is likely to be in the near future.*

### Introduction

The owners of Australian consumer goods brands face an unprecedented challenge to their business over the next three years. Premium own-label products, like those now dominating UK grocery retailers' shelves, are on the way.

The UK grocery retail market has already undergone its own-label revolution, and that experience can reveal important lessons for the Australian market. As in Australia, the UK market is highly concentrated, real estate and labour are expensive and as a consequence extremely low margins are not sustainable. Premium own-label products have played a key part in improving margins and helping UK grocery retailers in their battle for market share and growth.

The move to premium own-labels will not happen overnight in Australia, but it is coming, and it will have a huge impact on national brands. The time to act is now – only the well prepared will survive.

### The outlook

- Australian grocery retailers are looking for ways to improve margins in addition to cutting costs, and will turn to own-label products to boost profits

\* Retail & Consumer Outlook - Australia 2005 and Beyond is available by request at [www.pwc.com/au/rc-outlook](http://www.pwc.com/au/rc-outlook).



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- The market share of own-label products will at least double within five years, following the example set by British supermarkets
- Growth in own-label sales will hurt independent brands by reducing the number of national brands, slashing their market share and pushing some producers from the market

## Preparing for the grocery revolution

To meet the market's growth expectations, Australian retailers like Coles and Woolworths are looking to boost their margins by increasing own-label revenue.

During 2004, Woolworths shares traded at an overall price-to-earnings ratio of 22.3 and Coles traded at 21. So what are the options to achieve continued earnings growth? Organic top line growth? This is proving increasingly difficult. It is hard for such large retailers to consistently exceed GDP growth for sustained periods without increasing market share – and the Australian Competition and Consumer Commission has made it clear it is already concerned about the market dominance of the larger retailers.

What about overseas growth? While there have been some notable successes in the push for overseas growth, there is considerable risk associated with this, and the history of consumer retailing is littered with the corpses of unsuccessful initiatives in this area from some of the world's best retailers. Many failed to export their own highly successful formats, then made mistakes regarding overseas

acquisitions and later struggled to export their management, knowledge and systems.

Initiatives now laid to rest include Marks & Spencer's entry into Canada as a test market for the US, and its eventual acquisition of Kings supermarkets in the US was followed by several unsuccessful attempts to sell the operation. Sainsbury's sold Shaw's, its US arm, in 2004. The list of unsuccessful overseas ventures is a long one, so our own retailers are unlikely to defy this history.

What about earnings growth through further cost reductions?

Yes, cost reduction programs will continue, and further savings will be found. For example, Woolworths' Project Refresh has already saved a reported \$3.2 billion in costs<sup>1</sup>, and it is confident that further savings will be realised.

However, the grocery retailers are looking to add to the margin improvements gained from cost savings by increasing revenues from own-label products in order to meet ambitious earnings growth expectations.

### Premium own-labels are the next big thing

In Australia, own-label products already comprise 19 per cent of volume – however they only constitute an estimated 10-12 per cent of value, because the current lines are mostly designed to appeal to the price-conscious. The creation of premium own-label brands will see this formula reversed by creating high-value, high quality products that are

designed to appeal to a greater range of customers. In the UK, premium own-label brands are sometimes more expensive than many national brands, and have redefined the market.

In the UK, where own-label products are estimated to account for over 50 per cent of grocery sales in the top three supermarkets<sup>2</sup>, leading retailers such as Tesco and Sainsbury's have a portfolio of own-label ranges aimed at different consumer segments.

The low-cost products in their 'Value' and 'Low Price' ranges account for 10 per cent or less of their total own-label lines (which number over 12,000 and around 3,500 respectively), with their premium 'Finest' and 'Taste the Difference' and organic, health-focused, and 'fair trade' lines accounting for a larger share. And the customer segments targeted by these ranges are not necessarily mutually exclusive – Tesco claims that 37 per cent of its customers buy both 'Finest' and 'Value' products.<sup>3</sup>

In June 2003, Coles told The Australian Financial Review it was planning to increase private label sales from 8 per cent to 16 per cent by mid-2006. More recently it updated its forecast to 30 per cent by mid-2007, and also said it would clear 15 per cent of dry grocery shelf space in 2005 to make way for its new own-label products. In March 2005 it also announced a three-tier own-label strategy, with products grouped in discount (Coles \$mart Buy), mid-price (You'll Love Coles)

1) Woolworths half-year profit announcement, February 2005

2) Mintel, 2005

3) Tesco Plc 2004 Annual Review

and premium (George J Coles) ranges to target different segments.

Woolworths is moving in the same direction. It has introduced a wide range of consistent own-label packaging in the fresh food produce section since mid-2004, and is developing a premium own-label range to be rolled out in 2005.<sup>4</sup> Both retailers emphasise the high quality of their premium own-label ranges as well as price competitiveness when compared with branded products.

Consumers are savvy buyers. Presented with an attractively packaged, first-class product at a price that reflects the savings made by having low marketing, advertising, promotion and selling costs, UK shoppers have taken quality own-label brands to heart. This shows consumers' growing awareness of what they are paying for and what brands are about.

Margins for retailers on own-label brands are approximately 6–15 percentage points better than on national brands. That is huge in a business that survives on 3–6 per cent net margins. It is simply irresistible.

### **It won't happen overnight**

We are not saying the switch to own-label brands will happen overnight. It takes significant investment and skill to do what Sainsbury's and Tesco have done. For example, back in the mid-1980s, Tesco was already employing more food technologists to design its frozen pizza recipe than the national brand leader. To add insult to injury, taste-testing

found that consumers preferred Tesco's product over the national brand.

This has enormous implications for branded manufacturers.

### **Existing brands pushed to the wall**

The market is a cruel place sometimes. This is what we expect to happen:

First, the number of national brands will shrink, especially the number three and four products in the market. While there has already been a decline, the forthcoming shakeout will be like the effect of the first supermarkets on the corner shop scene. Coles' 15 per cent cutback to dry shelf space for national brands is only the start.

Second, if the experience of the UK holds true in Australia, the market shares of surviving national brands will decline. Between 1982 and 1990 national brands lost market share, falling from 53 per cent to 33 per cent of total consumer food spending in the UK<sup>5</sup>, as consumer preferences changed in favour of the growing own-label product ranges and eating out more often. Since then, premium own-label products have squeezed the national brands even further, dominating some food categories and increasing competition in others.

Third, survivors' margins will come under intense pressure as diseconomies of scale bite into profits from lower manufacturing and distribution volumes and higher marketing and fixed costs.

### **So what's new?**

It could be argued that Australia has had own-label products for years without such drastic change, and that premium own-label brands haven't taken off in other Western markets like the United States.

However, the Australian grocery retailing market has more in common with the UK market – both are dominated by a small number of major players, real estate and labour are expensive, and as a consequence extremely low margins are not sustainable. UK retailers looked beyond the budget product market and focused on developing premium own-label products, which enabled them to successfully compete with the leading brands.

The Australian majors' stated strategy is very similar, and this new focus on high quality own-label product is very different from their earlier efforts to build up own-label ranges.

Franklins' rise in the early 1980s hit the larger retailers hard. Coles and Woolworths diverted effort away from their own-label strategies as a result of Franklins' price discounting strategy, and focused instead on internal cost savings. Even when Franklins stumbled, they continued their focus on internal cost savings to lower the risk of being caught out in another price war should low-cost operators like ALDI or Costco turn up on their doorstep. In fact ALDI is already here, and Costco may yet decide to enter the Australian market. How will Coles and Woolworths defend their market shares against these low-price and low-cost operators? Largely by building loyalty to their quality own-label brands.

<sup>4</sup> Woolworths half-year profit announcement, February 2005

<sup>5</sup> "Marketing's mid-life crisis", McKinsey Quarterly, 1993

We believe that the crunch is coming and independent manufacturers need to prepare for it.

## Conclusion

The universe of independent brand manufacturers in Australia is about to be shaken by a proven competitor – premium store own-label brands. Consumer goods manufacturers will have to take a hard look at whether survival is possible in this brave new world.

Quality own-label brands have helped – or forced – UK manufacturers to get back to basics and challenge themselves to find how they really add value that consumers appreciate and, more importantly, are prepared to pay for.

They are stronger as a result, but they have had to change many things about what and how they sell, and relearn some of the marketing 101 lessons about creating and maintaining brands

Consumer goods companies face a range of hard choices. Some will make a dignified exit by selling or licensing their brands, while others will be looking to take up licences and buy brands to give them enough scale to stay competitive. Or, “if you can’t beat ’em join ’em”: many will settle for a new life as own-label suppliers.

## The way I see it

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The landscape of the UK food retail market has changed dramatically

over the last ten years. Due to significant retailer consolidation, the major players – Tesco, ASDA and Sainsbury’s – now account for 60 per cent of the UK main grocery shopping market.<sup>1</sup>

Further consolidation in the sector is now unlikely, given competition concerns, and new stores are less easy to build because of planning restrictions. Price competition on staple goods such as bread and milk has now brought prices to previously unheard-of lows; significant costs have also been taken out of the supply chain. Combine these factors with an unenviable track record in opening up new foreign markets, and you can see why the retailers have prioritised leveraging maximum value from their existing UK store footprint.

In recent years these retailers have changed from being passive landlords of shelf space to being aggressive category managers, focused on capturing the maximum value from customers’ store visits. Technology, via loyalty card information, is playing an important role in better understanding customer buying preferences. Arguably the biggest change in the UK grocery market however has been the way in which retail brands have been leveraged.

Own-label brands started as economy or low-cost retailer branded products in the early 1990s. However, the retailers quickly realised the relatively limited nature of low-cost economy own label, and began to apply sophisticated brand management techniques (ironically

once the preserve of the FMCG manufacturer) to build premium and value-adding sub-brands. By 2005 these own-label brands had metamorphosed into a segmented portfolio of sub-brands providing a differentiated proposition for alternative price points, product quality, organic produce, alternative dietary needs, healthy eating and fair trade consumers. In addition, advertising expenditure on own brands has increased from zero to £5.5 million in 2004, and we conservatively expect this figure to double in the next few years.

These brands have been skilfully developed in a number of categories where significant growth potential exists. For example, in recent years the expansion of own-label penetration has been largely gained from the chilled categories – upmarket, healthy and fresh products where consumers are prepared to pay a premium, and where no incumbent brands were established. The most successful premium brand, Tesco’s Finest (which now boasts sales in excess of £500 million) has also recently been launched into non-food areas such as clothing, white goods and homewares.

The development of these sophisticated own brands has brought significant financial benefits for the retailers, and has permanently changed the balance of power between manufacturer and retailer. Manufacturers have had to reassess their competitive strategies as a result. Shelf space is now more under threat and often it will only be profitable to remain on the shelf if you are either the number one or two brand. Retailers will require considerable payment from manufacturers to maintain these

<sup>1</sup> BMRB/ Mintel 2004

listings, as well as generous funding for any promotional activities.

Manufacturers have responded by picking 'battleground' categories carefully, heavily investing in 'power brands' and discarding underperforming brands. The increased investment in 'power brands' is exemplified by large increases in media and promotional spend, and more aggressive innovation strategies to maintain competitive positioning. The winners are still dominating their categories, the losers are now

looking to divest brand ownership and concentrate on own label manufacture.

Despite the own brands' considerable success, not all categories are dominated by them – recent research has shown that while own label penetration is high in the canned vegetable, dried fruit and pasta categories, manufacturer brands continue to dominate in cooking sauces, crisps, snacks, sugar and soup categories.

In the UK we expect the march of the premium own brands to

continue apace. The retailers are now acquiring the brand management skills that they require and are managing these brands as separate assets. And the consumer's desire for own-label shows no sign of abating – since 1999 own-label consumption has increased by 18 per cent.

In future, we may see own brands with their own retail outlets, as in the case of George (the ASDA clothing brand) – or even retailers stocking other retailers' own brands.

## Take action

### Play the game by the new rules

- Rethink manufacturing basics, including whether investment in assets allocated to manufacturing and distribution should be reinvested in branding
- Look for more transparency when negotiating trading terms to ensure that any trade-off delivers benefits
- Pick your battles carefully – identify which products and brands you should support and invest in, and rationalise the others

### Get shipshape

- Ensure every stock-keeping unit (SKU) sold is profitable – frequently up to 30 per cent of consumer goods companies SKUs make zero or negative contributions
- Improve cost accounting systems and overhead allocation, particularly where big brands or SKUs are being penalised and small ones are being subsidised

### Build sustainable brands

- Aim all brands at the number one or two market spots to ensure they can survive and if that's not feasible, consider exit options
- Build real brand equity through brand loyalty rather than turning customers into promotion junkies who switch brands according to the latest special offer
- Consider becoming an own-label manufacturer – even if an earlier decision not to do this was taken

### Rethink marketing

- Examine whether it is still affordable to support brands through meaningful levels of advertising and promotion in the face of rising media costs and channel proliferation
- Avoid ever-diminishing consumer impact at ever-increasing traditional media prices by ensuring that the marketing department is not just reinforcing old sales, marketing and distribution silos
- Keep a close check on the return on investment from marketing spending by using accurate measurement systems
- If necessary, sell or license one or more brands to someone better positioned to market them

### Innovate or fail

- Emulate the truly great brands that survive through continual innovation. Examples in recent years have included detergents in tablets, toothpaste that whitens and triple-bladed razors for a closer shave
- Ensure that a significant proportion of current sales come from products introduced relatively recently – or risk falling behind the curve

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