A Food product manufacturing and retailing

A.1 Introduction

A.1.1 In the main sections of the thesis we discussed the structure and orientation of value creation and the relation between value creation and business processes. In this chapter we will apply the insights developed in the previous chapters to the evolution of the food retailing and industry in Holland in general, and a number of Dutch companies in this sector in particular.

A.1.2 In this appendix we will not attempt to formulate strategic recommendations for these companies. We will merely illustrate the way each in which sector evolves in time within the context of the framework and terminology we have developed in the previous chapters, in order to illustrate the applicability and the relevance of our insights.

A.2 Branded food products

A.2.1 The evolution of this industry is described along the broad lines of history. The evolution in the branded food products sector can be divided in a number of phases, along the lines of our development matrix (see Chapter 3.9, Figure 3.8):

- The early developments (1900-1960);
- Growing industrialisation (1960-1980);
- Heterogeneous diversification (1970-1995);
- Stagnation and new directions (from 1995 onwards).

A.2.2 In this description the phases of development as were discussed in Chapter 3 (see Figure A-1) are becoming clearly recognisable.

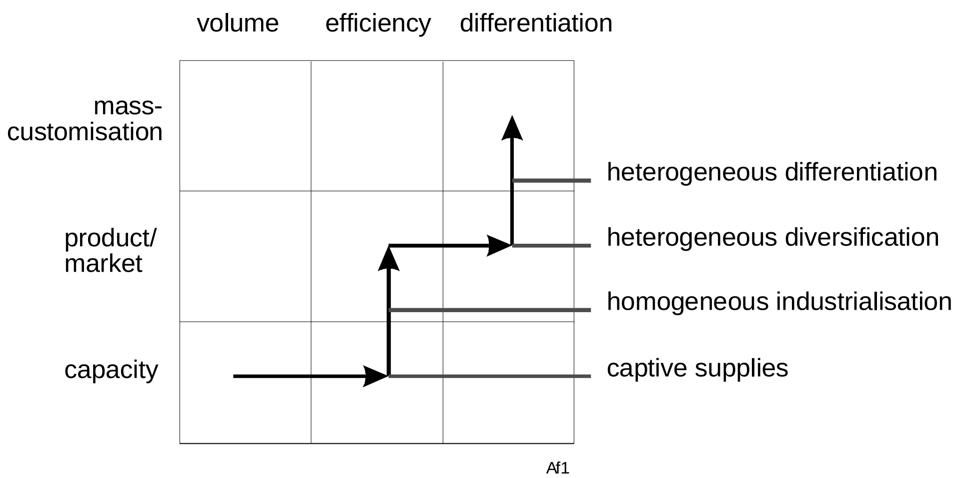

Figure A-1: Business Evolution Grid food products sector

1900 - 1960:

Early development of branded food products

A.2.3 At the beginning of this century the early retailers were craftsman-type shops which sold raw materials from open containers such as coffee, tea, cocoa and spices. These ingredients were not obtained from industrial companies but were bought from traders. From 1920 to 1960 these craft-type retailers gradually evolved into chains of self-service shops. With this development the fragmentation of the retail market has gradually disappeared.

A.2.4 This movement from craftsman-type retail shops to self-service shops has made it necessary to pre-pack the ingredients, in other words the supply chain had to be industrialised. A number of retailers have translated this necessity into the foundation of proprietary factories. In the Netherlands De Gruyter and Albert Heijn are examples of this. In France it is companies such as Casino and in Switzerland companies such as Migros have operated in a similar way.

A.2.5 In the early days these factories did not have a true brand identity and when there were brands, the product name was mostly synonymous with the brand name. Examples of such products are Maggi, Aspirin, Nescafe, Douwe Egberts, Van Nelle, etc. In so far as brand names existed they marked the difference between proprietary products, manufactured by the retailer itself, and products which were manufactured by third parties. The shops themselves existed merely to sell the production of their own factories in the marketplace.

A.2.6 The rise of these factories meant a strong industrialisation in the supply chain of the products, where economies of scale enable large efficiency benefits. In the relation between the retailer and the suppliers the supply side developed a strong concentration of power, dictating mandatory (on the penalty of not being delivered, or, for a period of time, even legally sanctioned) market prices to the retailers. In the latter phase of this development the proprietary (retailers) factories offered a protection against the excesses which grew out of the vertical price control as exercised by external suppliers.

1960 - 1980:

A growing industrialisation

A.2.7 In the period from 1960 to 1980 industrialisation accelerated in this sector. Parallel to the evolution of retailers developing towards chains of supermarkets, they largely abandoned their proprietary manufacturing. The retail concept itself has an independent value creating function and it appears to be possible within the chain to create sufficient specialisation and competitive distinction.

A.2.8 This abandoning proprietary production has not been easy for all of the retailers. Many could not adjust to the idea that shops were not there to sell their own products, and adhered too long to the dogma of proprietary production. In the Netherlands for example this caused the demise of De Gruyter supermarket chain.

A.2.9 On the supplier side, professional product management came up, especially Ansoff's ideas about product management strategy which were published in the sixties. His theory about product/market segmentation and the corresponding concept of brand competition has found a place in the strategic vocabulary of the suppliers. This laid the foundation for the large food brand companies which were to emerge later.

A.2.10 Especially during this period, new branded food products were created on a large scale and such companies grew primarily by acquisition and by focusing on the primary process efficiencies created through automation and mechanisation. Heineken, Unilever, and Procter & Gamble are prime examples of companies that showed developments along these lines.

A.2.11 In the latter part of this development, in the competition of these products in the various market segments not only efficiency differences but also quality differences became apparent. A strong quality improvement in the area of the branded food products manufacturing led to a strong distinction from the proprietary brands of the retailers, which gradually landed on the bottom shelves of the assortment.

A.2.12 The traditional vertical price control that went with the period before was substituted by the creation of low end products under the retail brand name by the very same branded food products manufacturers. For the manufacturers this possibility was interesting because it meant filling excess capacity and so ensuring that their manufacturing volume remained above break-even point.

1970 - 1995:

Heterogeneous diversification

A.2.13 In the period from 1970 to 1995 the shift in emphasis towards quality and the further refinement in product market segmentation subsequently led to heterogeneous diversification on a large scale. Retailers abandoned a relatively simple supermarket concept for a one-stop shopping concept, and the more sophisticated retailers added fresh products to their assortment. This had been impossible before, because of the limited lifetime of such products.

A.2.14 The ever-increasing fragmentation of product/market segments increased the need to create brand names as the basis for distinction from competitors. Although the brand name initially represented the image of quality of the products linked to this brand, it evolved more and more towards an independent identity in the psychology of the client. However, the link to product quality remained important, and there are examples of branded products, for instance Pampers, which have gradually became a hollow brand because they lost their advantage in product quality. The accent in value creation shifts more and more towards the ability of branded articles to create a margin based on image and therefore differentiation develops into the primary value creating mechanism.

1995:

From stagnation to where?

A.2.15 In the middle of the nineties the end of this heterogeneous diversification has become visible which could lead to a structural stagnation in the value creation of branded articles. If we look at the three basic components of value creation: volume, efficiency and differentiation, we see this structural stagnation in all of them:

- *Volume*
  As for volume we are reaching a consumption ceiling in most Western European countries. More wealth does not lead to an increase in consumption volume; therefore, the markets are structurally limited in their volume growth.
  The growth in the large retail chains is largely based on diversification and parallelisation" [i] of the market. If we look at suppliers this means that they can only grow at the expense of competitors, and that in fact the market has become a substitution market. Large oligopolies in branded dominated groups of articles are more and more setting the scene on the supplier side.

- *Efficiency*
  From an efficiency perspective, the production costs are now almost completely based on primary factor costs. The production cost of marmalade is largely determined by the raw materials cost, energy consumption and the minimised labour content of the manufacturing process, transport costs, etc. In a general sense these factors are equal for all manufacturers, and they no longer create a base for structural cost advantages.
  For the time being, room for further improvement in efficiency can especially be found in two areas. In the first place, there are still possibilities to improve the logistical connections between retailers and suppliers.
  At this moment projects under the banner 'effective customer response (ECR)' are undertaken all over world to reduce the supply chain costs even further. A second area with scope for efficiency improvement is an increase of the productivity of the indirect organisation at the supplier side (as well as with the retailers) through the use of modern information technology, and a new structure and instrumentation of the supporting processes.
  With respect to these efficiency possibilities, there is an undercurrent of exogenous pressure on costs, that will continue to put negative pressure on efficiency, e.g. energy costs, labour costs, environmental costs, etc. In addition, many of the branded food manufacturers have become so big that the volume-based economies of scale can hardly be obtained. Many of these companies are continuously confronted with over-capacity, due to volatile volume shifts in the substitution markets in which they operate. Due to the disadvantages from other utilisation, some food manufacturers are continuously pressed to manufacture for retailers.

- *Differentiation*
  As regards the differentiation side of these companies, signs of stagnation are developing. The further heterogenisation of the assortment leads to an explosive growth in the number of different articles produced. The physical limitations of space in the outlets increases the battle for a place on the shelf. The shops are simply getting full.
  Whereas the retail brands were traditionally positioned at the bottom of the assortment, a strong evolution towards higher quality levels has taken place. Some of these retail brands are now approaching the position of the A-brands in terms of market position. These high quality retail brands, (e.g. Albert Heijn's Culinary Soups and Traiteur Meals, Loblaws' President Choice, Virgin Coke) exert a downward pressure on the price-creating ability of A-brands and jeopardise any future differentiation. The creation of A-brands increasingly demands large investments, not only in product quality and product and process technology, but also in marketing, in terms of branding and brand identity of the product. This constant increase of investments and the decrease in scope for further product-based differentiation are creating the dangerous situation of diminishing returns on such imported investments for a number of branded food suppliers.
  Finally, the evolution towards ever-higher levels of sophistication in the branded products area in recent years has again created a hole at the bottom of the assortment. Smaller suppliers who specialise in products that still have a quite acceptable quality are now filling this hole.
  In an attempt to close the hole at the bottom of the assortment, a number of branded suppliers are now introducing so-called fighting brands from a defensive point of view; they are low-priced products of moderate quality for the bottom of the assortment. This introduction conflicts with a further increase of the differentiation level of the A-brands. In other words, branded product manufacturers increasingly find themselves between a rock and a hard place in terms of value creation. There is only limited scope for creating value in both the supply chain, based on effective customer response and business process redesign, and in economies of scale, on the basis of concentrating manufacturing capacity on a European scale.

A.2.16 For the long term, one can predict that unless a breakthrough occurs towards mass individualisation, the emphasis in the interaction between retailers and suppliers will be increasingly on the zero sum aspects and with that the balance of power between retailers and suppliers will also change.

A.2.17 Suppliers are played off against each other and retailers are increasingly capable of exercising their power over the suppliers. This increase in aggression is clearly demonstrated by the recent fight between Procter & Gamble and Unilever over the introduction of Omo Power, an aggression which not just manifested itself in the battle between those two competing suppliers, but also in the way this battle was fought with the retailers. However, in the long term for branded food manufacturers differentiation is the only way out.

A.3 The fresh sector

A.3.1 So far we have been looking at the branded food products. However, in modern retail formulas fresh products have become a very prominent factor. The evolution in this group has developed along completely different lines compared to the branded food products described before.

A.3.2 The availability of this part of the assortment is much more recent than that of the branded food products, and the interaction between retailers and supplier has had its own development. Necessarily so, as there is an essential difference between groceries and fresh products with respect to their life cycle. The industrial bulk logistics that for efficiency reasons are used in the grocery industry are for that reason inadequate for fresh products.

A.3.3 The interaction between retailers and suppliers in the fresh sector has from the outset been strongly focused on the integration of logistic change, in order to achieve the shortest possible throughput-time. Co-logistic with suppliers in the grocery sphere is only at the beginning of its evolution, but in the chain of fresh products it has already reached a high level of sophistication.

A.3.4 On the other hand the product itself is still in its conception very much oriented towards craftsman and raw materials, just like in the early phases of the branded food products in the grocery area.

A.3.5 Only recently some first careful attempts have been made to create branded products in the fresh area by means of processing and pre-processing (Chiquita, Dolmer, etc.), to create a larger, competitive distinction in levels of differentiation. This strong orientation of co-logistics and co-operation with the supplier side has led to a very concentrated, harmonious co-operation between retailers and suppliers in the fresh sector.

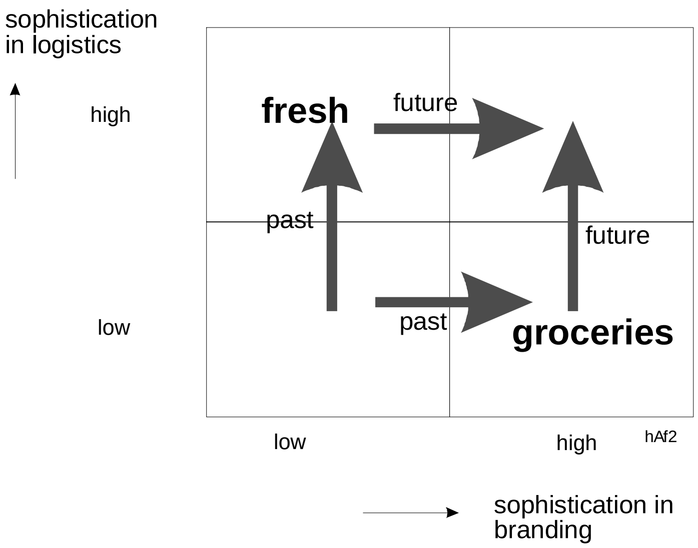

Figure A-2: Logistics versus branding sophistication

A.3.6 If we plot the level of logistics sophistication against the level of branding sophistication (see Figure A-2), we see that the fresh sector initially developed along the logistical line and it is only recently that a movement towards sophistication and branding became visible. With grocery articles the opposite is true. From an historical sophistication in branding, new ideas with respect to higher levels of logistical sophistication are now becoming manifest. Although their paths are completely different, the characteristics of fresh groups and grocery groups are converging. This means that the original distinction in organisation will gradually disappear.

A.4 Evolution of specific companies

A.4.1 There is a clear evolution in grocery products and retailing, from capacity through captive supplies to its homogeneous, industrial activities and from there towards a more heterogeneous range of products and product branding. Currently there are only limited possibilities for manufacturers to create further economic value in the future by growth in volume or efficiency. Differentiation seems to be the only way out, but it can no longer be achieved within the boundaries of product diversification and branding. New approaches are required, which will inevitably lead to mass individualisation.

A.4.2 If we project the general evolution as described above on the value creation of a number of companies concerned, these changes and shifts in the orientation of value creation become very visible.

Ahold

A.4.3 In Figure A-3 the evolution of differentiation and efficiency is shown for the Ahold company, which operates the biggest Dutch retail chain, Albert Heijn. Although the analysis has been carried out on the Ahold figures, the evolution of Albert Heijn shines through very neatly.

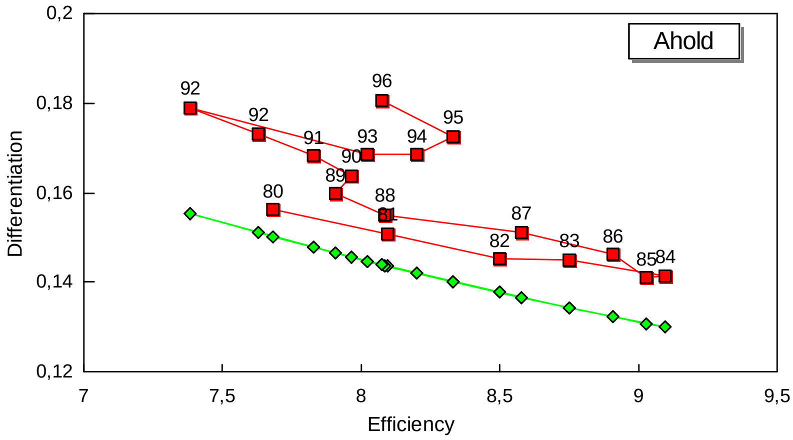

Figure A-3: “Ahold differentiation efficiency evolution’

A.4.4 In the early eighties the Dutch retail sector was at the end of a large-scale acquisition and concentration movement. Previously, large groups of companies were created by quiet take-overs.

A.4.5 Some companies, for example De Gruijter, disappeared because they could not detach themselves efficiently from their manufacturing structure. In this period Albert Heijn came to the conclusion that the level of its cost structure was too high to remain competitive and began an immense internal and external overhaul to lower its cost and price framework. This overhaul, which has become very famous in the Dutch retail branch under the slogan 'Albert Heijn gaat op de kleintjes letten' ('Albert Heijn is going to be penny-wise'), has created an erosion of differentiation (= price level) in the market. It has, however, also been very successful because the improvement of the company's efficiency during the period of 1980 - 1984 was larger than the equivalent loss of differentiation. On balance, even with dropping prices, Albert Heijn came out substantially better in 1984 than in 1980. It was able to sustain its growth in terms of market volume, partly thanks to diversification through effective competition with smaller retailers and specialised grocery stores, many of which disappeared in large groups during that period, and partly by acquiring market share from competitive retail chains.

A.4.6 Yet, Albert Heijn's growth in value creation was substantially higher than could be explained from the volume developments in the market. Around 1985 the company achieved the end of that evolution unobtrusively and then decided to put more emphasis on quality of supermarkets. Massive effort was placed into developing more sophisticated supermarket formulas under the banner of 'one stop shopping'. This evolution has reversed the development of both differentiation and efficiency and, on balance, Albert Heijn managed to boost its differentiation level back to the position of 1980 and even beyond that, without the corresponding loss in efficiency. Again, it was capable of translating the strategic movement into corporate value.

A.4.7 Admittedly, the fact that the development towards differentiation was aided by the positive developments of the Dutch economy as a whole in the latter part of the eighties and the fact that their striving towards efficiency was aided by the control the government over minimum wages, does not prevail the market shift in strategic emphasis in the middle of the eighties. However, it marked a point where around 1990 the question arose how to continue this evolution.

A.4.8 After extensive strategic study Albert Heijn decided in the early nineties that the road forward to Mass Individualisation is the only way in which the company could develop and that this evolution towards further levels of differentiation was incompatible with the current and existing structure of its business processes. The first results of this strategy are visible in the efficiency/differentiation graph. Firstly, the improvement of efficiency, largely by attacking the cost of complexity in the organisation, secondly the evolution towards still higher levels of differentiation as from 1993 onwards. It should be noted however that, especially the evolution of the US Ahold business, does have an influence on the financial performance as well. Nevertheless, the strategic evolution of Albert Heijn shows clearly in the graph.

Branded food product manufacturers

A.4.9 As the evolution of Ahold clearly shows the major steps in strategic development of the Albert Heijn the Dutch Albert Heijn retail chain, the move of the branded food product manufacturers towards higher levels of differentiation is visible in a number of Dutch food manufacturers. Most clearly these developments can be seen at CSM (sugar products manufacturing) and the Bols Wessanen Company, a merger between Lucas Bols (drinks) and

Wessanen (largely diaries and wheat products), which two companies merged in 1992.

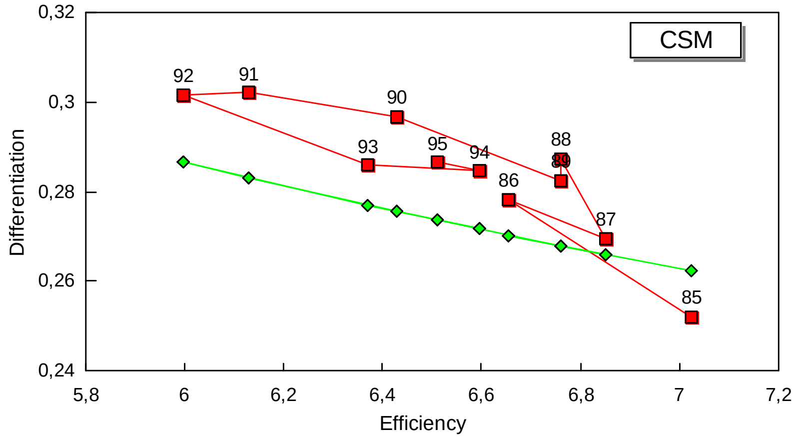

Figure A-4: CSM: differentiation-efficiency evolution

A.4.10 CSM (see Figure A-4) as over a long period of time being investing its cash flow from basic sugar refining into branded food products aiming at higher value added from quality branded products. On the whole this evolution has been successful from 1985 to 1991, as differentiation levels rose while sacrificing efficiency. Yet the exchange between the two was positive, and hence the cash flow per unit of volume has grown all through that period, with the exception of 1997.

A.4.11 As from 1992 however the company seems to hit a differentiation ceiling, with competition driving the price premium on the whole of the business down. Consequently of the period 1992 to 1994 the erosion of differentiation is counteracted by an improved efficiency, especially successful in '93 and '94. As from 1995 a company seems to moving towards differentiation again. Whether this evolution marks a strategic change in direction is yet too early to say.

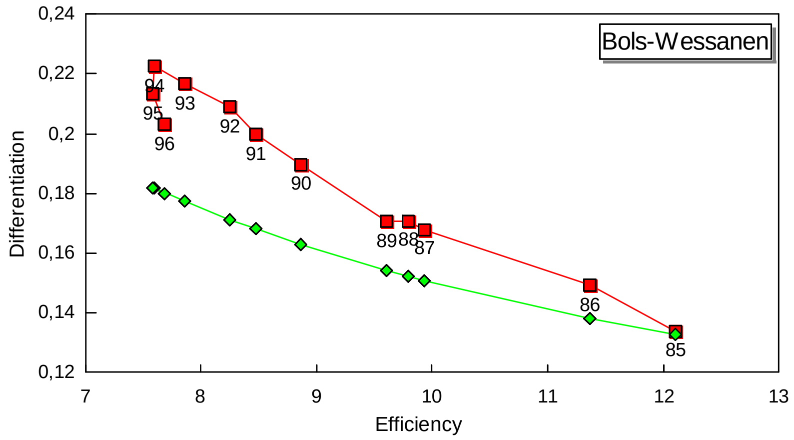

Figure A-5: Bols-Wessanen: differentiation-efficiency evolution

A.4.12 If we look to Figure A-5, showing the differentiation/efficiency development at Bols Wessanen, we clearly see the combined results of these companies [ii] moving towards higher differentiation levels and lower over an almost ten-year period (1995 to 1994).

A.4.13 Yet the success of this strategy seems to come to an abrupt halt in 1995, when differentiation levels drop at constant efficiency, which development is continued in 1996. And indeed the company has had to report to the market fairly dramatic drop in results.

A.4.14 Less clear, but still dominantly differentiation driven, are Unilever and Nutricia. With respect to Unilever (see Figure A-6) one sees a gradual evolution towards higher efficiency and differentiation levels, be it with very strong oscillations on the efficiency axis.

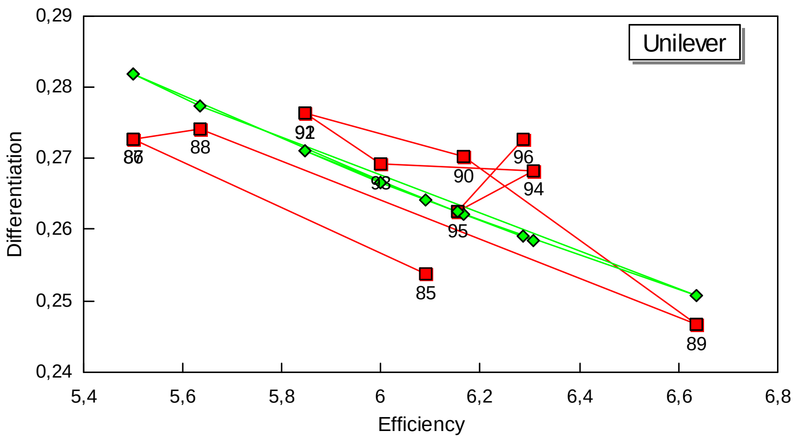

Figure A-6: Unilever: differentiation-efficiency evolution

Given the acquisitions and des-investments of Unilever, their business composition has changed quite considerably over that period of time, which change in composition might have caused some of the oscillations on the efficiency front. On the whole though, the strategy of Unilever towards higher differentiation levels, while improving efficiency as well is very visible from this graph.

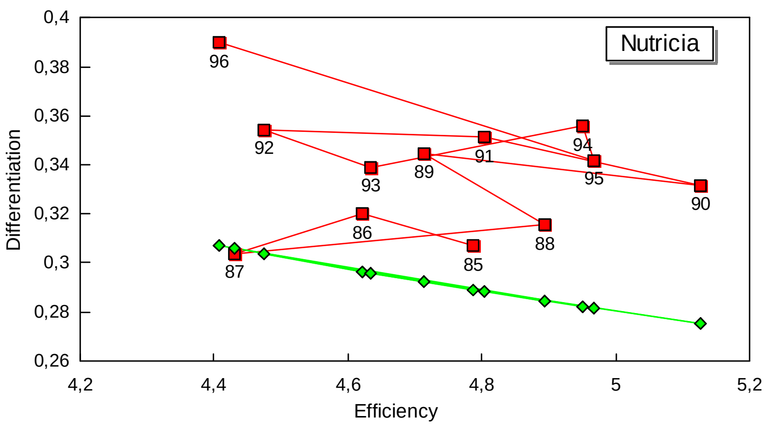

Figure A-7: Nutricia: differentiation-efficiency evolution

A.4.15 Something similar, although less influenced by changes in business composition, is visible in the differentiation/efficiency graph of Nutricia (see Figure A-7). Again, with strong oscillations in efficiency, the differentiation level of Nutricia rises. Not steadily, but a bit as an 'Echternach procession': two steps forward and one backward. Yet, on the whole, over more than a ten-year period Nutricia has been capable of boosting its differentiation while not losing substantial efficiency.

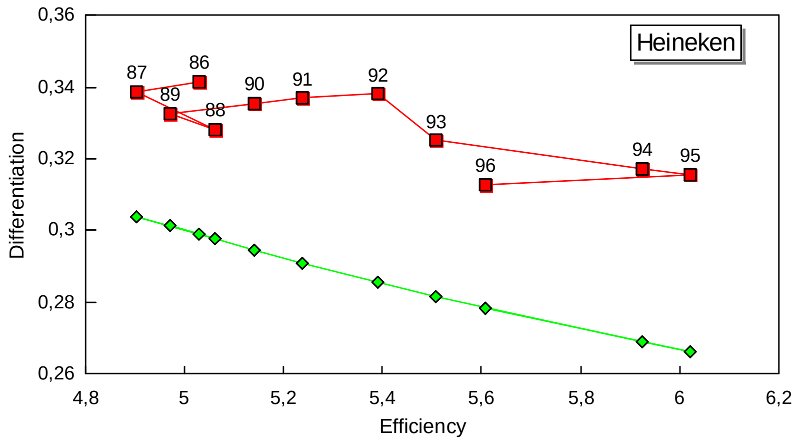

Figure A-8: Heineken: differentiation-efficiency evolution

A.4.16 The development of these companies is markedly different from the evolution of Heineken over the same period of time (see Figure A-8). In the interpretation of the Heineken results, one should be reminded that Heineken has expanded in this period substantially outside Europe. As a result, the picture does not reflect necessary the evolution of Heineken in the Western-European market. Nevertheless the company as a whole has placed strong emphasis on improving efficiency, while keeping its differentiation level in the market up. In 1996, Heineken suffers a dramatic drop in efficiency compared with 1995.

A.4.17 Even when we take account of the distortion caused by Heineken's international expansion, evolution of differentiation and efficiency of the company might reflect the relatively stagnant and increasingly competitive beer market, causing a ceiling in price premium for Heineken in its highly developed markets.

A.5 Conclusions

A.5.1 Looking at the food sector in the Netherlands, our model of phased evolution closely matches the historical development of both retailers as well as manufacturers. If we look to the more recent period, and use our differentiation and efficiency analyses in order to judge the strategic orientation of the value creation, most of the companies show emphasis on differentiation, while loosing or struggling with efficiency. This is consistent with the more qualitative description in the first section of this appendix on the relative state of the industry in its evolution towards more and more heterogeneity.

A.5.2 The only exception to this seems to be the Heineken Beer Company, and this might reflect the stagnation of value creation as can be predicted on the phased evolution in advanced markets. It could though be caused by distortions of the figures from Heineken's non-European business. In this respect the Heineken case is inconclusive.

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[i] Parallellisation is the term which is used to describe the taking over of the small, specialist, retailer business by the large national supermarket-chains.

[ii] The years before '92 were calculated by adding the financial results of both companies.