



COMPETITIVENESS & SUSTAINABLE GROWTH

Challenges for the Australian food and grocery industry

JUNE 2013



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Australian Food and Grocery Council

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1 Executive Summary

This report provides a fact-based overview of the financial performance of the Australian food and grocery industry¹, which represented 27.9 per cent of the Australian manufacturing industry in financial year (FY) 2010-2011, or \$110.7 billion in turnover, and employed 296,300 people in FY2011-2012.

The report is divided into three parts. The first is a high level overview of the key drivers for the industry. The second provides a detailed analysis of the data provided by 18 AFGC member organisations (the participants), which represent 18 per cent of the food and grocery manufacturing industry turnover. The analysis provides insight into the financial performance, channel dynamics and the key drivers of profitability. The third looks at two specific themes: the relative profitability of the participating group to international comparators and the comparison of the Australian manufacturing industry's cost base.

Industry developments:

The Australian economy has performed relatively well against other mature markets, however the manufacturing sector suffered as the contribution to gross domestic product declined by a total of 6.1 per cent between FY08 and FY12. Despite somewhat subdued consumer confidence the retail sector and in particular the supermarket sector remains resilient and has continued to grow at 4.5 per cent per annum between FY08 and FY12².

However, the food and grocery manufacturing industry declined by 2.2 per cent between FY09 and FY11. This was driven by a number of key drivers. The competitive retailer sector, which continues to engage in extended deep promotion activity supported by increased trade spend, development of in-store and direct source models, and the continued competitive pressure from lower cost imports.

Further, the Australian manufacturing industry's competitiveness is comparatively weak driven by high input costs (labour, fuel and raw materials), and is subject to a persistently strong Australian Dollar (AUD).

The food and grocery manufacturing industry is facing continued pressure to remain competitive and grow.

Key findings from this study:

The profitability of the participants over the last four years fell from 6.9 per cent in FY09 to nearly 5.7 per cent in FY12 as a percentage of gross sales.

Profitability was significantly impacted by gross sales levels contracting by 3.2 per cent in FY12, caused by declining sales volumes in the retail channel and the continued growth in trade spend. Trade spend of the participants increased from 19.5 per cent of gross sales in FY09 to 23.4 per cent in FY12 with no consequent lift in volumes.

Operating costs have remained relatively stable at 23 per cent of gross sales between FY09 and FY12. The analysis indicates that participants have taken measures to reduce cost structures through productivity improvements and in some cases plant closures and capacity reduction. Capital expenditure has continued to grow at 10% per annum between FY09 and FY12 mainly directed at cost reduction initiatives.

¹ The industry definition used in the State of the Industry report 2012 includes Food & Beverage manufacturing, Grocery Manufacturing and Fresh Produce Production

² Source: Australian Bureau of Statistics, catalogue number 8501.0

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The trend in marketing and Research and Development (R&D) spend has continued to decline between FY09 and FY12 from 4.5 per cent to 3.8 per cent and 0.6 per cent to 0.4 per cent as a percentage of gross sales respectively. Continued decline of investments in brands, innovation and R&D may have a further detrimental impact on the industry's growth and sustainability.

Key themes:

Pressure on profitability compared to global comparators

The performance of the participants was analysed against the performance of a sample set of international comparator organisations. The analysis found that the participants' performance on gross margin at 38 per cent³ is on par with the international comparators. However, the earnings before interest and taxes (EBIT) margin performance, however, was 2 per cent lower for the participant group compared to international comparators.

Declining cost competitiveness

According to the Competitive Alternatives Study 2012⁴, the cost of operating in Australia has been consistently increasing versus other mature markets; negatively impacting the competitiveness of the manufacturing industry in Australia. Key drivers included the relatively high cost of transportation, utilities, labour and rent, the strong AUD and the increasing regulatory burden compared to other regions in the study. Participant data also indicates a 2 per cent higher operating cost as percentage of net sales compared to the international comparator group between FY10 and FY12. This is impacted by the relatively small Australian domestic market, which provides limited opportunities for food and grocery manufacturers to generate scale efficiencies compared to other regions.

Overall, the major trends indicate a deterioration of the attractiveness of Australia as a base for value added manufacturing of food and grocery products.

³ Margins presented as percentage of net sales

⁴ Competitive Alternatives | KPMG's Guide to International Business Location Costs (2012)

2 Objectives

KPMG was engaged by the AFGC to assist to deliver a fact-based study on the performance of the food and grocery industry in Australia and to better understand the current health of the industry and identify barriers to growth. This study builds upon the pilot study undertaken by KPMG with a smaller sample of industry participants conducted in late 2012.

3 Scope and Methodology

3.1 Scope

This study included organisations from AFGC membership (the participants). Organisations include food and grocery manufacturing companies with production facilities in Australia covering several industry sectors. The participants agreed to provide data, which included confidential data, to the study and agreed to participate in the validation check process through a key point of contact.

Data request lists agreed as part of this project are contained at Appendix 7.2.

3.2 Project Overview

3.2.1 Planning and design of method

The planning phase included a review of the method, results and key learnings from the Part I Pilot study. A refined method was developed together with a project plan, series of hypotheses and guidelines, and an agreed data set and scope for the study.

Based on this, a toolkit 'Part II: Key Facts' was developed that covered project overview, data request, and guidance on how to complete the data request and participation acknowledgement. The study design and toolkit was agreed with the AFGC.

3.2.2 Member participation

Members received information outlining the study from the AFGC and a request to participate. Once a member had agreed to participate, they were provided with the toolkit and a key contact person from the KPMG team to assist with the data collection and validation activities.

3.2.3 Collection of data

The nature of the data can be summarised into four key areas covering Financial, Channel, Product and a qualitative questionnaire on the key drivers⁵. The data was collected through a standardised questionnaire sent out to the members. The questionnaires were not altered for (or by) individual participants. Together with the questionnaires, participants were provided with a guidance document containing instructions and definitions of the metrics used.

The data was submitted directly to KPMG using a secure KPMG File Transfer Protocol (FTP) server. KPMG provided each participant with a unique username and password that could not be traced back to the participating organisation. The participant was assigned a number to protect the identity of the participating organisation. The FTP server was accessible only by the participant and the KPMG project analysts.

⁵ Please refer to Appendix 7.2 for a description of the data requested

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3.2.4 Sample size and participant selection

KPMG conducted a pilot study among a small number of member companies in 2012. For the purpose of this study, a broader sample was desired and participation was sought from the broader AFGC member base where all members were encouraged to participate in this study.

Table 3.1: Resulting sample size and representation of the food and grocery industry

	Count	% of industry
Total	18	18%

Note: Total revenues of Australian Food and Grocery Council members and the industry is based on the revenues as registered in publicly available sources and may therefore vary from sales levels as defined in this study
Source: KPMG analysis, Australian Food and Grocery Council

This study is based on a sample of 18 participating companies representing approximately 18 per cent of the food and grocery industry (excluding Fresh) as defined in the State of the Industry report 2012. To protect the confidentiality of the participants, the names of the participants are not disclosed. The participating companies cover a broad range of sectors and categories across the food and grocery sectors. To protect the confidentiality of participants, the specific sectors covered are not disclosed.

The participating companies are distributed as follows:

Figure 3.1: Distribution of sample by number of employees

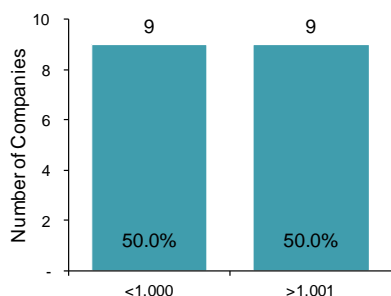
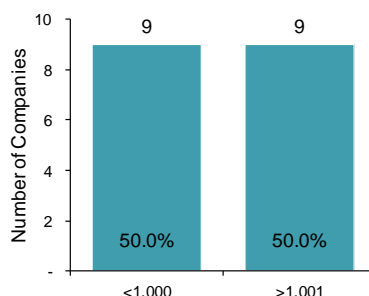


Figure 3.2: Distribution of sample by Revenue (\$ millions)



3.2.5 Analysis of the data

This section outlines the approach that KPMG used to analyse the data as well as the key assumptions.

Accuracy of the data provided

It was assumed that the data submitted by participants was complete. KPMG did not seek to verify the data provided for accuracy and representation. KPMG did however perform a high level data integrity check on the information provided. The data provided was checked for balancing of the profit and loss statement and balance sheet across the various input sheets within the data request template. To reduce inconsistencies, the data request template automatically calculated the key line items based on pre-populated fields and formulae. KPMG consulted with the participants' data analysts to clarify any ambiguity and/or request for data to be resubmitted if required.

Once the participant data was deemed to be clean, it was combined in a central database.

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Presentation of the results

Unless indicated otherwise, all analyses of participant data relate to the full participant group. KPMG consolidated the data from all participants to form a combined database.

Exclusion from the analyses

In cases where KPMG was not provided with sufficient information, the participant was excluded to ensure integrity of the data analysis. Therefore, some analyses are based on a smaller sample. The sample size is marked in these instances.

In section 5 relating to Cost, there were limitations in the data provided on the breakdown of costs, therefore the analysis included only those participants that were able to provide a full breakdown to enable this analysis to be performed.

Estimations

To the extent where incomplete information was submitted and no additional granularity could be provided, KPMG either excluded the provided information from the analyses or obtained estimations from the participants to avoid inconsistencies in the data.

Further, where there were changes to firm's reporting and cost allocation methods KPMG sought to clarify these changes and adjust the data to ensure comparability to previous years.

Normalisations

To the extent possible and relevant, KPMG has requested management to quantify the impact of any one-off items such as impairments on operational performance. The relevant line items were updated accordingly to identify the underlying performance of the participant.

Assumptions and definitions

Treatment of varying fiscal years

Due to the lack of monthly data, and differing participant year-end periods, KPMG did not seek to match time-series data. As such, it was assumed that there is no significant variation in different firm year ends.

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Table 3.2: Definitions of metrics used

Metric	Definition
Trading discounts	Retailer claim back from the supplier. Trading discounts comprise of longer term trade spend such as rebates, settlement discount and supply chain charges
Promotional Allowances	Short term retail claims, such as mark downs, scan deals (supplier support for products on sale) or catalogue support
Net sales	Gross Sales <i>less</i> Trading Discounts <i>less</i> Promotional Allowances
Cost of Goods Sold	Sum of Cost of Materials and Conversion Costs
Cost of materials	Sum of Commodities, Other Raw Material, Packaging, Manufacturing Variances, and Stock write off
Conversion Costs	Sum of Direct Labour, (manufacturing-related) Depreciation, Utilities and Other Manufacturing costs
Finished goods ready for sale	Sum of any finished goods that are purchased ready for sale
Gross margin	Net Sales <i>less</i> Cost of Goods Sold
Operating costs	Sum of Warehousing, Logistics & Distribution (incl. primary freight), Salaries & On costs, Marketing, Depreciation & Amortisation, Royalties, IT Costs, R&D and Other
EBIT	Gross Margin <i>less</i> Operating costs
Working capital	Sum of Inventory and Trade Debtors <i>less</i> Creditors
Return on Assets	EBIT <i>divided by</i> Total Assets
Total assets	Total of cash & cash equivalents, Trade Debtors, Inventory, Net Property Plant & Equipment, Net Goodwill & Intangibles and other assets
Total liabilities	Total of creditors, Borrowings, Tax payable and Other liabilities
Net Capital employed	Total Assets <i>less</i> Total Liabilities
Capital expenditure	The total of Capex related to (1) stay in business, (2) Cost Savings / Profit Generation / Expansion, (3) Information Technology (IT)

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Channel definition

Participants were asked to present their data segmented into four key channels: Retail, Food Service, Export and Other. Participants allocated gross sales, net sales and volumes to these channels. Despite some variation in channel categorisation by participants, allocation to these channels was achieved. The descriptions of these channels are as follows:

Retail: sales attributable to supermarket, convenience stores, bulk discount stores and independents. Examples include Coles and Woolworths (top two retailers), Metcash, Aldi, Costco (big five retailers) and smaller retailers (e.g. Franklins).

Sales to Woolworths, Coles, Metcash, Aldi and Costco were further broken down by branded and private label products.

- *Branded:* Sales attributable to branded products to the five main retailers
- *Private label:* Sales attributable to private label product sales to the five main retailers

Food service: Sales attributable to food and beverage manufacturers, hospitality, restaurants and cafes (HORECA) and caterers:

- *Products:* Sales of finished goods to foodservices customers, i.e., HORECA, defence, hospitals, wholesalers (Bidvest), schools and other
- *Ingredients:* Sales of ingredients to foodservices customers that utilize these ingredients as inputs to another manufacturing process, i.e., sale of sugar to be used in a manufacturing of soft drinks by a beverage manufacturer

Export: Sales attributable to export activities

Other: Sales value and volume metrics of finished goods from other channels such as business-to-business, sales direct to the consumer and other channels not otherwise identified.

4 Industry trends and challenges

The food and grocery manufacturing industry is experiencing significant pressures on its performance from a range of drivers. These are:

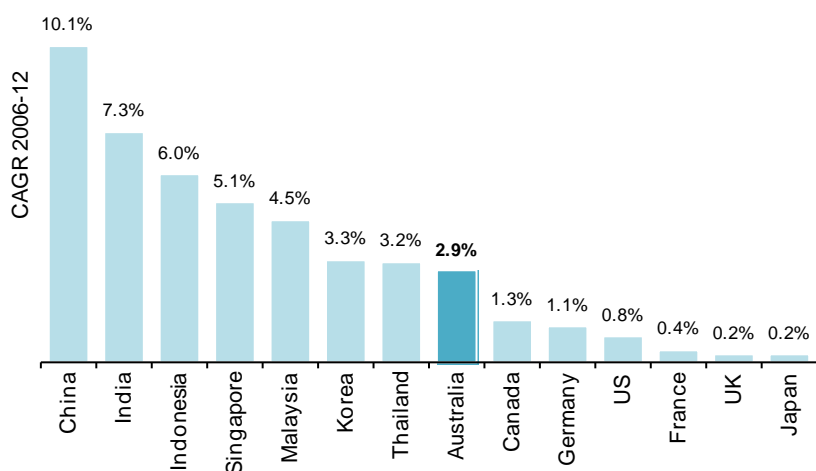
- Subdued confidence in the broader economic environment.
- A strong Australian currency.
- Competitive nature of the supermarket retailing sector.
- Continued increases in input costs.

This chapter provides a high-level overview of these drivers as they continue to intensify creating an environment for continued structural change in the food and grocery manufacturing sector in Australia. We anticipate further structural changes in order to improve the levels of return in the sector.

4.1 Australian economic fundamentals

The Australian economy ranks as one of the highest growth countries compared to other mature countries, with an annual Gross Domestic Product (GDP) growth rate of 2.9 per cent.

Figure 4.1: Gross domestic product growth (2006-12)



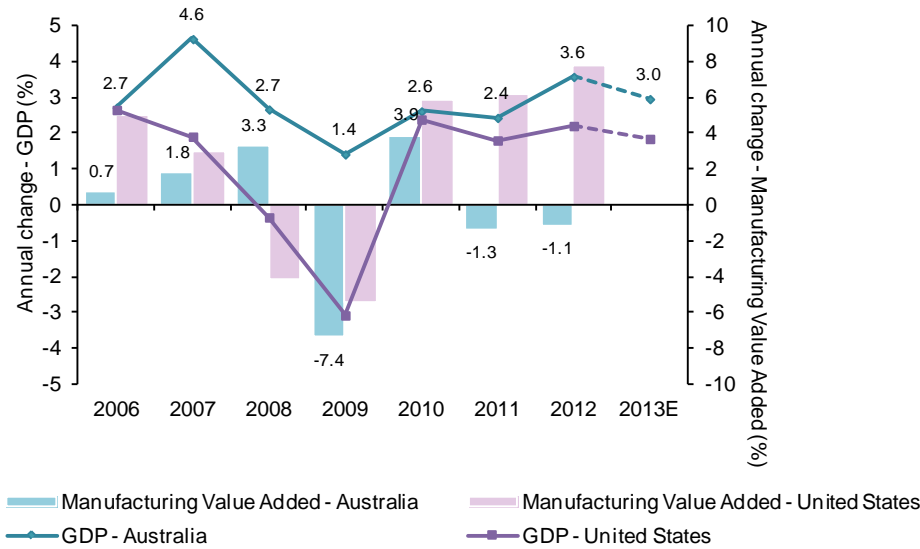
Source: International Monetary Fund

The economy has moved at a similar pattern to that of the United States of America, but has been relatively resilient with a slowdown to 1.4 per cent growth at the height of the global financial crisis (GFC).

The Australian economy continues to show signs of resilience by moderate growth in GDP, employment and average weekly earnings.

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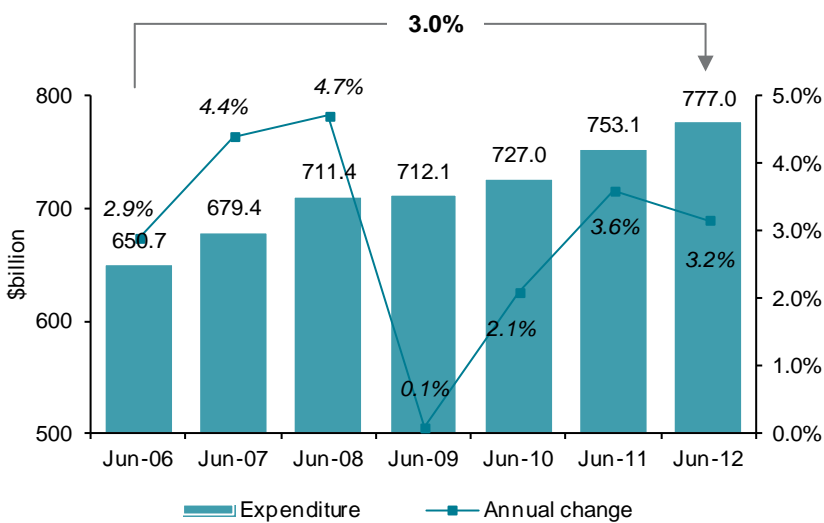
Figure 4.2: Gross domestic product and manufacturing growth – Australia versus US (2006-12)



Source: International Monetary Fund; US Bureau of Economic Analysis; Australian Bureau of Statistics catalogues number 5206.0

The manufacturing sectors' value added suffered a steep decline in 2009 and continues to decline year on year. The Australian manufacturing sector's contribution to GDP declined by a total of 6.1 per cent during 2008 to 2012. In contrast, the US manufacturing sector has rebounded after 2009 despite weaker GDP growth. Research by the Australian Industry Group⁶ suggests that Australian manufacturing value added declined as labour productivity in Australia did not keep up with rising wage costs combined with a negative impact of increasing non-labour costs, such as energy prices. In contrast, the US saw an increase in productivity.

Figure 4.3: Household final consumption expenditure (2006-12)



Source: Australian Bureau of Statistics, catalogue number 5204.0

Overall consumer drivers in the Australian economy remain stable. Household spending continued to grow at 3 per cent compound annual growth rate (CAGR) between FY06 and FY12 supported by low unemployment levels and labour cost

⁶ Australian Industry Group: Performance of manufacturing: Australia and the US compared, November 2012.

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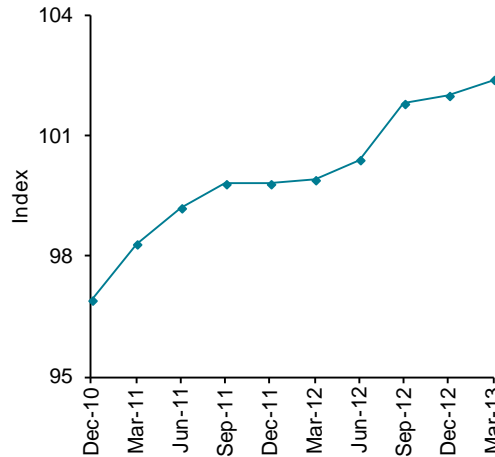
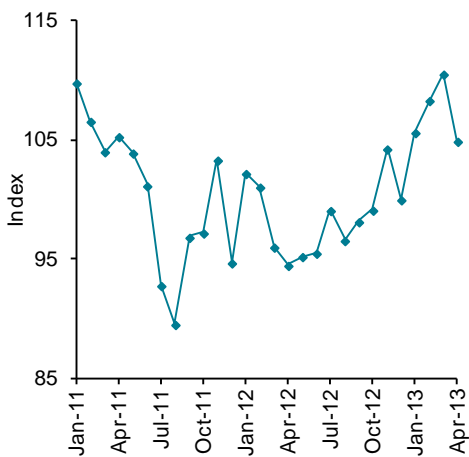
growth. The unemployment rate has held steady at a relatively low 5-6 per cent since 2009, and average weekly earnings in Australia grew at an annual average of 4.3 per cent during FY06-12⁷, outpacing inflation. The Consumer Price Index changed at a CAGR of 2.6 per cent over the same period.

Several factors continue to prevail that may be negatively impacting business confidence, including the ongoing debt crisis in Europe, softening housing prices, and a substantial rise in consumer propensity to save money. The Australian household savings rate⁸ increased to 10.0 per cent in FY12, compared with an average of 2.0 per cent in the four years before the GFC⁹.

Economic uncertainty remains as consumer confidence fell again in April 2013. This may be attributed to heightening risks in Europe and variable equity prices in Australia¹⁰. The Reserve Bank has reduced interest rates to historically low levels to help drive spending and boost consumer sentiment¹¹.

Figure 4.4: Consumer Confidence Index

Figure 4.5: Consumer Price Index



Source: Left: Westpac Banking Corporation, Melbourne Institute (sourced from tradingeconomics.com; accessed May 2013); Right: Australian Bureau of Statistics catalogue number 6401.0

Consumer confidence is subdued due to growing economic uncertainty in Australian and abroad.

⁷ Average Weekly Earnings; IBISWorld Business Environment Profiles, October 2012

⁸ Derived by net savings as a proportion of gross disposable income

⁹ Australian Bureau of Statistics catalogue number 5204.0 (November 2012)

¹⁰ Australian Economic Update: Consumers pare back expectations for Aussie economy; JP Morgan Economic Research; April 2013

¹¹ Media release May 7, 2013; Reserve Bank of Australia; May 2013

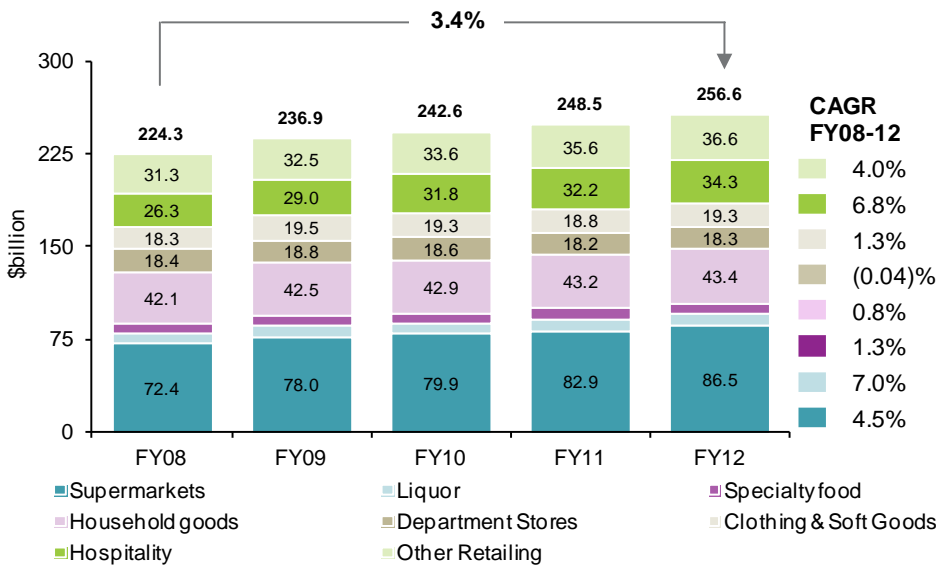
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4.2 Resilient retail sector

According to the Australian Bureau of Statistics¹², the retail industry in Australia generates an annual turnover of \$257 billion. Overall turnover grew by 3.4 per cent CAGR during FY08-12, with a slowdown to 2.4 per cent in FY11 and a return to 3.2 per cent growth in FY12.

The supermarkets sector is the largest and accounts for 34 per cent of total turnover. This sector grew fastest at 4.5 per cent CAGR during FY08-12, compared to the more stagnant household goods and department store categories, which witnessed growth rates of 0.8 per cent and (0.04) per cent CAGR respectively during the same period.

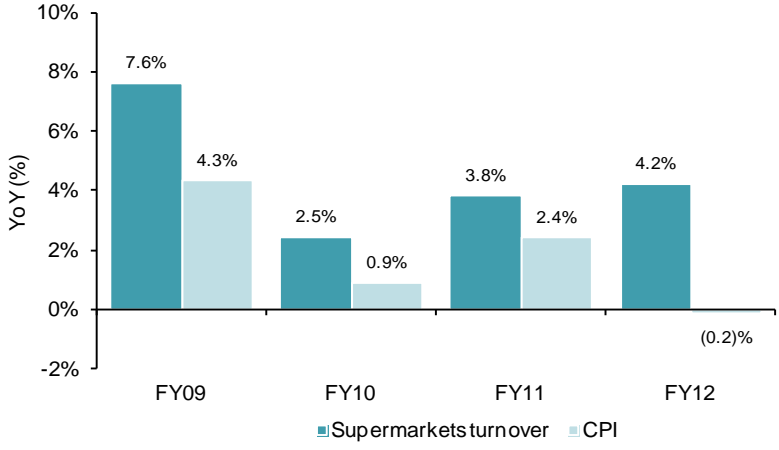
Figure 4.6: Australian retail industry turnover (FY08-12)



The retail supermarket sector continues to grow at 4.5 per cent per annum primarily driven by accelerated volume growth.

Note: Specialty food includes butchery and green groceries. Baked goods on same premises are excluded. "Other retailing" includes newspaper and book retailing, other recreational goods retailing, pharmaceutical, cosmetic and toiletry goods retailing and other retailing n.e.c
 Source: Australian Bureau of Statistics, catalogue number 8501.0

Figure 4.7: Consumer Price Index (food and non-alcoholic beverages) versus food retail turnover (FY09-12)



Note: Consumer Price Index (food and non-alcoholic beverages) excludes sub-categories 'fruit and vegetables' and 'meals out and take away foods'
 Source: Australian Bureau of Statistics, catalogue number 6401.0

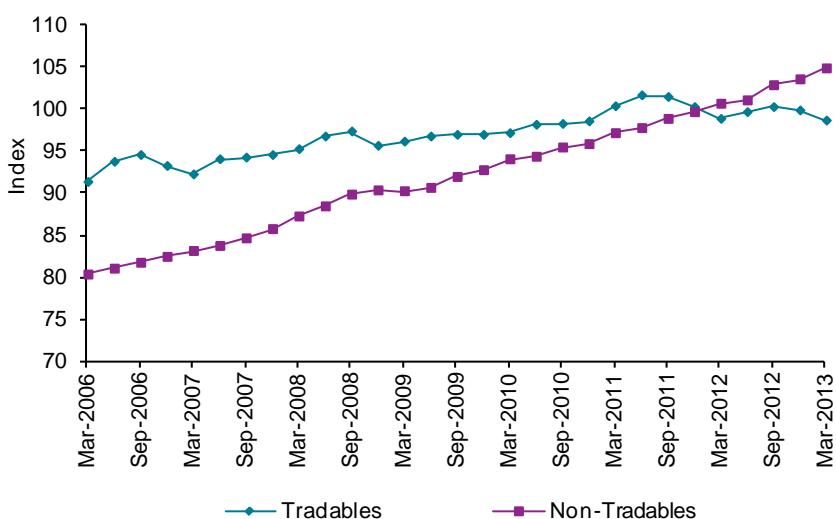
¹² Source: Australian Bureau of Statistics, catalogue number 8501.0

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The Supermarkets sector has continued to grow in FY12; however, price came under pressure with the Consumer Price Index (CPI) falling in FY12 by 0.2 per cent. Supermarkets turnover increased at 3.8 per cent and 4.2 per cent in FY11 and FY12 respectively, compared to the CPI annual change of 2.4 per cent and (0.2) per cent in the same years. Growth in this sector may, therefore, be primarily volume-driven, fuelled by population growth, product diversification and changing consumer behaviour.

Similar to the CPI in food retail, the Australian economy saw a general price deflation of tradables starting in December 2011 versus a consistent increase in non-tradables.

Figure 4.8: Consumer Price Index tradables versus non-tradables (FY09-11)



Source: Australian Bureau of Statistics, Reserve Bank of Australia website, visited on 5 June 2013

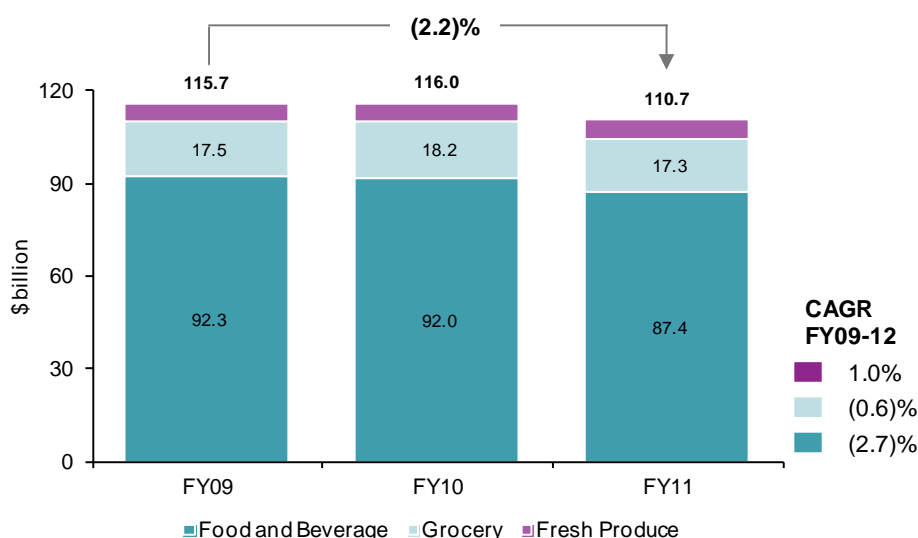
4.3 The Australian food and grocery manufacturing industry in decline

The Australian food and grocery industry generated a turnover of \$110.7 billion in FY11. Food and beverage manufacturing contributed \$87.4 billion, grocery manufacturing \$17.3 billion and fresh produce \$6.0 billion. The industry represented 27.9 per cent of the Australian manufacturing industry and employed approximately 296,300 people in FY11-FY12, of whom 222,300 were employed in food and beverage manufacturing¹³.

¹³ Australian Food and Grocery Council and KPMG | State of the Industry 2012

Australian Food and Grocery Council

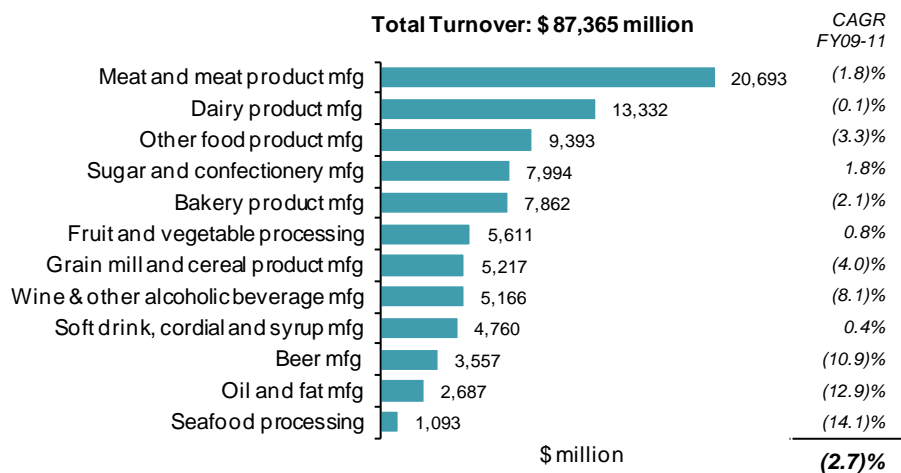
Figure 4.9: Food and beverage, grocery and fresh produce industry turnover (FY09-11)



The food and grocery manufacturing industry experienced an overall 2.2 per cent decline between FY09 and FY11.

Source: Australian Food and Grocery Council and KPMG | State of the Industry 2012

Figure 4.10: Overview of food and beverage sector - by turnover (FY09-11)



Source: Australian Food and Grocery Council and KPMG | State of the Industry 2012

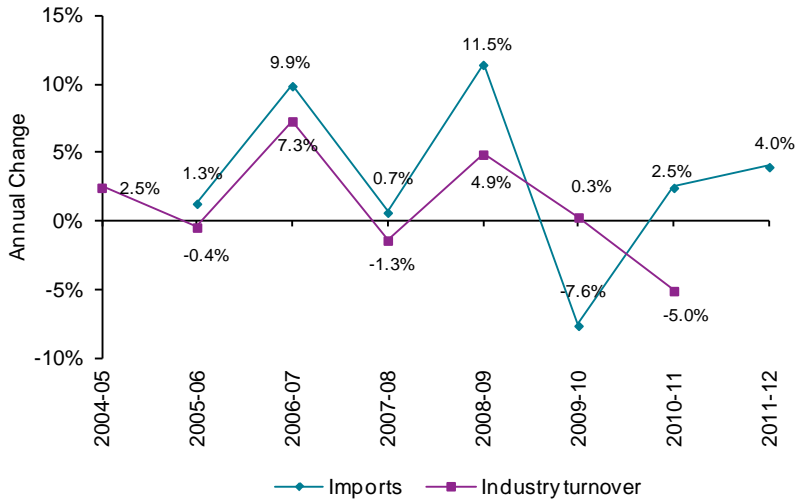
Contrary to the growth trend observed in the retail supermarket sector, the food and grocery industry contracted by 2.2 per cent CAGR between FY09 and FY11. The food and beverage sector recorded a steeper decline of 2.7 per cent CAGR.

The supermarket sector, however, continued to grow at 4.6 per cent per annum between FY08-11, with retailers focusing on developing new fresh-food concepts with in-store butchers, onsite baking and fishmongers. Further, the retail supermarket sector has also expanded into new categories outside the food and grocery categories (e.g. apparel, general merchandise), which may explain some of the difference between the sector growth rates.

Food and grocery imports also continued to grow, supporting some of the supermarket turnover growth across various categories.

Australian Food and Grocery Council

Figure 4.11: Imports versus turnover in the food and grocery manufacturing industry

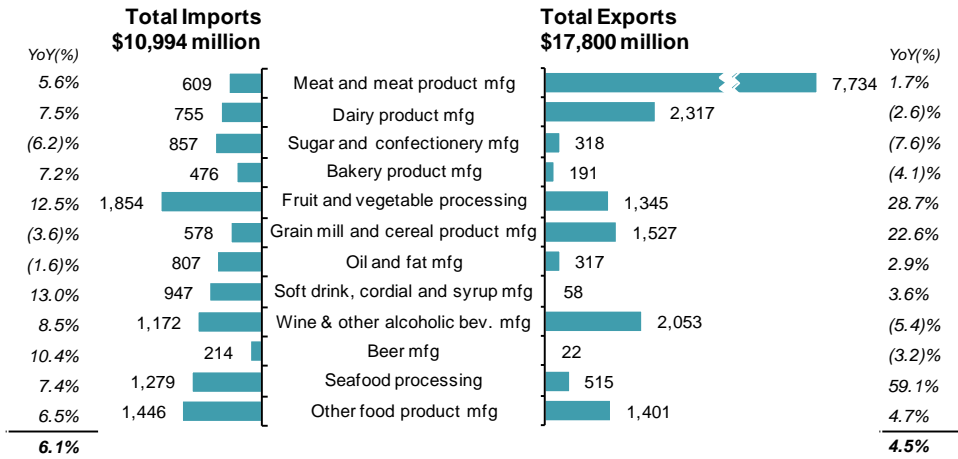


Food and grocery imports are growing at 4 per cent in line with supermarket retailing.

Source: Australian Food and Grocery Council and KPMG | State of the Industry 2012

Between FY11 and FY12, imports in the food and beverage sector increased by 6.1 per cent while exports grew by only 4.5 per cent.

Figure 4.12: Import/export of food and beverage industry sector (FY11-12)



Note: For this analysis the ABS categories were mapped to the State of the Industry categories
 Source: Australian Bureau of Statistics, KPMG analysis, Australian Food and Grocery Council and KPMG | State of the Industry 2012

4.4 Issues impacting the food and grocery manufacturing industry

In recent years, the food and grocery manufacturing industry has been faced with several issues across the value chain, impacting growth and profitability.

The major retailers continue to pressure for improved net price and explore global sources of supply

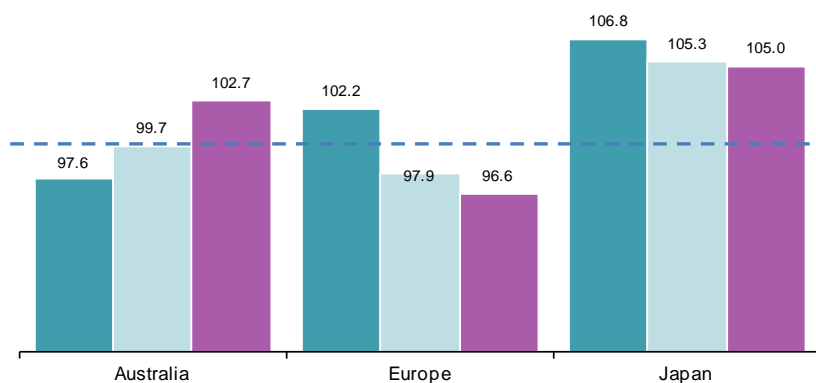
The food and grocery retailing industry is highly competitive with a small number of supermarket retailers in a dominant position. The supermarket retail channel is the major sales channel for the food and grocery manufacturers in Australia. The leading supermarket retailers have engaged in extensive price based promotional strategies to drive sales growth impacting returns available in a range of categories. Further the focus on price competition has seen a growth in international sourcing for lower cost imported products.

Many food and grocery manufacturers have increased their focus on building other channels (e.g. food services and direct to consumer) for their products to reduce their significant exposure to the retail channel. This has been met with mixed success.

Cost of doing business

The cost of doing business in the Australian manufacturing sector is increasing in both absolute terms and relative to other geographies as shown in the figure below.

Figure 4.13:
Cost index – Agri Food (FY08-FY12)¹⁴



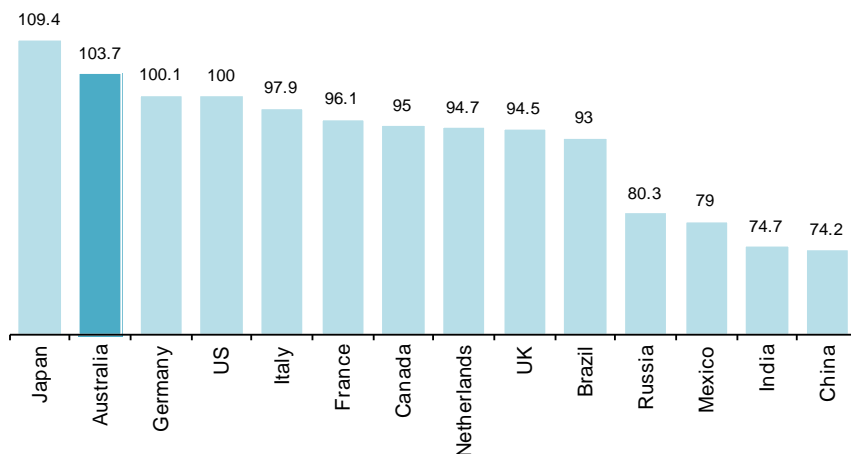
Note: The United States of America (dotted line) is the benchmark. Cost index relates to agri-food industry
Source: Competitive Alternatives | KPMG's Guide to International Business Location Costs, KPMG (2012)

As the cost of doing business in Australia continues to grow and the Australian Dollar shows little signs of easing, suppliers and retailers accelerate sourcing opportunities in lower cost markets.

¹⁴ The cost index is calculated by modelling a sample food processing operator, using 26 location-sensitive costs and comparing the relative local currency prices to an equivalent operation in the US

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Figure 4.14:
Cost index – Manufacturing (2012)



Note: Cost comparison by country relates to overall industries
Source: Competitive Alternatives | KPMG's Guide to International Business Location Costs, KPMG (2012)

The price differential of operating in Australia compared to the US, Europe and neighbouring Asian markets is widening. Further, the differential with higher cost Japan is narrowing. In the sample set of countries included in KPMG's Competitive Alternatives study¹⁵, Australia ranks second only to Japan for cost of doing business in the manufacturing sector and moved from 97.8 in 2010 to 103.7 in 2012.

One of the key drivers of the increased cost of doing business is wage levels. In the last five years, the wage price index (before bonuses)¹⁶ increased by 13.5 points from 99.8 in December 2008 to 113.3 in December 2012¹⁷.

In addition, the Competitive Alternatives study shows that energy costs in Australia are the highest of mature markets and have risen by 70 per cent between 2008 and 2012. In 2012, average costs per kilowatt hour in Australia were US\$0.214 versus an average of US\$0.116 in other mature markets¹⁸, a premium of 84 per cent on average.

For a comparison of utility and labour cost compared to other geographies, refer to appendix 7.3.

¹⁵ Competitive Alternatives | KPMG's Guide to International Business Location Costs, KPMG (2012)
¹⁶ Wage price index: Ordinary hourly rates of pay excluding bonuses (Private sector: Manufacturing industry)
¹⁷ Australian Bureau of Statistics, catalogue number 6345.0
¹⁸ Canada, United States, France, Germany, Italy, Netherlands, UK and Japan

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Wheat and sugar commodity prices in Australia are key input costs for the food and grocery manufacturers.

Figure 4.15:
Wheat (domestic) commodity costs

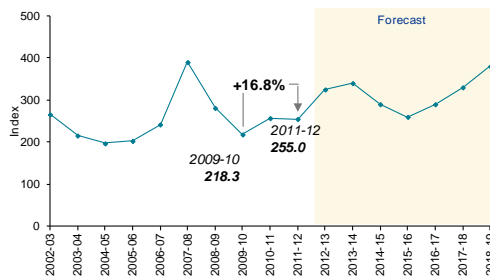
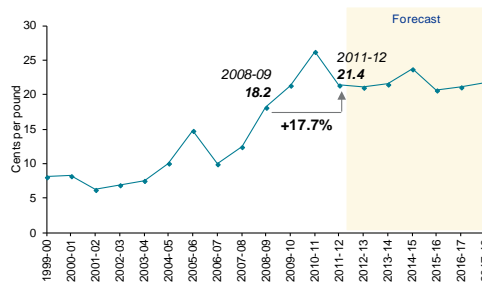


Figure 4.16:
Sugar commodity costs (World price)



Source: IBISWorld Business Environment Profiles

The wheat price index increased by 17 per cent from 2009-10 to 2011-12. Sugar prices increased to a 30-year ultimate high in 2010-11 due to global deficits and adverse weather conditions in two consecutive years. Prices however dropped significantly in 2011-12 as supply stabilised but remained above pre-GFC levels.

Regulation is another notable factor impacting the cost of doing business in Australia. According to the Ipsos Director Sentiment Index¹⁹, over 70 per cent of directors believe that the level of regulation has increased over the past year, and 60 per cent expect an increase in the following year. Employing workers as well as workplace health and safety were identified as aspects of the business most affected by regulation.

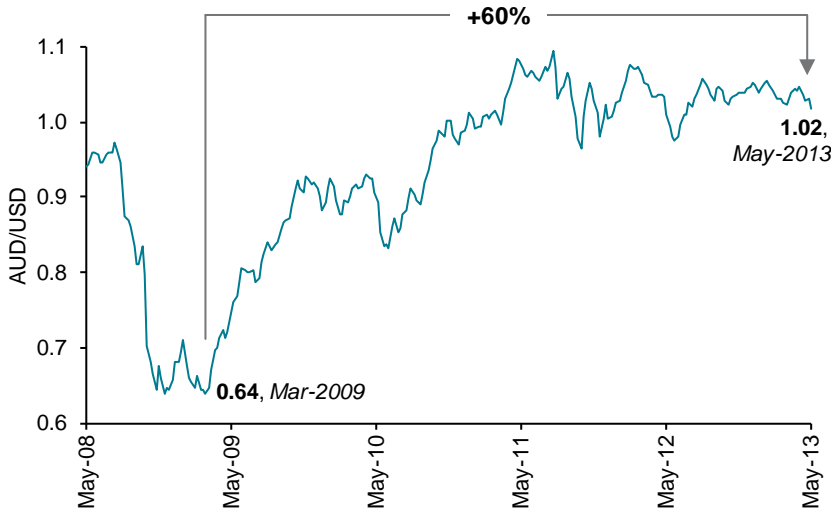
¹⁹ A random sample of members sourced from the Australian Institute of Company Directors' database was interviewed for the study (504 respondents) – *Director Sentiment Index: Research Findings First Half 2013*, Ipsos MediaCT and Australian Institute of Company Directors; April 2013

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Strong Australian dollar impacting export competitiveness

The competitiveness of Australia as a manufacturing country is negatively impacted by the foreign exchange rate. In March 2009, the AUD traded at \$0.63/USD, since then the AUD has appreciated nearly 60 per cent to \$1.018/USD as at 12 May 2013.

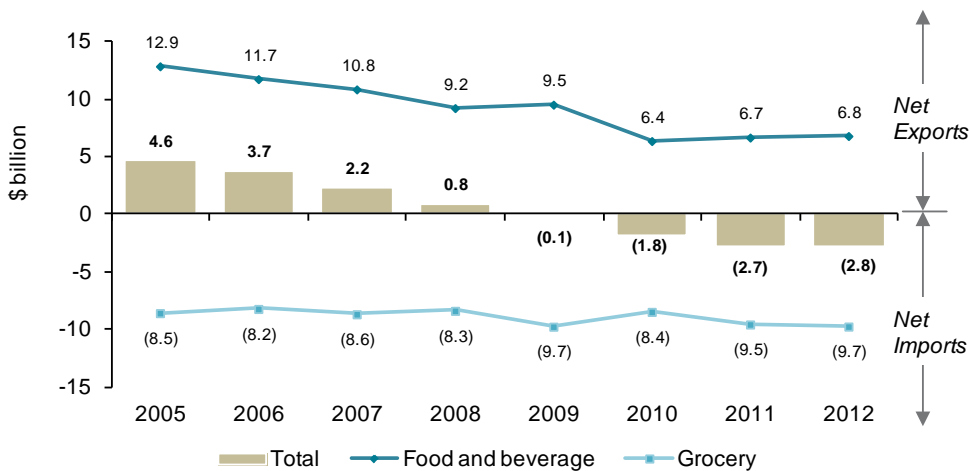
Figure 4.17: AUD/USD exchange rate trend



Source: OandA

In the State of the Industry report 2012, the food and grocery manufacturing industry shifted from being a net exporter to a net importer of manufactured food and grocery products.

Figure 4.18: Trade Balance (FY05-12)



Source: Australian Food and Grocery Council and KPMG | State of the Industry 2012

The food and grocery manufacturing industry is also increasing imports and has become a net importer.

The grocery sector has been a net importer for many years, and has remained relatively flat except for a decline in imports during the GFC. Net exports in the food and beverage sector declined considerably in 2010, mainly impacted by the GFC, reduced demand and a strengthening of the AUD.

4.5 Conclusion

Despite positive overall fundamentals and an economy that continues to grow, the food and grocery manufacturing sector is under pressure. The combination of rising input costs, reducing prices and an increase in lower cost imports has negatively impacted competitiveness and profitability reducing the attractiveness for further investment in the food and grocery manufacturing sector in Australia.

Against such issues, both the government and policy makers are challenged with the task of creating improved business conditions to enhance the competitiveness of the sector.

While these trends are widely recognised in the industry, the impact on the financial performance of the industry participants is unclear. The aim of this study is to report on the overall performance of the food and grocery industry by undertaking detailed analysis on confidential firm level data, aggregated and reported at an industry level.

5 Performance of participants

5.1 Overview

This chapter provides a view on the performance of the sector based on the information provided by the 18 participating companies. The following diagram and Appendix 7.1 show a consolidated financial summary.



Note: (a) Percentage figures are stated as per cent of gross sales unless stated otherwise
 (b) NSV is net sales value
 (c) Volumes displayed in units based on participants data
 Source: Participant data, KPMG analysis (N=18)

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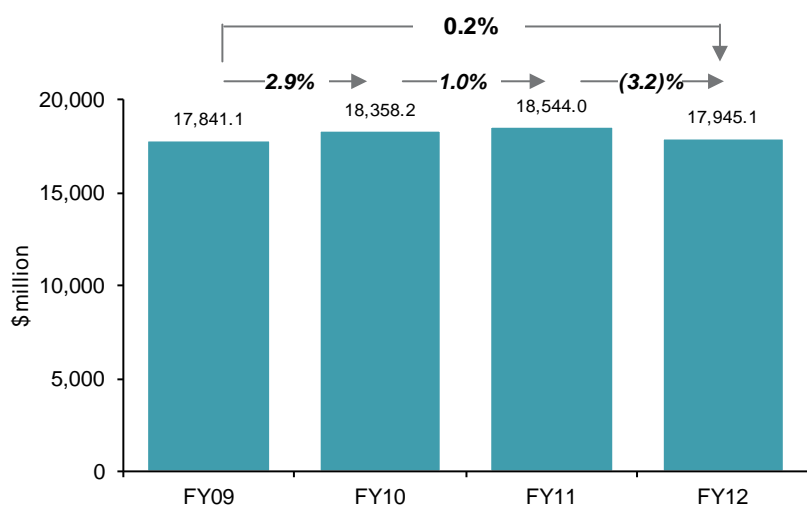
In aggregate across the 18 participants, the earnings before interest and taxes (EBIT) margin declined from 6.9 per cent in FY09 to 5.7 per cent of gross sales in FY12 and 8.5 per cent to 7.4 per cent of net sales.

- The key factor attributable to this decline was a decrease in gross sales in FY12, mainly as a result of reduced volumes in the retail channel.
- The effect of the decline in gross sales was exacerbated by a consistent increase in trade spend (from 19.5 per cent in FY09 to 23.4 per cent of gross sales in FY12), which negatively impacted net sales.
- A decline in overall cost of goods sold was not sufficient to hold the gross margin levels.
- Combined with flat operating costs, the reduction in gross sales resulted in an erosion of profitability.
- Despite these challenging conditions, capital expenditure continued to grow with a focus on cost saving programmes and/or investments in expansion/profit generation initiatives.

5.2 Sales

Gross sales of the participants were \$17.9 billion in FY12, almost on par with FY09 gross sales of \$17.8 billion. After low single digit increases in FY10 and FY11, gross sales contracted by 3.2 per cent in FY12. This decline appears to be mainly driven by reduced volumes in the retail channel falling 3.2 per cent in FY12.

Figure 5.1: Gross sales trend (FY09-12)



Source: Participant data, KPMG analysis

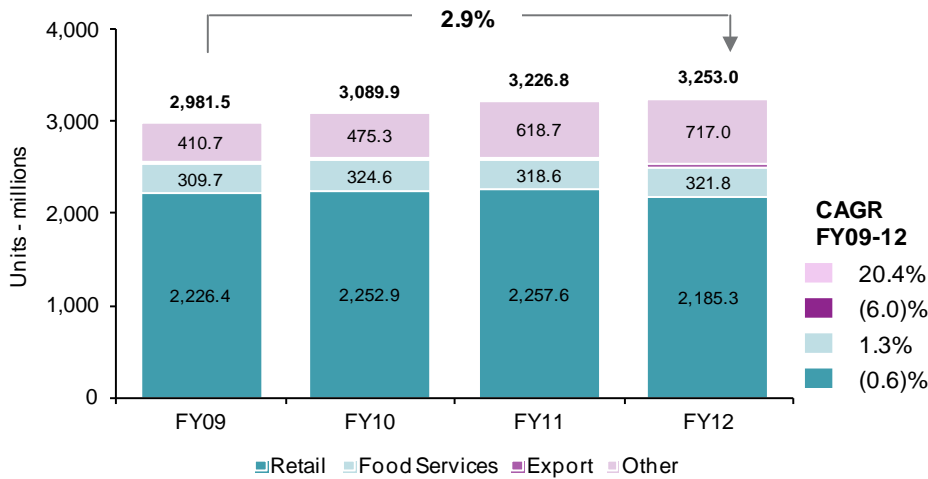
Sales levels in FY10 and FY11 were relatively high when compared to the remainder of the period in scope for the study. The increase in FY10 appears to be driven by revenue growth in the retail channel.

Over the FY09-12 period, total volumes increased by 2.9 per cent.

On an overall level, the gross sales level have remained relatively flat at 0.2 per cent CAGR but contracted by 3.2 per cent in FY12.

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Figure 5.2: Volumes by channel (FY09-12)



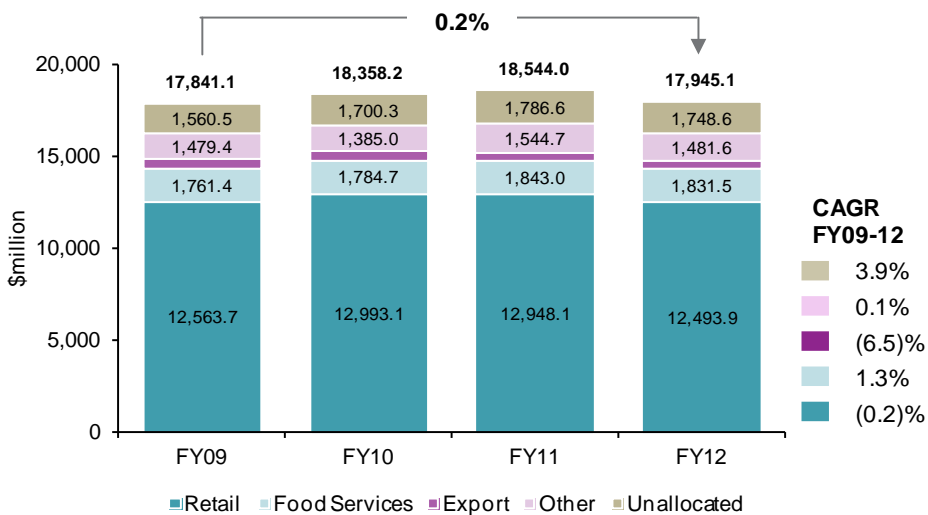
Volumes increased by 2.9 per cent driven by growth in other channels.

Source: Participant data, KPMG analysis

Contrary to the volume-driven growth of 4.5 per cent in the retail supermarket sector as discussed in Chapter 2, participants' volume increases appear to be largely driven by growth outside of the retail channel. Sales to the retail channel contracted by 0.6 per cent over the full period, with a 3.2 per cent decline in FY12.

Volumes in the 'Other' category increased by 30.2 per cent and 15.9 per cent in FY11 and FY12 respectively; however, with a reduced rate of gross sales decline, it appears that volume growth was experienced in either products of lower unit prices or unit prices reduced during the period.

Figure 5.3: Gross sales by channel (FY09-12)



Sales to the retail channel contracted by 0.2 per cent.

Sales for export declined slightly above the 4.2 per cent decline in exports of the whole food and grocery industry.

Source: Participant data, KPMG analysis

The decline in retail volumes for the participant group is mirrored in a total retail sales decline of 0.2 per cent over the full period. Gross sales for export in this sample group declined by 6.5 per cent between FY09 and FY12 which is above the 4.2 per cent decline in exports of the food and grocery industry over the same period²⁰.

²⁰ Australian Food and Grocery Council and KPMG | State of the Industry 2012

Australian Food and Grocery Council

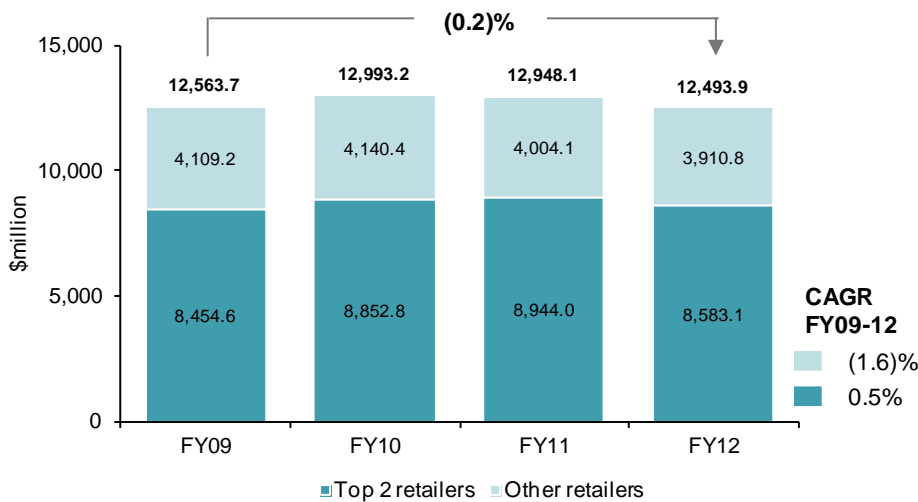
The food services channel, accounting for 10.2 per cent of total gross sales for the participant group, recorded its first decline in FY12 at a rate of 0.6 per cent.

The category 'Other' (including business-to-business, industrial sales, direct-to-consumer sales and other channels), comprising 8.3 per cent of gross sales, witnessed a decrease in gross sales in FY12 after showing growth to 11.5 per cent in FY11.

Sales to the two leading retailers in the sector account for 67-69 per cent of the participant group's gross sales and have increased by 0.5 per cent per annum between FY09 and FY12.

The remaining contribution of gross sales in the retail channel consists of a relatively long tail of customers such as Aldi, Metcash, Franklins, Independents, Route Trade, and discount retailers. These customers as a group contracted by CAGR 1.6 per cent as well as reducing their contribution to gross sales for the retail channel from 33 per cent in FY09 to 31 per cent in FY12.

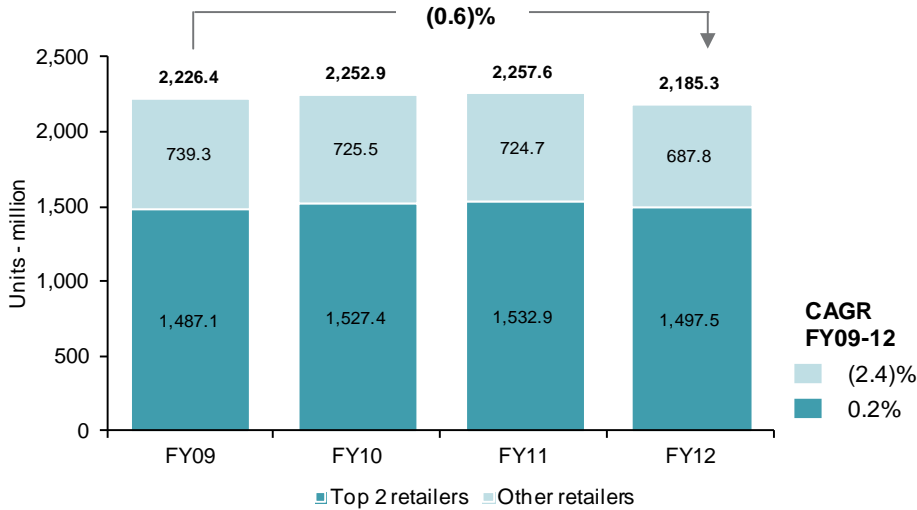
Figure 5.4: Retail sales by sales channel (FY09-12)



Source: Participant data, KPMG analysis

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Figure 5.5: Retail sales volume split by sales channel (FY09-12)



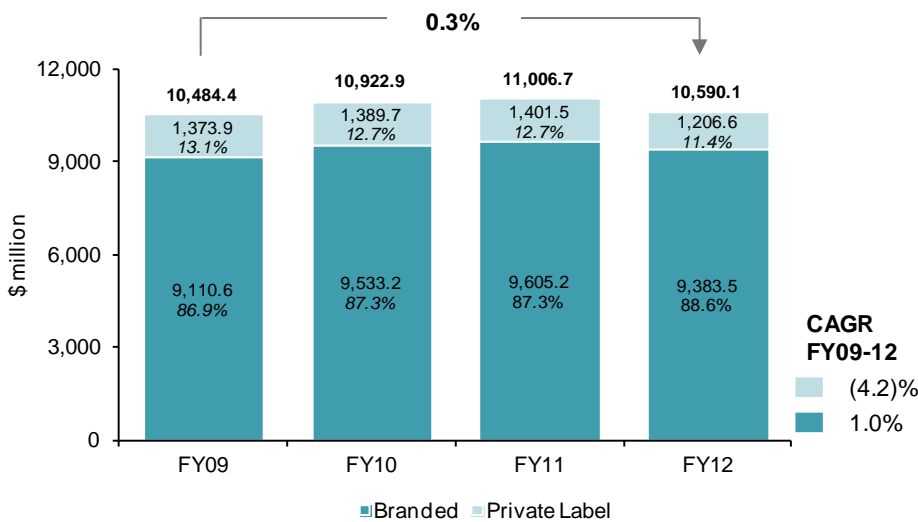
Source: Participant data, KPMG analysis

Volumes sold by the participants to the two main supermarket retailers grew at a stronger rate in FY10 and FY11 compared to other retailers before shrinking by 2.3 per cent in FY12. This is compared to minor volume declines to the other retailers in FY10 and FY11, followed by a steeper decrease in FY12.

5.2.1 Private label versus branded products

The participants generated sales through the production and sale of both branded products and private label products for the retailers. Branded products account for the 89 per cent of the participants retail channel revenues. The share of branded products in total revenue remained relatively stable at 87 per cent until FY12 when it grew to 89 per cent as private label sales declined.

Figure 5.6: Gross retail sales by branded products versus private label (FY09-12)

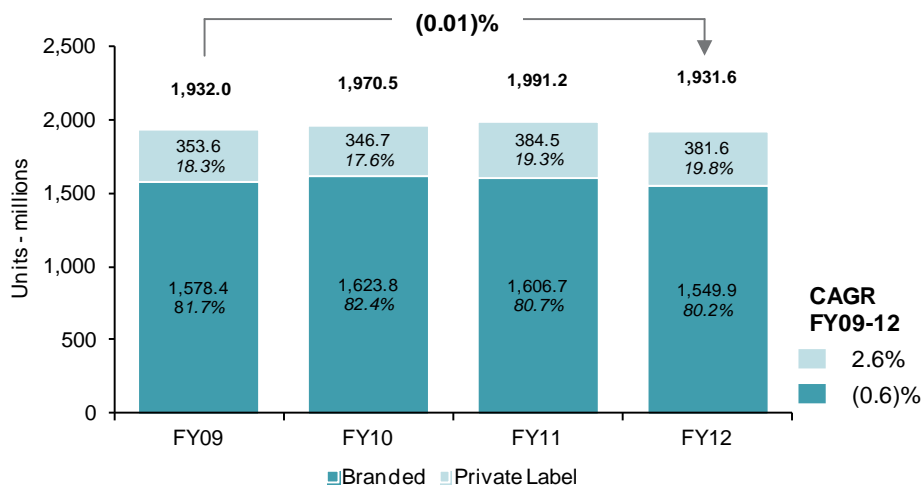


Source: Participant data, KPMG analysis

Private label products represent a relatively stable 13 per cent of gross sales, however are declining in FY12 for the participant group.

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Figure 5.7: Retail volumes by branded products versus private label (FY09-12)



Source: Participant data, KPMG analysis

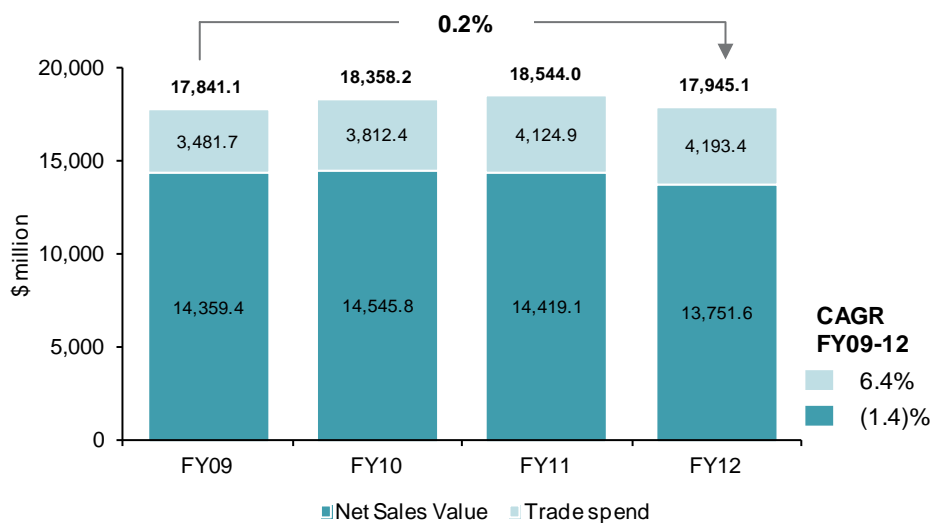
While sales generated by private label has declined between FY09 and FY12, volume increased. This suggests a lower average revenue contribution per unit, which could be the result of a mix change or reduced prices.

The declining revenues in the sector could potentially be driven by an increase in lower cost sourcing of private label products through imports.

5.2.2 Trading discounts and promotional allowances (trade spend)

Trade spend increased considerably at 6.4 per cent CAGR between FY09 –12, significantly outpacing growth in gross sales of 0.2 per cent over the same period, resulting in trade spend growth as a share of gross sales. Trade spend is increasingly used by the participants to retain sales volumes.

Figure 5.8: Share of trading discounts, promotional allowances and net sales as a proportion of gross sales (FY09-12)



Source: Participant data, KPMG analysis

Nearly two-thirds of the FY10 gross sales increase of \$517 million was offset by the increase in trade spend. In FY11, faster trade spend growth resulted in a downward pressure on net sales, i.e. \$312.5 million increase in trade spend compared to \$185.7 increase in gross sales. In FY12, the first year that gross sales declined, the

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impact on net sales was exacerbated by further growth in trade spend of \$68.5 million and a reduction of gross sales of \$598.9 million. This resulted in an overall decline of net sales of around \$670 million from FY11 to FY12, a 5 per cent decline.

Table 5.1: Trade spend as per cent of Gross Sales by channel (FY09-12)

	FY09	FY10	FY11	FY12	CAGR
Top 2 retailers	23.0%	24.4%	25.7%	26.9%	5.8%
Other retailers	17.1%	18.0%	19.7%	20.8%	5.0%
Food services	9.8%	9.6%	11.5%	12.5%	9.8%
Other	11.7%	11.1%	10.1%	11.6%	-1.8%
Total Trade Spend	19.5%	20.8%	22.2%	23.4%	6.4%

Source: Participant data, KPMG analysis

Comparison of the percentages of gross sales spent on trade spend by the participants suggests that the highest proportion is spent on the top two retailers. Trade spend for the food services channel appears to be growing at the fastest rate of 9.8 per cent CAGR.

Table 5.2: Trade spend growth vs. Volumes growth by channel (FY10-12)

% year-on-year	Δ	FY10	FY11	FY12	CAGR
Top 2 retailers					
Trade Spend		11.3%	6.3%	0.2%	5.8%
Volume		2.7%	0.4%	(2.3)%	0.2%
Other retailers					
Trade Spend		5.9%	6.0%	3.2%	5.0%
Volume		(1.9)%	(0.1)%	(5.1)%	(2.4)%
Food services					
Trade Spend		(1.1)%	24.0%	7.9%	9.8%
Volume		4.8%	(1.8)%	1.0%	1.3%
Exports and Other					
Trade Spend		(9.1)%	(5.3)%	10.0%	(1.8)%
Volume		15.1%	27.0%	14.6%	18.8%
Total Trade Spend		9.5%	8.2%	1.7%	6.4%
Total Volume		3.6%	4.4%	0.8%	2.9%

Source: Participant data, KPMG analysis

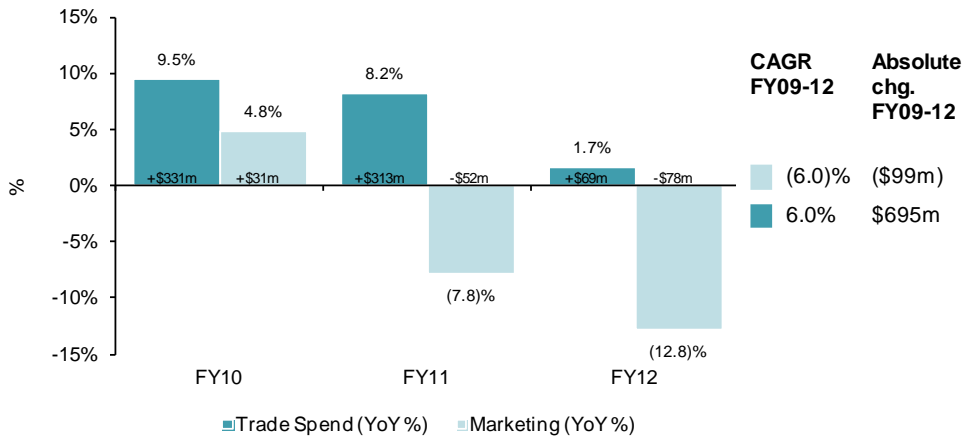
However, trade spend and volumes do not consistently result in increased volumes as is shown above.

Trade spend is on average 6 per cent higher for the two largest retailers compared to the rest of the retail channel.

Trade spend does not appear to result in higher volumes.

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Figure 5.9: Comparison of movement of trade spend and marketing costs (FY09-12)



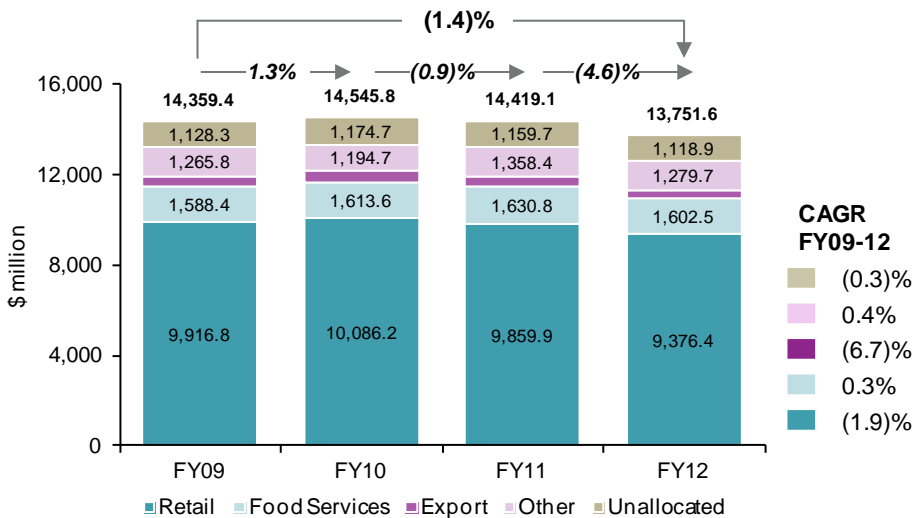
Marketing spend may be substituted by trade spend.

Source: Participant data, KPMG analysis

5.2.3 Net sales

Net sales declined by 1.4 per cent CAGR between FY09 and FY12, predominantly driven by a 1.9 per cent decline in retail sales. In contrast to gross sales, net sales declined in FY11 due to the higher trade spend.

Figure 5.10: Net sales by channel (FY09-12)



Source: Participant data, KPMG analysis

5.3 Costs

Cost including trade spend represent nearly 95 per cent of gross sales and grew by CAGR 0.6 per cent from \$16.6 billion to \$16.9 billion during FY09-12. This is higher than the 0.2 per cent CAGR of gross sales over the same period.

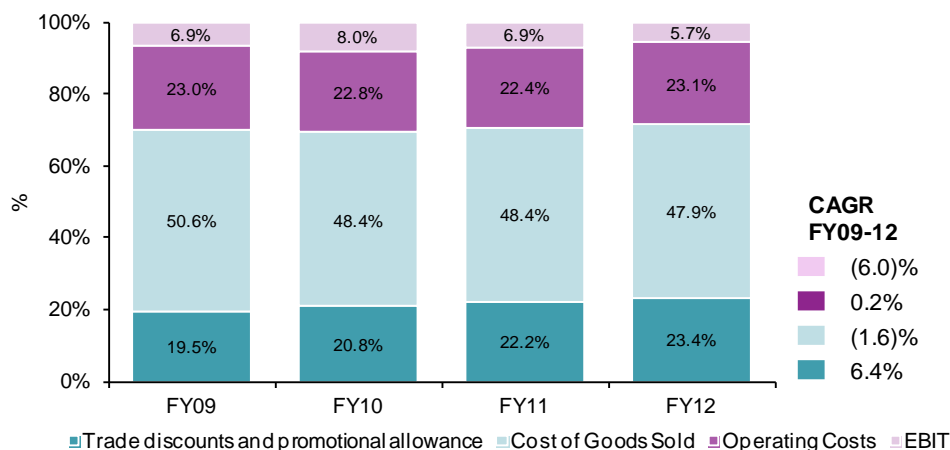
Total costs have been segmented into two broad categories for the analysis:

- Cost of Goods Sold; and
- Operating costs.

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The following figure breaks down the individual cost elements into these categories:

Figure 5.11: Key cost categories as a proportion of gross sales (FY09-12)



Trade spend increased by 6.4 per cent, having the largest impact on EBIT compared to other cost categories.

Source: Participant data, KPMG analysis

The overall EBIT margin as per cent of gross sales declined from 6.9 per cent in FY09 to 5.7 per cent in FY12. Trade spend has been the largest contributor to the margin decline.

5.3.1 Cost of goods sold

In absolute terms, cost of goods sold for the participant group decreased at a CAGR of 1.6 per cent, from \$9.0 billion in FY09 to \$8.6 billion in FY12. Cost of sales' proportion of gross sales fell from 51 per cent in FY09 to 48 per cent in FY12.

Cost of sales can be divided into three components – cost of materials, conversion costs and finished goods:

- Cost of materials encompass cost of commodities, other raw material, packaging, manufacturing variances;
- Conversion cost related to costs involved in the conversion of materials into finished goods such as direct labour, utilities, manufacturing related depreciation and other manufacturing costs; and
- Finished goods related to goods procured (domestically or internationally) for the purpose of direct resale to the customer.

Table 5.3: Split of cost of goods sold (FY09-12)

	FY09	FY10	FY11	FY12	CAGR
Cost of Materials	23.2%	22.2%	21.4%	22.0%	0.9%
Cost of Conversion	9.0%	8.8%	8.8%	9.0%	2.8%
Finished Goods	17.1%	15.3%	16.2%	14.7%	-2.3%

Note: Compounded annual growth rates based on absolute figures
Source: Participant data, KPMG analysis, N=9

Nine out of the 18 companies in the sample generate sales through the sale of finished goods. Typically, the cost category would account for approximately 15 per cent of gross sales (for companies that deploy this activity). Cost of materials is the largest cost driver at an average rate of 22 per cent of gross sales.

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Cost of Materials

Table 5.4: Split of cost of materials (FY09-12)

	FY09	FY10	FY11	FY12	CAGR
Commodities	14.4%	14.6%	14.8%	14.7%	0.7%
Other raw material	12.3%	11.3%	10.6%	9.8%	-7.2%
Packaging	2.9%	2.8%	2.5%	2.6%	-2.9%
Stock write off	0.3%	0.1%	0.3%	0.2%	-12.2%
Manufacturing variances	0.8%	0.8%	0.7%	0.7%	-6.6%

Note: Compounded annual growth rates based on absolute figures
Source: Participant data (n = 14), KPMG analysis

The primary drivers for cost of materials are commodity prices and other raw material prices. The commodity prices remained relatively flat as a percentage of gross sales at 14.7 per cent. Other raw material costs decreased from 12.0 per cent in FY11 to 10.0 per cent of gross sales, or by 10.5 per cent in absolute terms, in FY12. Participants indicate that the relatively high Australian Dollar and procurement improvement programs reduced some operating input costs.

Conversion Costs

Table 5.5: Conversion cost breakdown (FY09-12)

	FY09	FY10	FY11	FY12	CAGR
Direct Labour	4.7%	4.6%	4.5%	4.7%	0.04%
Depreciation	1.1%	1.1%	1.1%	1.1%	2.50%
Utilities	1.3%	1.2%	1.3%	1.5%	3.99%
Other Manufacturing Costs	5.2%	4.9%	5.0%	4.9%	-1.95%

Note: Compounded annual growth rates are based on absolute figures
Source: Participant data (n = 16), KPMG analysis

Direct labour costs have remained relatively flat as a percentage of gross sales with a decline in FY11 while volumes sold by the participants increased by 2.9 per cent per annum between FY09 and FY12. This suggests that the participants were able to reduce some direct labour costs through measures such as through plant closures, capacity consolidation and productivity improvement. This reduction in direct labour is further supported by a finding in the State of the Industry Report 2012 where the food and grocery industry experienced an overall decline in employment levels by 2.2 per cent²¹.

More recent trends in FY12 indicate further growth in direct labour costs is potentially driven by wage inflation pressures and reducing opportunities for cost reduction and productivity gains.

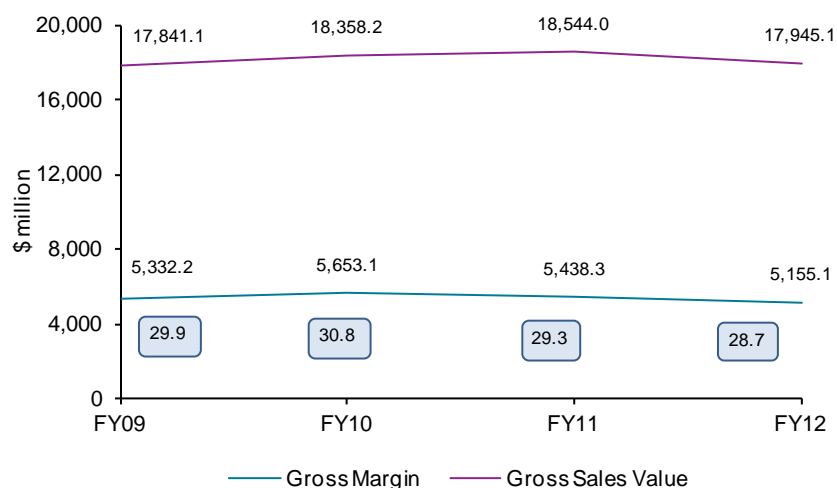
²¹ Australian Food and Grocery Council | State of the Industry 2012

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Gross Margin

The combination of declining gross sales in FY12, increasing trade spend and some reduction in cost of materials has resulted in a reduction of gross margin from 29.9 per cent in FY09 to 28.7 per cent in FY12.

Figure 5.12: Gross margin versus gross sales (\$ and per cent) (FY09-12)



Source: Participant data, KPMG analysis

Gross margin declined from 29.9 per cent in FY09 to 28.7 per cent in FY12.

5.3.2 Operating costs

Table 5.6: Total operating costs (FY09-12)

	FY09	FY10	FY11	FY12	CAGR
Warehousing, Logistics & Distribution	9.4%	9.4%	9.8%	10.1%	2.2%
Salaries & on-costs	8.2%	7.8%	7.6%	8.1%	-0.7%
Marketing	4.5%	4.6%	4.2%	3.8%	-5.6%
Depreciation & Amortisation	1.1%	1.4%	1.2%	1.2%	2.8%
Royalties	0.6%	0.6%	0.8%	0.8%	12.2%
IT costs	0.6%	0.7%	0.6%	0.6%	2.3%
R&D	0.6%	0.5%	0.4%	0.4%	-13.2%
Other	4.1%	3.8%	3.9%	4.5%	2.5%

Note: Compounded annual growth rates are based on absolute figures
Source: Participant data (n=15), KPMG analysis

Warehousing, Logistics, Distributions and Salary costs all grew in FY12.

Marketing spend and R&D expenses continued to decline.

Total operating costs over the FY09-12 period have grown slightly at 0.2 per cent CAGR.

The largest components of operating costs are warehouse, logistics and distribution (WLD) constituting 10.1 per cent of gross sales, and Salaries and on-costs constituting 8.1 per cent of gross sales.

- WLD costs relate to the costs that participants incurred to transport and store the goods for sale.
- Salaries and on-costs refer to salaries, bonuses and secondary benefits paid to management, corporate support and other indirect labour.

WLD costs increased at an annual average of 2.2 per cent since FY09, peaking at 4.7 per cent growth in FY11 and subsequently declining slightly in FY12. As a percentage of gross sales, WLD costs increased by 0.7 per cent over the full period. The relatively fixed nature of the costs for the infrastructure and the significant component related to fuel costs which have been increasing are the key drivers of cost growth in this cost category.

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Salaries and on-costs have remained stable in absolute terms while gross sales have declined. This suggests that the efforts undertaken by the participants to realign the cost of labour were not sufficient to protect margins.

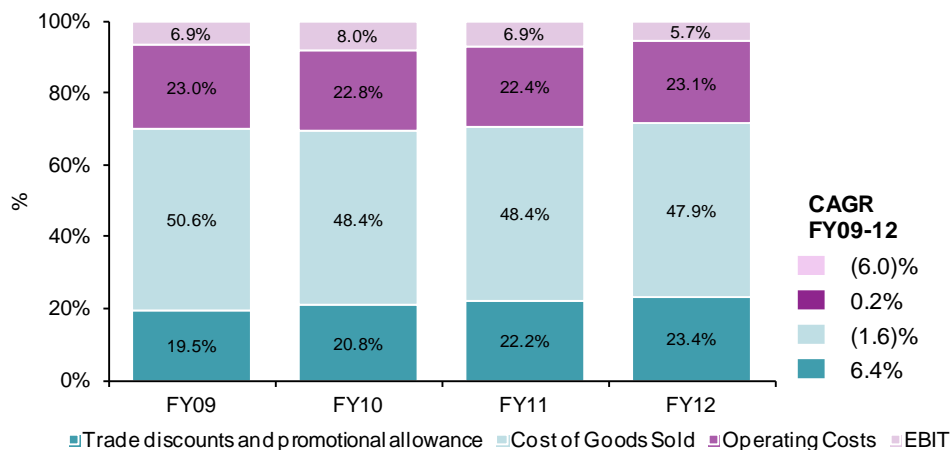
The negative impact of increases in labour and WLD costs on margins was somewhat moderated by decreases in marketing and R&D costs. Marketing spend, which accounts for 4 per cent of gross sales, decreased by an average of 6 per cent over the last four years. The evidence suggests that manufacturers are reducing marketing spend and potentially reallocating this to trade spend to support volume growth. However, performance results do not indicate an uplift in volumes in line with trade spend growth in FY12.

The participants have reduced R&D expenditure considerably, as evidenced by a decline of 13 per cent CAGR in R&D costs during FY09-12. This may be as a result of multi-year programs that may have been part of capital expenditure, and therefore, reflected in the balance sheet (section 5.5). Also some of the R&D facilities may have been relocated to offshore locations. KPMG has not been provided with the data to support this.

On an overall level, operating costs have increased and savings in some cost categories were not sufficient to offset declines in sales.

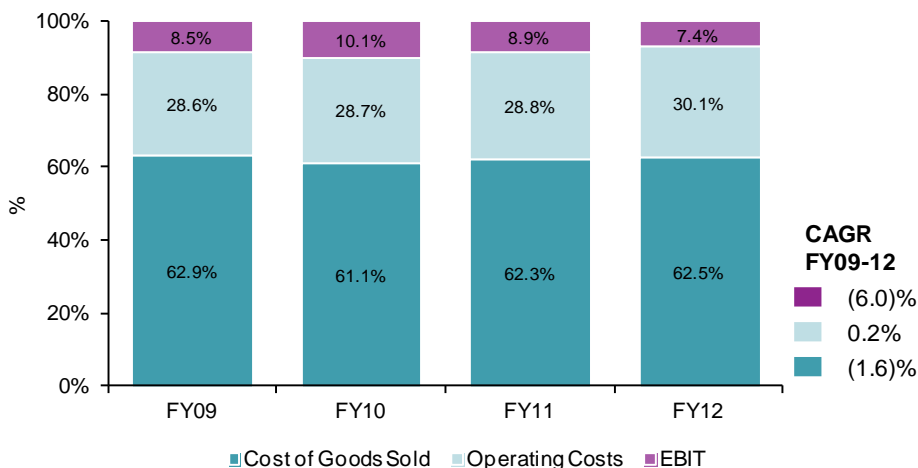
5.4 Profitability

Figure 5.13: Cost categories and EBIT as a proportion of gross sales (FY09-12)



Source: Participant data, KPMG analysis

Figure 5.14: Cost categories and EBIT as a proportion of net sales (FY09-12)



Source: Participant data, KPMG analysis

The analysis of sales and costs in sections 5.2 and 5.3 provides insights into what could be driving growth in the respective areas over the FY09 to FY12 period. This section covers the impact of revenue and costs on profitability, both gross margin and EBIT on the group of participants.

In dollar terms, gross margin decreased by 1.1 per cent CAGR, from \$5.3 billion in FY09 to \$5.2 billion in FY12. The gross margin proportion of gross sales decreased from 29.9 per cent in FY09 to 28.7 per cent in FY12.

Overall operating costs remained flat however reductions were observed in R&D and marketing. Aggregate EBIT declined at a CAGR of 6 per cent during FY09-12. EBIT as a proportion of gross sales decreased from 6.9 per cent in FY09 to 5.7 per cent in FY12.

As a percentage of net sales, EBIT declined from 8.5 per cent to 7.4 per cent between FY09-12.

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5.5 Balance sheet

The following table depicts the aggregated balance sheet for the participants for the period FY09-12.

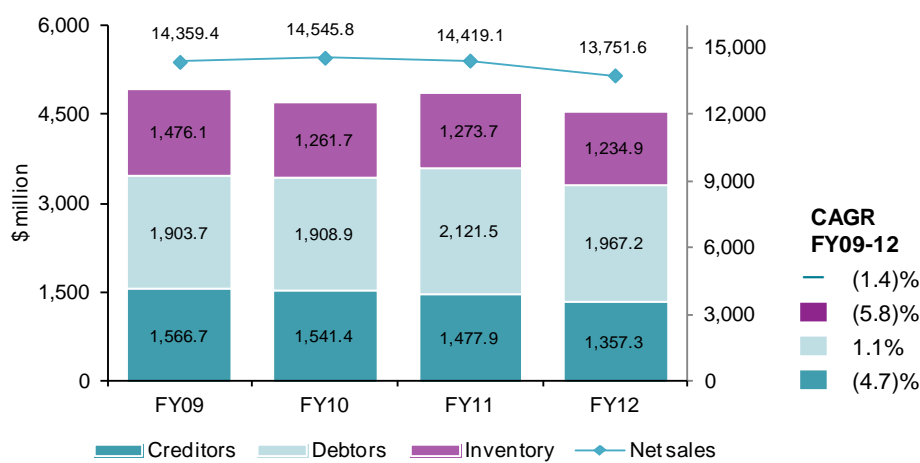
Table 5.7: Balance sheet (FY09-12)

	FY09	FY10	FY11	FY12	CAGR
Trade debtors	1,903.7	1,908.9	2,121.5	1,967.2	1.1%
Inventory	1,476.1	1,261.7	1,273.7	1,234.9	-5.8%
Tax assets	100.0	109.0	112.6	98.0	-0.6%
Property, Plant and Equipment (PPE)	3,234.2	3,287.0	3,289.4	3,259.3	0.3%
Goodwill & Intangibles	5,080.9	4,255.6	3,022.8	2,449.8	-21.6%
Other assets	874.6	1,315.2	1,128.7	1,423.9	17.6%
Total Assets	12,669.4	12,137.5	10,948.8	10,433.1	-6.3%
Creditors	1,566.7	1,541.4	1,477.9	1,357.3	-4.7%
Borrowings	953.5	1,042.3	1,158.9	959.3	0.2%
Tax payable	157.7	218.2	136.1	90.7	-16.8%
Other liabilities	869.6	754.9	767.4	849.7	-0.8%
Total Liabilities	3,547.5	3,556.8	3,540.3	3,256.9	-2.8%
Net Capital Employed	9,121.9	8,580.7	7,408.5	7,176.2	-7.7%

Source: Participant data, KPMG analysis

5.5.1 Working Capital

Figure 5.15: Working capital, excluding cash (FY09-12)

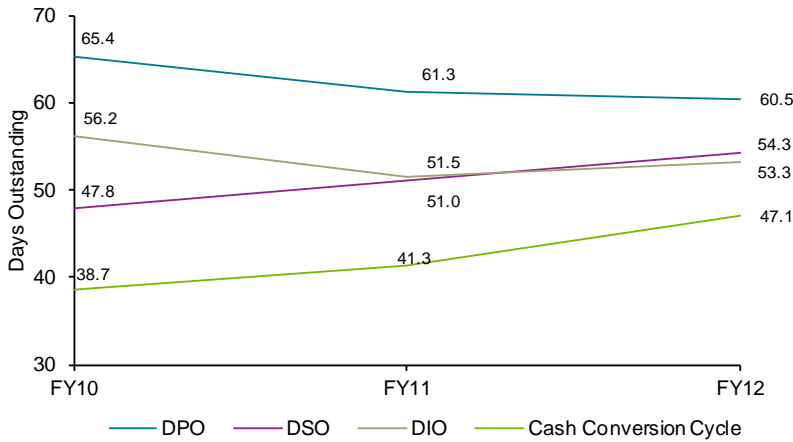


Source: Participant data, KPMG analysis

Working capital as a percentage of net sales increased from 12.6 per cent in FY09 to 13.4 per cent in FY12. The increase appears to be the result of an increase in debtors. Inventory levels have reduced by 5.8 per cent over the period with a temporary increase in FY11.

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Figure 5.16: Working capital days (FY09-12)



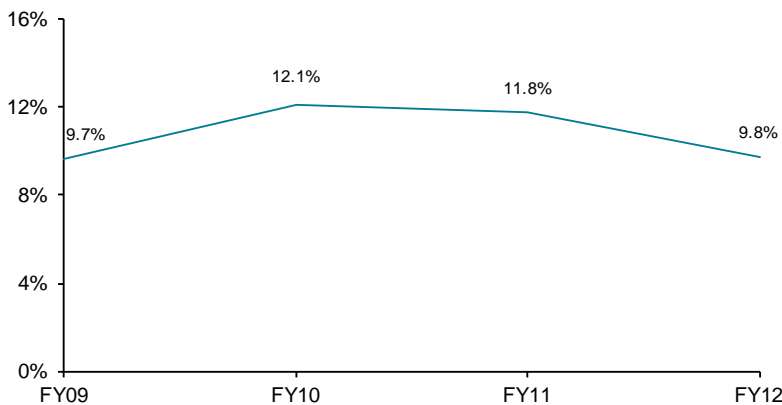
Source: Participant data, KPMG analysis

The cash conversion cycle increased driven by higher debtor days, offset by lower inventories.

Days of purchases outstanding have shortened from 65 to 61 between FY10 and FY12, suggesting a tighter credit environment with suppliers demanding shorter payment periods. Days of sales outstanding is on the other hand increasing from 48 in FY10 to 54 in FY12, which suggests a widening debt collection period. Days of inventory outstanding declined from 56 to 53 with a low of 52 in FY11.

Total assets in the sample notes a decline of 6.3 per cent CAGR, from \$12.7 billion in FY09 to \$10.4 billion in FY12, mostly due to higher impairment of goodwill and intangibles. Over the same period, profitability (EBIT) decreased at an average rate of 6 per cent. As a result, the return on assets decreased to 10 per cent in FY12 from 12 per cent in FY11.

Figure 5.17: Return on assets (FY09-12)



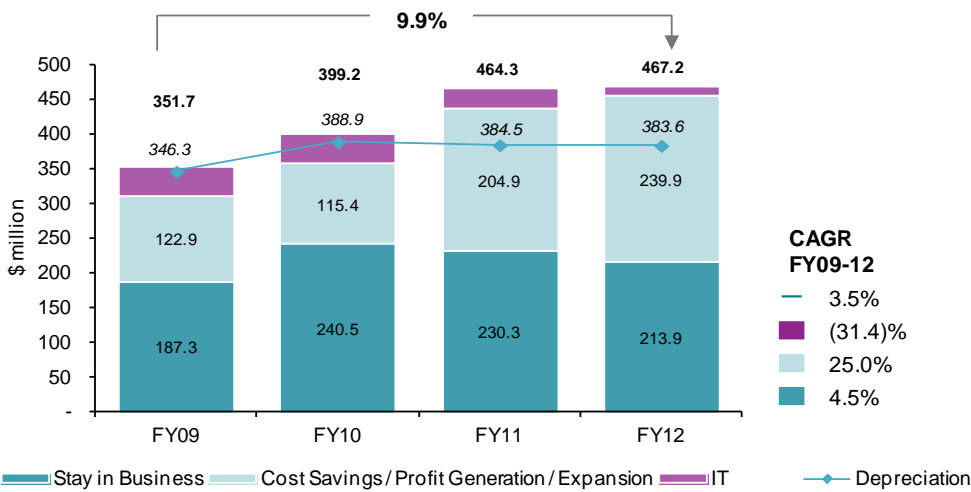
Source: Participant data, KPMG analysis

5.6 Capital Expenditure

Capital expenditure (capex) consistently increased between FY09 and FY12 at a rate of 10 per cent CAGR, outpacing depreciation levels. The three categories of capex investigated are:

- Stay in business; investments made to maintain existing assets and their value
- Cost savings/profit generation/expansion; investments made to reduce the cost or increase the value of the total asset base and generate a basis for profit growth
- Information technology; capital expenditure related to the implementation of IT systems

Figure 5.18: Split of capital expenditure by purpose and depreciation (FY09-12)



Capex grew by 10 per cent CAGR between FY09 and FY12, and was primarily focused on cost saving and expansion initiatives.

Source: Participant data, KPMG analysis

The main driver for the growing capital expenditure was profit generation and expansion, including cost saving programs.

6 Key themes in the industry

Further analysis has been undertaken to better understand the key issues impacting the current and future financial performance of the participants. This includes:

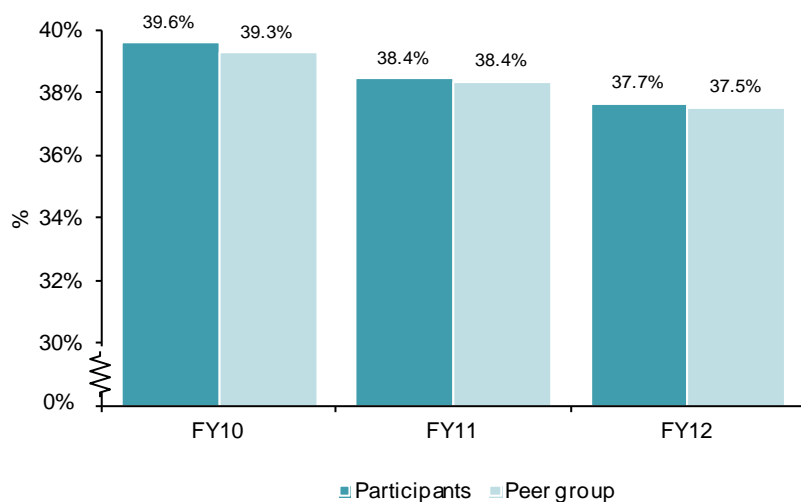
- Comparison of the profitability of the participant group versus international peers
- Development of the competitive position of Australia from a cost perspective

6.1 Profitability of the participating group relative to international comparators

The results of the participants were compared to the average performance of gross margin and EBIT of 41 international organisations listed in the CapitalIQ database as at April 2012. These companies are listed in Appendix 7.4.

Participant values are based on the mean of the gross margin (Gross Margin/Net Sales) and EBIT margin (EBIT/Net Sales) of the participant data set.

Figure 6.1: Gross margin as percentage of net sales (FY10-12)

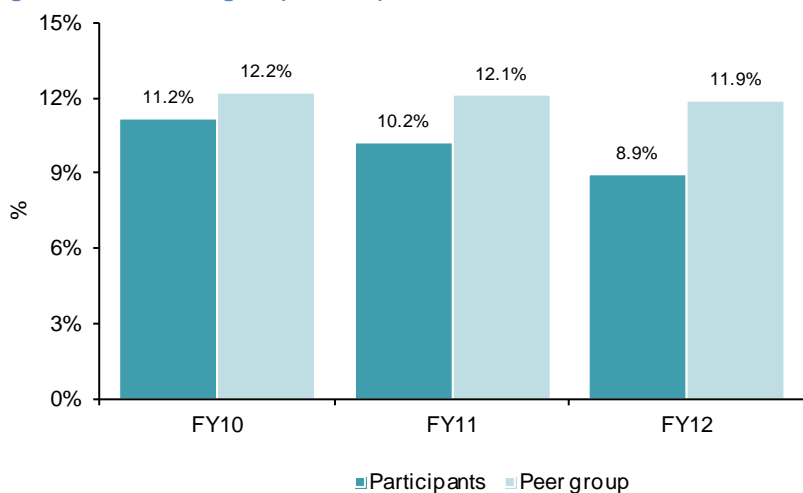


Note: Analysis is based on mean of gross margins
Source: Participant data, CapitalIQ database, KPMG analysis

It is noted that on a gross margin level, the average gross margin of the participating group is relatively on par with the international benchmarks at 38 per cent gross margin of net sales across the FY10 to FY12 period.

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Figure 6.2: EBIT margins (FY10-12)



Note: Analysis is based on mean of EBIT margins
Source: Participant data, CapitalIQ database, KPMG analysis

On an EBIT level, the participants record a relatively low margin of 8.9 per cent of net sales versus 11.9 per cent internationally in FY12. The Australian participants recorded a higher relative cost structure. These results support the Union Bank of Switzerland 2011 findings²². The higher cost base of Australian food and grocery manufacturers is also supported by KPMG Competitive Alternative studies of 2008-12.

The cost base of Australian food and grocery manufacturers is relatively high as the small domestic market provides limited opportunity to grow scale and achieve scale efficiencies.

²² 'Exploring Treasure Island' Mach II; UBS Investment Research; 2011

6.2 Comparison of the Australian cost base

The Competitive Alternatives 2012²³ report compares the cost and other key factors of operating in various international locations in mature and high growth markets. The report measures the cost competitiveness of each country and provides cost indexes for various industries.

The following figure illustrates the cost of operations in various regions, using the US as a baseline figure.

Figure 6.3: Cost Index Agri-food (FY08-12)

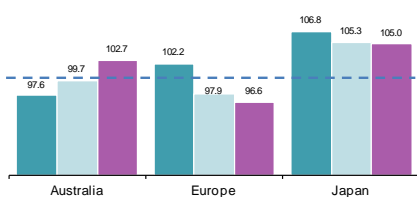
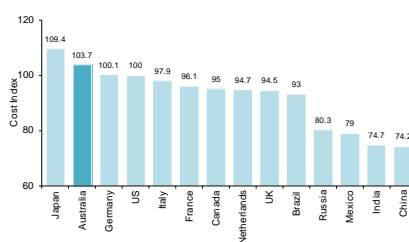


Figure 6.4: Cost Index – Manufacturing (2012)



Note: Cost comparison over time relates to agri-food (left), Cost comparison by country (right) relates to overall industries
 Source: Competitive Alternatives | KPMG's Guide to International Business Location Costs, KPMG (2012)

From 2008 to 2012, the cost of operating in Australia has been consistently increasing, with the major cause being the currency appreciation against the US dollar (USD). From a low of \$0.64/USD in March 2009, the AUD has appreciated nearly 60 per cent to \$1.02/USD in May 2013. Other major cost trends that impacted the cost index are:

- Increases in rent causes overall industrial facility costs to increase.
- From 2008 to 2010, relative to other international locations, Australia had a decline in transportation costs; however from 2010 onwards, Australia ranks as having the highest overall transportation costs, largely due to the surface freight costs per load.
- Increases in utility costs, in particular, the continual increase in electricity prices from 2008 to 2012 of 70% from US\$0.126 to US\$0.214 per kilowatt hour.
- Already high labour costs which are continually increasing.

²³ Competitive Alternatives | KPMG's Guide to International Business Location Costs, KPMG (2012)

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Regulation is another notable factor impacting the cost of doing business in Australia. According to Ipsos Director Sentiment Index²⁴, over 70 per cent of directors believe that the level of regulation has increased over the past year, and 60 per cent expect an increase in the following year. Employing workers and workplace health and safety were identified as aspects of the business most affected by regulation.

For a comparison of utility and labour cost compared to other geographies, refer to appendix 7.3.

²⁴ A random sample of members sourced from the Australian Institute of Company Directors' database was interviewed for the study (504 respondents) – *Director Sentiment Index: Research Findings First Half 2013*, Ipsos MediaCT and Australian Institute of Company Directors; April 2013

Australian Food and Grocery Council

7 Appendices

7.1 Summary of key financials

Table 7.1: Table of key items

\$m	FY09	FY10	FY11	FY12	% year-on-year Δ			
					FY10	FY11	FY12	CAGR
Gross Sales	17,841.1	18,358.2	18,544.0	17,945.1	2.9%	1.0%	-3.2%	0.2%
Trade spend	3,481.7	3,812.4	4,124.9	4,193.4	9.5%	8.2%	1.7%	6.4%
<i>As % of gross sales</i>	<i>19.5%</i>	<i>20.8%</i>	<i>22.2%</i>	<i>23.4%</i>				
Net Sales Value	14,359.4	14,545.8	14,419.1	13,751.6	1.3%	-0.9%	-4.6%	-1.4%
Total Cost of Goods Sold	9,027.2	8,892.8	8,980.8	8,596.6	-1.5%	1.0%	-4.3%	-1.6%
<i>As % of gross sales</i>	<i>50.6%</i>	<i>48.4%</i>	<i>48.4%</i>	<i>47.9%</i>				
<i>As % of net sales</i>	<i>62.9%</i>	<i>61.1%</i>	<i>62.3%</i>	<i>62.5%</i>				
Gross Margin	5,332.2	5,653.1	5,438.3	5,155.1	6.0%	-3.8%	-5.2%	-1.1%
<i>As % of gross sales</i>	<i>29.9%</i>	<i>30.8%</i>	<i>29.3%</i>	<i>28.7%</i>				
<i>As % of net sales</i>	<i>37.1%</i>	<i>38.9%</i>	<i>37.7%</i>	<i>37.5%</i>				
Operating Costs	4,107.1	4,179.8	4,151.3	4,136.8	1.8%	-0.7%	-0.3%	0.2%
<i>As % of gross sales</i>	<i>23.0%</i>	<i>22.8%</i>	<i>22.4%</i>	<i>23.1%</i>				
<i>As % of net sales</i>	<i>28.6%</i>	<i>28.7%</i>	<i>28.8%</i>	<i>30.1%</i>				
EBIT	1,225.1	1,473.3	1,287.1	1,018.2	20.3%	-12.6%	-20.9%	-6.0%
<i>As % of gross sales</i>	<i>6.9%</i>	<i>8.0%</i>	<i>6.9%</i>	<i>5.7%</i>				
<i>As % of net sales</i>	<i>8.5%</i>	<i>10.1%</i>	<i>8.9%</i>	<i>7.4%</i>				
Volume								
Retail Channel	2,226.4	2,252.9	2,257.6	2,185.3	1.2%	0.2%	-3.2%	-0.6%
Total Channels	2,981.5	3,089.9	3,226.8	3,253.0	3.6%	4.4%	0.8%	2.9%
Other items								
Total Assets	12,669.4	12,137.5	10,948.8	10,433.1	-4.2%	-9.8%	-4.7%	-6.3%
Inventory	1,476.1	1,261.7	1,273.7	1,234.9	-14.5%	1.0%	-3.0%	-5.8%
Return on assets	9.7%	12.1%	11.8%	9.8%	n/a	n/a	n/a	n/a
Capital expenditure	351.7	399.2	464.3	467.2	13.5%	16.3%	0.6%	9.9%
<i>As % of gross sales</i>	<i>2.2%</i>	<i>2.4%</i>	<i>2.7%</i>	<i>2.9%</i>				
<i>As % of net sales</i>	<i>2.7%</i>	<i>3.0%</i>	<i>3.5%</i>	<i>3.7%</i>				

Table 7.2: Split of cost of goods sold as per cent of net sales (FY09-12)

	FY09	FY10	FY11	FY12	CAGR
Cost of Materials	29.1%	28.6%	28.2%	29.5%	0.9%
Cost of Conversion	11.3%	11.4%	11.6%	12.1%	2.8%
Finished Goods	21.4%	19.7%	21.3%	19.7%	-2.3%

Note: Compounded annual growth rates based on absolute figures
Source: Participant data, KPMG analysis, N=9

Table 7.3: Split of cost of materials as per cent of net sales (FY09-12)

	FY09	FY10	FY11	FY12	CAGR
Commodities	18.1%	18.7%	19.2%	19.4%	0.7%
Other raw material	15.4%	14.4%	13.8%	13.0%	-7.2%
Packaging	3.6%	3.5%	3.3%	3.5%	-2.9%
Stock write off	0.3%	0.2%	0.3%	0.2%	-12.2%
Manufacturing variances	1.0%	1.0%	0.9%	0.9%	-6.6%

Note: Compounded annual growth rates based on absolute figures
Source: Participant data (n = 14), KPMG analysis

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Table 7.4: Split of cost of conversion as per cent of net sales (FY09-12)

	FY09	FY10	FY11	FY12	CAGR
Direct Labour	5.9%	5.8%	5.8%	6.2%	0.04%
Depreciation	1.3%	1.3%	1.4%	1.5%	2.50%
Utilities	1.6%	1.5%	1.7%	1.9%	3.99%
Other Manufacturing Costs	6.5%	6.2%	6.4%	6.5%	-1.95%

Note: Compounded annual growth rates are based on absolute figures
Source: Participant data (n = 16), KPMG analysis

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7.2 Survey

Figure 7.1: Questionnaire

Check items still outstanding. Please review Check sheet.

Questions	Answer								
1 How many employees do you have in Australia?	Total Headcount - (includes directly employed and indirectly employed e.g. third party/contractors)								
2 Do you manufacture products in Australia?									
2a If "yes" to above, Select from drop down the % of products manufactured in Australia in FY09									
2b Select from drop down the % of products manufactured in Australia in FY12									
3 Please rate the top three contributors to your Gross Margin performance over the past 3 years? Of these top three contributors, has the impact been positive or negative?	<table border="1"> <thead> <tr> <th>Impact</th> <th>Comments</th> </tr> </thead> <tbody> <tr><td>1</td><td></td></tr> <tr><td>2</td><td></td></tr> <tr><td>3</td><td></td></tr> </tbody> </table>	Impact	Comments	1		2		3	
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4 Please rate the top three contributors to your EBIT margin performance over the past 3 years? Of these top three contributors, has the impact been positive or negative?	<table border="1"> <thead> <tr> <th>Impact</th> <th>Comments</th> </tr> </thead> <tbody> <tr><td>1</td><td></td></tr> <tr><td>2</td><td></td></tr> <tr><td>3</td><td></td></tr> </tbody> </table>	Impact	Comments	1		2		3	
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5 Please rate the top three contributors to changes in trade spend over the past 3 years? Of these top three contributors, has the impact been positive or negative?	<table border="1"> <thead> <tr> <th>Impact</th> <th>Comments</th> </tr> </thead> <tbody> <tr><td>1</td><td></td></tr> <tr><td>2</td><td></td></tr> <tr><td>3</td><td></td></tr> </tbody> </table>	Impact	Comments	1		2		3	
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6 Please rate the top three contributors to changes in promotional spend over the past 3 years? Of these top three contributors, has the impact been positive or negative?	<table border="1"> <thead> <tr> <th>Impact</th> <th>Comments</th> </tr> </thead> <tbody> <tr><td>1</td><td></td></tr> <tr><td>2</td><td></td></tr> <tr><td>3</td><td></td></tr> </tbody> </table>	Impact	Comments	1		2		3	
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Figure 7.2: F1 – Income statement

F1 - Income Statement / Volume					Financial year period for participant (i.e Sept - Aug etc)	
Financial Year period	FY09	FY10	FY11	FY12	Participant comments (if required)	KPMG Definition & Guidance (where relevant)
Volume						
Net revenue (millions)						What is the retail customer's unit price & items
Net volume (millions)						Weighted average unit volume (WUAV) = Total weight of product sold
Income Statement						
Gross Sales						Customer list price before discounts
Trade Discounts						Trade discounts including Trading Terms. Enter values as positive
Provisional Allowances						Allowable discounts including Cash Sales, Co-operative fees etc. Enter values as positive
Net Sales Value	0	0	0	0		
Enter as positive values						
Charged to stock						Oil, Wheat, Butter, Milk Powder, Sugar etc.
Stock write off						Unusable product that is written off including unsaleable customer returns, surplus packaging and damaged goods
Total Cost of Materials						
Direct Labour						Labour costs directly attributed to the manufacture of product
Utilities						All energy related costs (including gas, electricity, water etc)
Depreciation						All factory related depreciation
Other Manufacturing Costs						All other manufacturing based head and costs including manufacturing based head office costs
Total Conversion Cost						
Finished goods ready for sale						Any finished goods that are purchased ready for sale
Total Cost of Goods	0	0	0	0		Sum of "Total Cost of Materials" & "Total Conversion Cost" & "Finished goods ready for sale"
Gross Margin	0	0	0	0		
Enter as positive values						
Warehousing, Logistics & Distribution						Total transport costs to ship product to the customer. This includes factory gate, primary freight charges and from Cities & Workshops, packing costs and all storage related costs of finished goods
Marketing						Any revenue payable for the campaign (including brand lift etc)
Salaries & on-costs						All advertising spend including media, production costs, print, agency costs and on-costs. Does not include any general salary related costs which could be referred to "Salaries and on-costs"
Depreciation & Amortisation						Depreciation related to non-manufacturing assets and amortisation resulting from write-downs of any goodwill and intangibles
Other						Other operating costs that do not fall in the above categories. Please provide a short description in cell
Total Operating Costs	0	0	0	0		Set of types of expenses that fall in this category is "Travel & Entertainment costs"
EBIT	0	0	0	0		
Total Depreciation	0	0	0	0		
EBITA	0	0	0	0		

Legend
 Participant input cells
 Calculated cells - do not input values
 Calculated cells - do not input values

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Figure 7.3: F2 – Balance sheet

F2 - Balance Sheet / Capex

Balance Sheet line items	FY09 (\$ millions)	FY10 (\$ millions)	FY11 (\$ millions)	FY12 (\$ millions)	Participant comments (if required)	KPMG Definition & Guidance (where relevant)
Cash & cash equivalents						Total of cash and cash equivalents (if overdrafts, enter as negative value)
Trade receivables						
Prepaid expenses						
Other receivables						
Property, plant and equipment (PPPE)						Net PPE (line row 24 - 27)
Goodwill & intangibles						Net Goodwill and Intangibles (line rows 28 - 30)
Other assets						Other assets not reflected in the above asset categories
Total Assets	0	0	0	0		
Accounts payable						
Other liabilities						Other liabilities not reflected in the above liability categories
Total Liabilities	0	0	0	0		
Net Capital Employed	0	0	0	0		Total assets less liabilities i.e. equity value
Calculating net "PPE" and "Goodwill & Intangibles"	FY09	FY10	FY11	FY12	Participant comments (if required)	KPMG Definition & Guidance (where relevant)
Property, Plant and Equipment (PPE)						Book value of PPE
less accumulated depreciation						Accumulated depreciation for PPE. Enter as negative value
Net PPE	0	0	0	0		
Goodwill & Intangibles (GI)						Book value of Goodwill & Intangibles
less accumulated amortisation						Accumulated amortisation for PPE. Enter as negative value
Net Goodwill & Intangibles	0	0	0	0		
Capex spend	FY09	FY10	FY11	FY12	Participant comments (if required)	KPMG Definition & Guidance (where relevant)
Pay in Business						Spend related to keeping current operations running and includes Regulatory, Safety, Maintenance /
Capital Expenditure (Capex)						Capital Expenditure (Capex) related to new plant, equipment, IT spend
Total Capex	0	0	0	0		

Figure 7.4: N1 – Channel information

N1 - Channel information

Channel	Sales (\$ millions)				Net Sales Value (\$ millions)				Volume - sales (millions)				Volume - tonnes (millions)				KPMG Definition & Guidance (where relevant)
	FY09	FY10	FY11	FY12	FY09	FY10	FY11	FY12	FY09	FY10	FY11	FY12	FY09	FY10	FY11	FY12	
Total Retail	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0	
Woolworths Private Label																	Value and volume metrics from Woolworths Private Label products to Woolworths. Sales and volume metrics from Private Label products to Woolworths.
Coles Private Label																	Value and volume metrics from Coles Private Label products to Coles. Sales and volume metrics from Private Label products to Coles.
Metcash Private Label																	Value and volume metrics from Metcash Private Label products to Metcash. Sales and volume metrics from Private Label products to Metcash.
Aldi Private Label																	Value and volume metrics from Aldi Private Label products to Aldi. Sales and volume metrics from Private Label products to Aldi.
Costco Private Label																	Value and volume metrics from Costco Private Label products to Costco. Sales and volume metrics from Private Label products to Costco.
Other Retail customers																	Value and volume metrics of all other Retail Customers i.e. convenience stores, petrol stations, Route Trans, milk bars, pharmacies etc.
Total Food Services	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0	
Products																	Value and volume metrics of finished goods to Foodservices customers i.e. HORECA, Defence, Hospitals, etc.
Industrial (Ingredients)																	Value and volume metrics of ingredients to Foodservices customers that utilize these ingredients as inputs to another manufacturing process i.e. a sale of sugar to be used in a manufacturing of soft drinks by a beverage manufacturer
Total Export	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0	Value and volume metrics of finished goods exported
Other channels	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0	Value and volume metrics of finished goods from other channels such as B2B
Total from channels	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0	

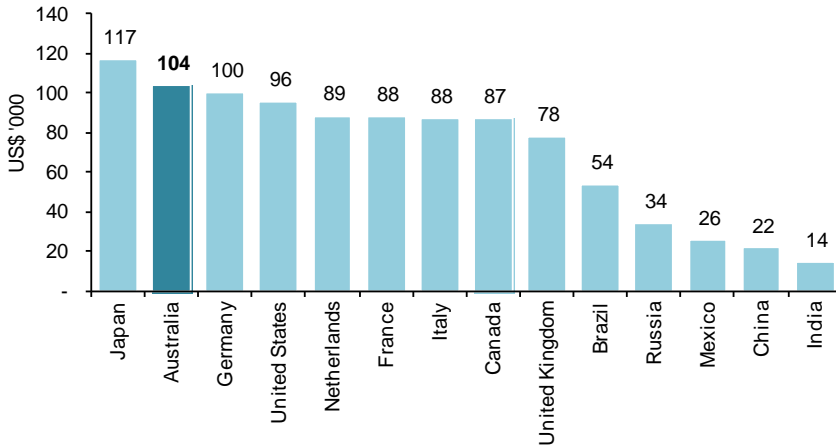
Figure 7.5: N2 – SKU information

N2 - SKU information

Product/SKU information	FY09	FY10	FY11	FY12	Participant comments (if required)	KPMG Definition & Guidance (where relevant)
Product Count						Total number of products for the year
New Branded SKUs						New Branded SKUs introduced that are a result of new products, new formulas. New SKUs resulting from changes in weight/volume/packaging of current products are EXCLUDED.
Branded SKU Deletions						See Guidance in the above cell
Total Branded SKUs						Total Branded SKUs in relevant financial year
New PL SKUs						New PLSKUs introduced that are a result of new products, new formulas. New SKUs resulting from changes in weight/volume/packaging of current products are EXCLUDED.
Deleted PL SKUs						See Guidance in the above cell
Total PL SKUs						Total PL SKUs in relevant financial year

7.3 Comparison utility and labour costs Australia

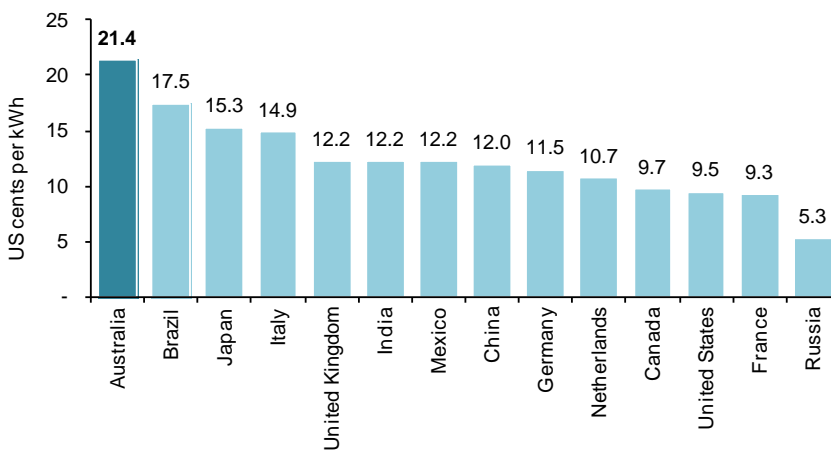
Figure 7.6: Average labour cost per employee per annum in US\$



Note: Average for 19 operations included in the overall results. Represents 42 different job positions, including professional and management positions

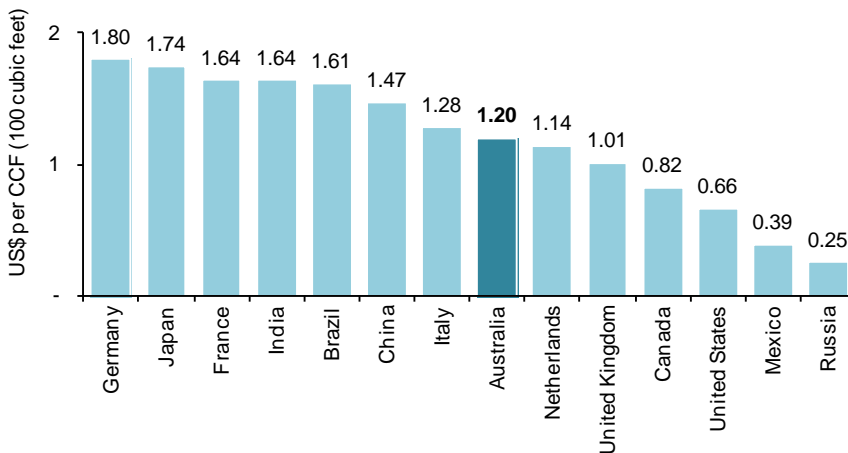
Source: Competitive Alternatives | KPMG's Guide to International Business Location Costs, KPMG (2012)

Figure 7.7: Electricity costs in US\$ cents per kWh



Source: Competitive Alternatives | KPMG's Guide to International Business Location Costs, KPMG (2012)

Figure 7.8: Natural gas costs per CCF in US\$



Source: Competitive Alternatives | KPMG's Guide to International Business Location Costs, KPMG (2012)

Australian Food and Grocery Council

7.4 International peer group list for profitability benchmarking

Company Name
Asahi Group Holdings, Ltd.
Buderim Ginger Ltd.
Campbell Soup Company
China Mengniu Dairy Co. Ltd.
Church & Dwight Co. Inc.
Coca-Cola Amatil Limited
Cott Corporation
Danone
Diageo plc
FFI Holdings Limited
Fonterra Co-Operative Group Ltd.
Freedom Foods Group Limited
General Mills, Inc.
George Weston Limited
Goodman Fielder Ltd.
H. J. Heinz Company
Heineken NV
Henkel AG & Co. KGaA
Hillshire Brands Company
JBS S.A.
Johnson & Johnson
Kellogg Company
Kirin Holdings Company, Limited
Kraft Foods Group, Inc.
Lassonde Industries Inc.
L'Oreal SA
Marfrig Alimentos SA
McCormick & Company, Incorporated
Mondelez International, Inc.
Nestlé S.A.
Parmalat SpA
Patties Foods Limited
Pepsico, Inc.
Reckitt Benckiser Group plc
SABMiller plc
Sapporo Holdings Ltd.
Suedzucker AG
The Coca-Cola Company
Ülker Bisküvi Sanayi Anonim Sirketi
Unilever NV
Warrnambool Cheese And Butter Factory Company Holdings Limited

Note: The peer companies were sourced from an aggregated database and KPMG did not seek to verify the information provided by the database with secondary resources, such as an annual report
Source: CapitalIQ

7.5 List of data sources

International Monetary Fund

World Economic Outlook (April 2013)

US Bureau of Economic Analysis

Value added by industry (April 2013)

Australian Bureau of Statistics

Gross Domestic Product: Catalogue number 5206.0 (March 2013)

Gross Value Added, Manufacturing: Catalogue number 5206.0 (March 2013)

Household final consumption expenditure: Catalogue number 5204.0 (November 2012)

Household savings rate: Catalogue number 5204.0 (November 2012)

Consumer Price Index: Catalogue number 6401.0 (March 2013)

Wage Price Index: Catalogue number 6345.0 (March 2013)

Retail turnover: Catalogue number 8501.0 (March 2013)

Westpac Banking Corporation, Melbourne Institute

Consumer Sentiment Index (sourced from tradingeconomics.com; accessed May 2013)

IBISWorld Business Environment Profiles

Average weekly earnings (October 2012)

Domestic price of wheat (April 2013)

World price of sugar (April 2013)

Australian Food and Grocery Council and KPMG

State of the Industry (2012)

KPMG

Competitive Alternatives | KPMG's Guide to International Business Location Costs (2012)

Ipsos MediaCT and Australian Institute of Company Directors

Director Sentiment Index: Research Findings First Half 2013 (April 2013)

OandA

JP Morgan Economic Research

Australian Economic Update: Consumers pare back expectations for Aussie economy (April 2013)

Reserve Bank of Australia

Statement by Glenn Stevens, Governor: Monetary Policy Decision (May 7, 2013)

Australian Food and Grocery Council

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