

Australian Food and Grocery
Council

COMPETITIVENESS & SUSTAINABLE GROWTH

OCTOBER 2012

CHALLENGES FOR THE AUSTRALIAN
FOOD AND GROCERY INDUSTRY

PART 1 – FACT BASE



one voice - adding value



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Contents

1	Executive Summary	7
2	Background	9
3	Objectives	10
3.1	Scope	10
3.2	Project Methodology.....	10
4	Methodology & Basis of Estimation	12
4.1	Basis of estimation	12
5	Key Themes	16
6	Industry Overview	17
6.1	Private Label Analysis	18
7	Performance of participants	26
7.1	Overview	26
7.2	Gross sales	27
7.2.1	Gross sales by channel	27
7.3	Costs	29
7.3.1	Trading discounts and promotional allowances	31
7.3.2	Cost of sales.....	32
7.3.3	Operating costs	34
7.4	Profitability.....	35
8	Future of the Industry	40
8.1	Introduction.....	40
8.2	Economics Analysis	41
8.2.1	The short-term impact of a mining/ mining construction boom	41
8.2.2	The long-term effects of a permanently expanded mining sector.....	45
8.2.3	A productivity improvement through innovation	48
9	Conclusion and next steps.....	51
10	Appendices	52
10.1	Table of Key Items	52
10.2	Glossary of Terms	52
10.3	Assumptions.....	53
10.4	List of data sources	54

Australian Food and Grocery Council

Figures

Figure 1: Project Methodology	11
Figure 2: Market map by Department, FY12.....	17
Figure 3: Revenue and Volume Performance by Department, FY10-FY12 (CAGR %) ...	18
Figure 4: Market Revenue Performance – Private label vs Branded (\$ billion).....	19
Figure 5: Market Volume Performance – Private Label vs Branded (billion units)	19
Figure 6: Private Label effects on Department Performance.....	20
Figure 7: Branded vs Private Label - Price Trend, FY10-FY12 (\$).....	21
Figure 8: Branded vs Private Label - Volume Trend, FY10-FY12 (billion units).....	22
Figure 9: Branded vs Private Label - Revenue Trend, FY10-FY12 (\$ bn).....	23
Figure 10: Correlation between Private Label and category performance	24
Figure 11: Private Label vs. Branded category performance	25
Figure 12: SKU trend of participating companies Private Label and Branded products, 2009 – 2011	25
Figure 13: Gross sales trend, 2009-2011 (\$billion).....	27
Figure 14: Gross sales by channel, 2009-2011 (\$billion).....	28
Figure 15: Retail sales by key customer, 2009 – 2011 (\$ billion)	28
Figure 16: Total costs as a proportion of gross sales, 2009 – 2011 (\$ billion)	30
Figure 17: Key cost categories as a proportion of gross sales from 2009 – 2011 (\$ billion)	30
Figure 18: Share of trading discounts, promotional allowances and net sales as a proportion of gross sales, 2009 – 2011 (\$ billion).....	31
Figure 19: Working capital (excluding cash), 2009 – 2011 (\$ billion)	32
Figure 20: Components of working capital, 2009 – 2011 (\$ million).....	32
Figure 21: Share of conversion costs and cost of materials as a proportion of cost of sales, 2009 – 2011 (\$ billion)	33
Figure 22: Break down of operating costs, 2009 – 2011 (\$ billion).....	34
Figure 23: Break down of Other, 2009 – 2011 (\$ billion)	35
Figure 24: Share of EBIT and Gross Margin of Gross Sales, 2009 – 2011 (\$ billion).....	36
Figure 25: Split of capex spend by type, 2009 – 2011 (\$ million).....	37
Figure 26: Return on Assets, 2009 – 2011 (%).....	37
Figure 27: Average EBIT and Gross Margins between KPMG and UBS sample companies, , (%)	38
Figure 28: Commodity price index (December 2008 index 100)	42
Figure 29: Industry output of selected industries for simulation 1.....	43
Figure 30: Employment by industry of selected industries for simulation 1	44
Figure 31: Local, domestic and export market share contributions to commodity output results for simulation 1	44
Figure 32: Industry output of selected industries for simulation 2.....	47



Australian Food and Grocery Council

Figure 33: Employment by industry of selected industries for simulation 2	47
Figure 34: Local, domestic and export market share contributions to commodity output results for simulation 2	48
Figure 35: Industry output of selected industries for simulation 3.....	50
Figure 36: Local, domestic and export market share contributions to commodity output results for simulation 3	50

Tables

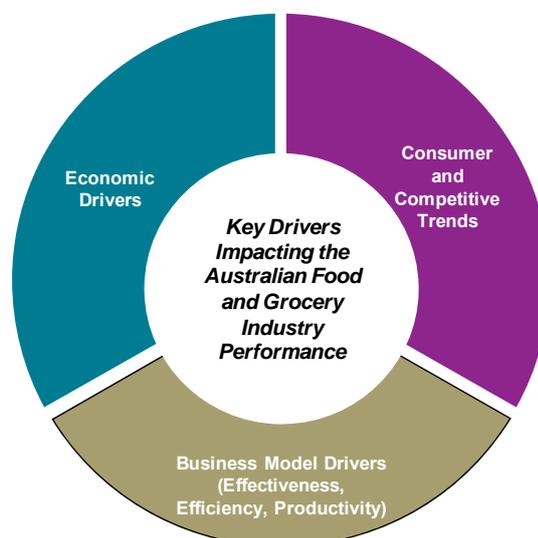
Table 1: Percentage changes for key macros in the short run mining boom simulation .. 42
Table 2: Percentage changes for simulation 2..... 45
Table 3: Percentage changes for simulation 3..... 48

1 Executive Summary

This report presents a fact base analysis of where the Australian food and grocery industry is currently positioned, key insights and possible future drivers.

The report was anchored around understanding the three key drivers impacting performance in the industry in order for the industry to capitalise on new opportunities and to remove barriers to growth.

Discussions were held with the AFGC board member group to review the key drivers impacting performance and expand it to provide a set of themes for the study to review. These themes included, amongst others, innovation; greater margin pressure; increasing cost to serve; increasing AUD and increasing competition. The study also looked at external analysis, in particular the UBS 'Exploring Treasure Island' reports, which highlighted differences in the profitability comparisons between the UBS analysis and what the participant companies were actually achieving.



Consumer and Competitive Trends

Consumer and competitive trends analysis was based around The Nielsen Company data. This data by department provides coverage of approximately 30% of the whole of the Australian Food and Grocery Industry.

Over the last three years, most departments have experienced both revenue and volume growth. However, The Nielsen Company data is heavily concentrated with Dairy Goods, Dry Grocery and Confectionary/Drinks comprising over 70% of revenue. Whilst Private label has grown at twice the rate of Branded products between 2010 and 2012 (based on revenue), its overall share of market revenue remains unchanged.

At the category level, it appears that growth in Private Label has not hindered overall category performance. In fact, generally categories experiencing Private Label growth also experienced growth in Branded products with minimal impact to overall average unit price.

Business Model Drivers

The UBS 'Exploring Treasure Island' reports both the gross and EBIT margins from Australian operations are lower than their global average. By contrast, comparing the profitability measures of the firms in the UBS paper against those in this report, the participating companies have lower profitability both at the gross and EBIT

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margin level. If the sample size is a fair reflection of the industry, there is an outside perception that the FMCG companies are more profitable than in fact they are.

Analysis conducted on the participants showed profitability as a % has not changed. EBIT as a % of sales has been relatively constant due to the growth of sales being fully absorbed by growth in uncontrollable costs and increases to trade discounts and promotional spend. The headline EBIT growth of 5.4% is an absolute growth in \$.

From a revenue perspective, the increase in revenue was driven largely through non retail channels. Of the three major retailers, Coles had the largest growth between 2009 and 2011 with Woolworths growing at the lowest rate of the three, although Coles still lags Woolworths on absolute sales.

Despite rising by 6.6% between 2009 and 2011, Utilities only equate to approximately 1% of overall costs and although the trend is for this to continue to grow it is not the largest cost bucket for the participants to concentrate on for business improvement initiatives.

Economic Drivers

Economic analysis of the food and grocery industry highlights that it is on the wrong side of Australia's two speed economy:

- Economy-wide modelling has highlighted that the short-term impacts of the mining boom has negatively impacted on all 11 food and grocery sectors contained within the model, with sugar production (-1.6 %) and grain milling (-1.1%) experiencing the greatest fall in output
- The fall in the sector's export competitiveness is the principal drag on the industries output

The results of the modelling also highlight the considerable potential relief the sector may experience if the record high commodity prices moderate in the medium term.

The potential returns to the industry from innovation highlight the return on a 5% productivity improvement could see output increase by between 2% and 3.5 and deliver a marked improvement in sector's export competitiveness.

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2 Background

Over the last five years, the Australian food and grocery manufacturing industry has come under strong pressure from a number of forces and pressures across the value chain. These include;

- Concentrated retail market;
- A strong Australian dollar;
- Growth in imported products;
- Growth in private/retailer branded label products;
- Increasing input costs (e.g. energy, labour, packaging);
- Increasing regulatory compliance;
- Labour scarcity pressures; and
- Volatile commodity prices.

The industry growth rates have slowed and with increased input costs the pressure on profitability is heightened. The outlook illustrates that the above trends are likely to continue in the immediate future.

3 Objectives

The AFGC believes that there is a requirement to present a fact based case, highlighting where the industry and subsequent food and grocery categories are currently positioned, the reasons why and the possible future drivers.

This industry paper addresses each of the factors that are currently impacting the performance of the sector and assist in outlining a future industry framework for further analysis in Part 2.

This paper is not for public release, it is provided for AFGC board members whom have chosen to participate in this study and only in their capacity as members of the board.

3.1 Scope

This study included organisations as represented on the AFGC Board. The participants agreed to provide confidential data to the study and agreed to participate in a factual accuracy process through a key point of contact.

Data request lists agreed as part of this project can be contained in Section 10.1.

3.2 Project Methodology

The methodology undertaken to conduct the project is contained in Figure 1. Note this methodology was modified throughout the project to meet the timeframes due to the delay in receipt of data.

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Figure 1: Project Methodology

Part 1 – Fact Base	Phase 1: Planning and kick off and interviews	Phase 2: Data collection	Phase 3: Data analysis & insight	Phase 4: Reporting	Part 2 – tbd
Key Activities	<ul style="list-style-type: none"> Kick off meeting with AFGC to further refine project scope, requirements, timelines, communications, expected outcomes, key risks. Project team on-boarding Finalisation of data request list to be issued to AFGC detailing information required to complete analysis Further desktop background research into agreed key areas of focus Develop approach to source external data as required Develop draft report outline Structured interviews with participants to understand significant events and identify initial hypothesis Draft of initial hypothesis 	<ul style="list-style-type: none"> Provide data request list and protocols to participant organisations including clear, concise and structured data collection method to facilitate meaningful analysis Data collection and management will be maintained on a strict the confidential basis and governed by the engagement letter and integrity and security of the source data will be maintained at all times Undertake initial cleanse and integrity check of data in order to develop initial company baseline Undertake factual accuracy process with client organisation representative and obtain sign off Progress and review meeting with AFGC 	<ul style="list-style-type: none"> Undertake data modelling and analysis across agreed key hypothesis to draw out underlying themes across key drivers of demand, costs, investment and business model for the industry Triangulate and test initial findings with external data points where available Develop initial findings and insights progress report Test initial findings with participant organisation through workshop with AFGC Board members (or sub-committee of the Board) Refine and undertake further analysis Refine draft report outline 	<ul style="list-style-type: none"> Final design and layout of report Preparation and development of detailed report and next steps Draft report completed for internal AFGC review Draft report issued to participant organisations for review/comment Updated draft report issued to AFGC for review. Final report issued and agreed next steps plan developed 	<ul style="list-style-type: none"> Develop part 2 scope and detailed plan
Deliverables	<ul style="list-style-type: none"> Project plan and timelines agreed Key responsibilities defined Draft report outline defined 	<ul style="list-style-type: none"> Baseline of company data signed off by participant organisations Progress update summary 	<ul style="list-style-type: none"> Initial insights (interim findings report) Workshop with participant organisations 	<ul style="list-style-type: none"> Final report structure Draft report Final report 	<ul style="list-style-type: none"> Part 2 – Plan and scope

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4 Methodology & Basis of Estimation

This report has drawn upon many sources of data to source the findings. These include ABS data, the State of the Industry 2012 report, The Nielsen Company data as well as data from seven members of the AFGC. The nature of the data can be summarised into 5 key areas covering Financial, Channel, Product / SKU, Headcount, Import and Export information¹.

4.1 Basis of estimation

Unless indicated otherwise, all analysis of participant data relate to the full participant group. However, given the detailed nature of the data requested, not all participants were able to provide data at the required level. Therefore, in some instances and where possible, KPMG estimated a number of data points. The aim was to ensure comparability and that where possible, firm observations were not unnecessarily lost.

Gross sales

For any firm that was unable to provide gross sales as part of income statement information (F1²) for part of the five year period, KPMG used the average ratio between net sales and gross sales for years in which data was available to be provided.

Gross sales by channel

For any firm that was unable to provided gross sales by channel (N1), the ratio between net sales and gross sales from the income statement (F1) for that year was used to gross up net sales across all channels. These estimated values were then summed by channel with other firms that provided gross sales by channel. This produced an estimate of total gross sales by channel. This approach above was applied to obtain gross sales of retail customers where net sales were provided but not gross sales.

Operating costs

For any firm that was unable to provide break down of total operating costs as defined in the income statement (F1) section of the data request for part of the five-year period, KPMG used the average proportion of the various cost items that constitute operating costs for years in which data was available to be provided.

¹ Please refer to Appendix 10.1 for description of data request

² Please see Appendix 10.1

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Definitions of metrics used

In addition to estimating data, particularly in relation to key financial metrics, KPMG worked with the data to ensure that metrics were consistent across firms. For example, there was some variation in the costs that sat above the “Gross Margin” line. Below, are definitions of metrics used in this report and how they were calculated based on submitted data:

Definitions of key metrics

Net Sales: Gross Sales *less* Trading Discounts *less* Promotional Allowances

Cost of sales: Sum of Cost of Materials and Conversion Costs where;

Cost of Materials: Sum of Commodities, Other Raw Material, Packaging, Waste and Stock write off

Conversion Costs: Sum of Commodities, Other Raw Material, Packaging, Waste and Stock write off

Gross margin: Net Sales *less* Cost of Sales

Operating costs: Sum of Warehousing, Logistics & Distribution, Royalties, Marketing, Salaries & Bonuses, IT, Travel & Entertainment, Depreciation & Amortisation, Professional Services, R&D and Miscellaneous costs

EBIT: Gross Margin *less* Operating costs

Working Capital: Sum of Inventory and Trade Debtors *less* Creditors

Return on Assets: EBIT *divided by* Total Assets

Channel definition

KPMG segmented channel data received into three key channels: Retail, Food Service and Export. Channel data submitted was allocated to the aforementioned three channels. Despite some variation in channel categorisation by participants, allocation to these three 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, Woolworths, Metcash, Aldi, Costco, Franklins and Route Trade Australia;
- Food service: Sales attributable to food and beverage manufacturers, HORECA (hospitality, restaurants and cafes) and caterers. Examples include Schweppes, Campbell's, Bidvest and NAFDA; and
- Export: Sales attributable to export activities.

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Sample size

Despite best efforts to present analysis at every level, there were instances where this was not achieved due to too few unique firms that submitted data. Where this was the case, KPMG limited any insights gained from the data to qualitative, directional comments to be investigated in a further phase of work. KPMG applied a minimum sample threshold of five unique firms to be able to present a particular analysis. The relatively high minimum sample threshold was chosen due to the small population pool (7), the distinct departments in which these participants play in and to provide anonymity of data.

Use of Nielsen Company Sales and Volume information

In Section 6, sales and volume data provided by The Nielsen Company (Nielsen) has been analysed. Nielsen captures sales and volume data from Retail channels only. As such, care needs to be taken when comparing the total industry size as determined by Nielsen against other sources such as the Australian Bureau of Statistics which represents the industry at a more holistic level. Furthermore, within the Retail channel, Nielsen does not offer coverage across all departments. The list of categories for which Nielsen provides coverage (and those which they do not) can be found in the following page

In relation to volume as measured by Nielsen, all units of measure have been aggregated together. For example, Nielsen measures one unit as: 1 each = 1 pack = 1 kg = 1 litre. KPMG did not receive further clarification from Nielsen on its units of measure.

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Department	Categories covered by Nielsen	Categories not covered by Nielsen
Dairy case	Butter, Cheese, Chilled Cream and Custard, Chilled Meals/Snacks, Dairy Blend, Dairy Desserts, Dairy Dips, Fresh Milk – Flavoured, Fresh Milk – White, Fresh Pasta and Sauce, Juice/Drinks Chilled, Margarine, Smallgoods, Yoghurt.	Proprietary Fresh Cakes
Confectionery / Drinks	Chocolate Confectionary, Cordial, Fruit/Tea/Coffee Drinks, Gum, Homebrew, Juice/Drinks Long life, Mineral/Still/Spring Water, Nutritious Snacks, Snack foods, Soft Drinks/Mixers, Sparkling Juices, Sports/Energy Drinks, Sugar Confectionary, Throat Soothers	Jelly, Christmas Cakes, Cones/Wafers, Chilled Cookie Dough
Dry grocery	Baby Foods, Baked Beans and Spaghetti, Biscuits, Bottled Sauce – Tomato, Cakes/Desserts – Packet/Canned, Canned Fish, Canned meals, Canned/Dried Vegetables, Cereal, Coffee Accessories, Coffee Ground/Beans, Coffee Instant, Coffee Whitener, Cook, Choc and Nuts, Dry Noodles, Dry Pasta, Honey, Hot Packs, Ice Blocks, Infant Formula, Instant/Package Soup, Jam/Fruit Spreads, Milk Modifiers, Milks and Creams, Packet Meals, Packet Recipe Mixes, Packet Sauce and Gravy, Pasta Sauce, Salad Dressing, Spreads, Stock, Sugar, Tea, Tomato Paste, Tomato Puree, Toppings, Wet Soup	Canned Fruit, Bottled Sauce excluding Tomato, Olive Oil, Dried Fruit, Dry Pasta, Mexican Foods, Baking Additives, Rice, Condiments, Cooking/Vegetable Oils, Flour and Baking Aids, Canned Tomatoes, Garlic Bread, Indian foods, Sugar Substitutes, Vinegar, Salt, Firelighters and BBQ Fuel, Bread Mixes, Solid Oils, Tofu Products, Chilled Baby Foods
Frozen food	Frozen Fish, Frozen Meals, Frozen Pizza, Frozen Potatoes, Frozen Poultry, Frozen Snacks, Frozen Vegetables (Excluding Potatoes), Frozen Yoghurt, Ice Cream	Frozen Savouries, Frozen/Chilled Desserts, Pet Food-Fresh/Frozen, Frozen/Chilled Pastry
Health & beauty	Acne Preparations, Analgesics, Antacids, Antiseptics, Cough and Cold remedies, Denture Accessories, Deodorants, Disposable Nappies, First Aid, Foot Care, Hair Colourants, Hair Spray, Rheumatic Rubs/Aromatherapy, Shampoo, Shaving Preps/Male Toiletries, Skincare-Creams and Lotions, Styling Aids, Sun care, Toilet Soap and Bath Additives, Vitamins and Minerals	Toothpaste, Razors and Blades, Conditioner, Toothbrush, Mouthwash, Baby Care, Incontinence Products, Laxatives, Cotton Wool, Depilatories, Dental Accessories, Talcum Powder
Household	Air Fresheners, Bleach, Brushware, Dishwashing Detergent, Disinfectant, Household Cleaners, Household Gloves, Insecticides/Pest Killers, Ironing Aids, Laundry Detergents, Pre-Wash, Sponges and Cloths, Toilet Cleaner	Toilet Tissues, Value Added Produce, Magazines/Newspapers, Deodorants, Sanitary Protection, Batteries and Torches, Kitchen/Laundry Accessories, Facial Tissue, Kitchen and Garbage Bags, Paper Towel, Moist Towelettes, Foil and Baking Paper, Fabric Conditioners, Hosiery, Stationery, Gardening Needs, Plastic Wrap, Family Planning, Disposable Cups/Plates/Party Accessories, Lighting Needs, Paper Napkins, Car Care, Adhesives, Shoe Care, Film and Cameras.
Pet food / accessories	Cat Food-Dry, Cat Food-Wet, Dog Food – Dry, Dog Food – Wet, Pet Accessories, Pet Drinks, Pet Food – Other	Bird Food
Tobacco products	Cigarettes	n/a
Fresh	n/a	Proprietary Fresh Bread, Smallgoods, Fresh Bread, Eggs, Fresh Cakes, Herbs and Spices, Fresh Poultry, Fresh Soup

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5 Key Themes

Each board member was approached for an interview during the data collection process in order to provide insights into how the industry is trending. Key themes were consistent through these interviews and have formed the basis of the data driven analysis to determine the trends in the industry.

The following illustration highlights the key themes arising from the interviews.

Greater Margin Pressure	Increased Cost to Serve	Capital Investment	Increased AUD	Increasing Competition	Effective Marketing	Innovation
Greater pressure from retailers for straight margin transfer	Increased Labour Cost	Low Asset Efficiency	Reduction in Exports	House Brand Product	More expensive to reach customers	Lower Innovation
Rising Trade Spend	Increased Energy Costs	Margin pressure makes it difficult to reinvest in assets for the future	Cheaper for retailers to Import	New Manufacturers in Australia	More \$ are moving from above to below the line impacting the value of businesses	Increasing Cost to Innovate
	Increased Supply Chain Costs			Offshore Manufacturers		
<ul style="list-style-type: none"> Margin differs depending on channel mix More expensive to market to customers Increased movement of \$ from above to below the line which is impacting the value of businesses 	<ul style="list-style-type: none"> What is happening to SG&A and Overhead costs? Domestic operational footprint vs import model - what are the costs / benefits (especially in competing categories) Business with greater domestic footprint are challenged vs the import model 	<ul style="list-style-type: none"> What is the capital spend as a % of sales? What is the industry's ability to re-invest in the future? If they cant then they will lose to more productive, lower cost manufacturers If you can't get a sustainable return you cant reinvest Investment - Focus on what actually happened and what results were derived from that Comparing over time will show this is improving and there is significant investment in Aus 	<ul style="list-style-type: none"> Are there any significant structural changes that companies are making as a result of the high AUD? 	<ul style="list-style-type: none"> Consumers moving more to promotional / value purchases in different categories House brand penetration is increasing partly due to increased consumer confidence in the better quality product 	<ul style="list-style-type: none"> Emerging marketing channels mean it is harder to get the return on your marketing \$ 	<ul style="list-style-type: none"> Are manufacturers who are innovating doing better financially than those who are not? What is the state of innovation in Australia? If you don't have good innovation and cant delight the customer you are going backwards

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6 Industry Overview

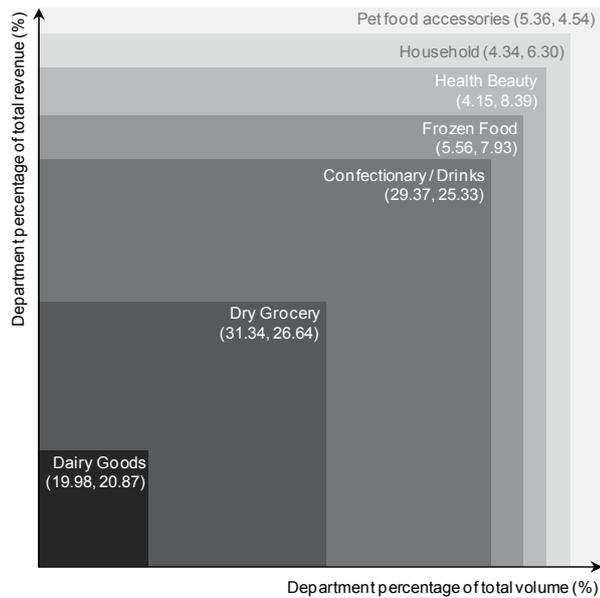
The AFGC State of the Industry Report 2012 defines the Australian food and beverage, grocery and fresh produce industry as having a \$110.7 billion turnover in the 2010-11 financial year.

The Nielsen data provided, as defined in the previous section, represents approximately 30% of the total industry at \$33.27 billion³ in the 2012 financial year.

For the categories covered by the Neilson Company, total sales revenue for FY2012 was \$33.27 billion up from \$32.60 billion on the previous year. The industry has continued to grow at an even rate of 2% over the last three years despite the effects of stagnant economic environment and low consumer confidence. The market, however, is heavily concentrated with Dairy Goods, Dry Grocery and Confectionary/Drinks comprising over 70% of revenue.

The following figure illustrates the % of revenue and volume that each department covered by Nielsen comprises of for the 2012 financial year.

Figure 2: Market map by Department, FY12
100% of Revenue = \$33.27 billion, 100% of Volume = 10.3 billion



Source: The Nielsen Company, September 2012 and KPMG analysis

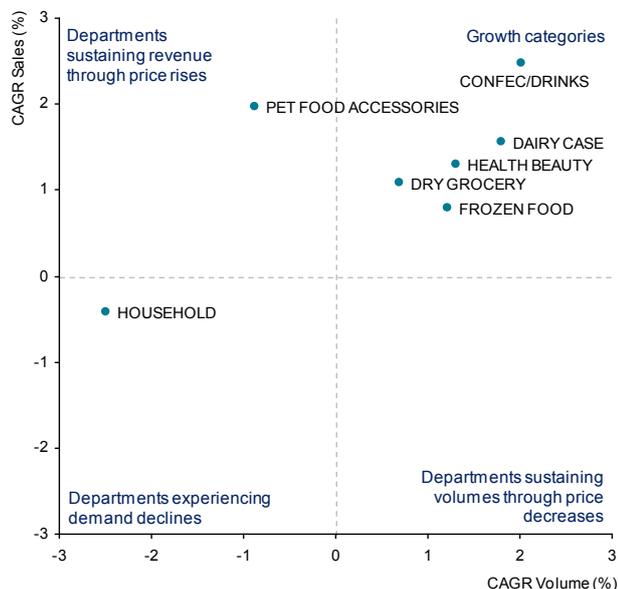
Figure 2 highlights the different growth rates of each department covered by Nielsen for the previous three years.

Industry turnover in 2010-11 was \$110.7 billion – Nielsen data analysed represents approx 30% of the industry turnover.

³ Excludes tobacco products

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Figure 3: Revenue and Volume Performance by Department, FY10-FY12 (CAGR %)



Source: The Nielsen Company, September 2012 and KPMG analysis

Of the seven departments covered, all apart from the household department saw increased CAGR % sales for financial years 2010-2012. The overall sales growth rate was 2.21% between 2010 and 2012

In terms of volume, the total volume for financial year 2012 is 10.3 billion Ea/kg/lt. This reflects an even growth rate in line with sales growth of 1.66%. Two departments saw a volume decrease over this period, Household and Pet Food Accessories.

The dollar per unit across the departments saw a modest increase of 0.54%. Some departments have performed better with increased revenue per product such as the Household and Pet food accessories departments which increased revenue per product sold by 3.22% and 4.33% respectively.

6.1 Private Label Analysis

Over the period 2010 to 2012 the split between Branded and Private Label products has remained relatively stable. In terms of sales revenue, the split has maintained at a steady 87% for Branded and 13% for Private Label products. Penetration of 13% appears low when compared to other sources which may suggest that the key departments under threat from Private Label are not covered by Nielsen. For example, IBISWorld estimates that for 2011-2012, Private Label generated \$20.9 billion and represented approximately 25% of the total market. Against Nielsen coverage of \$4.32 billion, this implies a \$16.6 billion gap.

There has been a small increase in the volume of Private Label products across all departments except Petfoods Accessories resulting in a 1% increase in market share for 2012, from 17% to 18% of the market.

Of all the departments covered by Nielsen only Household saw a negative CAGR % in both sales and volume (2010-2012).

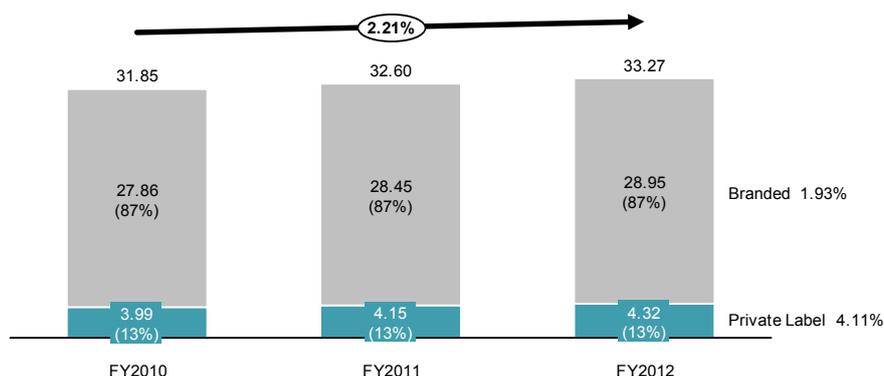
% of Sales Revenue between Private Label and Branded Products has been relatively unchanged between 2010 and 2012

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Comparable sales and volume growth of Private Label to branded products across the industry is, on average, more than double than that of Branded goods since 2010 for the departments covered by Nielsen.

The following figure illustrates the comparative revenue increase in Private Label and Branded products from 2010 to 2012.

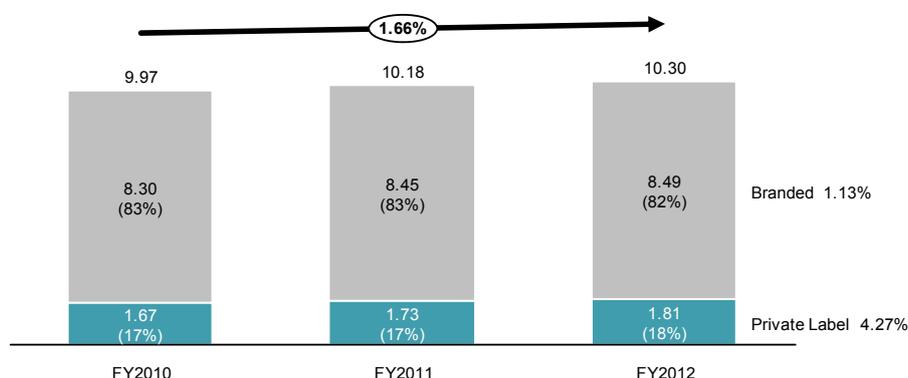
Figure 4: Market Revenue Performance – Private label vs Branded (\$ billion)



Source: The Nielsen Company, September 2012 and KPMG analysis

The following figure illustrates the comparative volume increase in Private Label and Branded products from 2010 to 2012.

Figure 5: Market Volume Performance – Private Label vs Branded (billion units)



Source: The Nielsen Company, September 2012 and KPMG analysis

The Private Label product range in food and grocery is growing at a significant rate and this has largely been due to strategies employed by large supermarket retailers to devote more shelf space to their own products. The growth in Private Label products can also be attributed to the poor economic conditions which have driven consumers to rein in spending and focus on saving. Coupled with the increasing range of Private Label products, this has provided consumers with a generally lower price point to that Branded goods.

Furthermore, culturally, consumers perceptions of Private Label are changing in that they consider Private Label products as quality products which may be just as good as Branded products. This wide acceptance by consumers means that people are being more open to consider purchasing private label goods.

Key fact

Private Label grew at twice the rate of Branded products between 2010 and 2012 for the categories covered by Nielsen.

Growth in Private Label does not appear to have impacted overall department revenues and volumes.

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Based on the data available, although Private Label growth is higher than Branded, the data shows that not all categories have had Private Label success with some Private Label categories in decline. Additional data would be required to explain if this is an actual deliberate range change by the retailer or if the consumer is switching back to the Branded products.

The following analysis highlights Private Label's impact on overall department performance in relation to revenue, volume and price per unit.

Figure 6: Private Label effects on Department Performance



Source: The Nielsen Company, September 2012 and KPMG analysis

There appears to be a limited correlation of Private Label volume increases impacting on the overall category unit price. Frozen Food and Health Beauty departments have seen a significant increase in Private Label over the past three financial years 2010 to 2012. This has had a marginal impact on overall unit price as these two departments have been experiencing growth in both overall revenue and volume.

Pet Food Accessories however has seen a decline in Private Label and a decline in overall volumes however an increase in the average unit price of the department has seen revenues increase over the past three financial years 2010 to 2012.

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Dairy Case has seen a marginal decline in Private Label and average unit price, however increased volumes sold has resulted in increased revenues over the past three financial years 2010 to 2012.

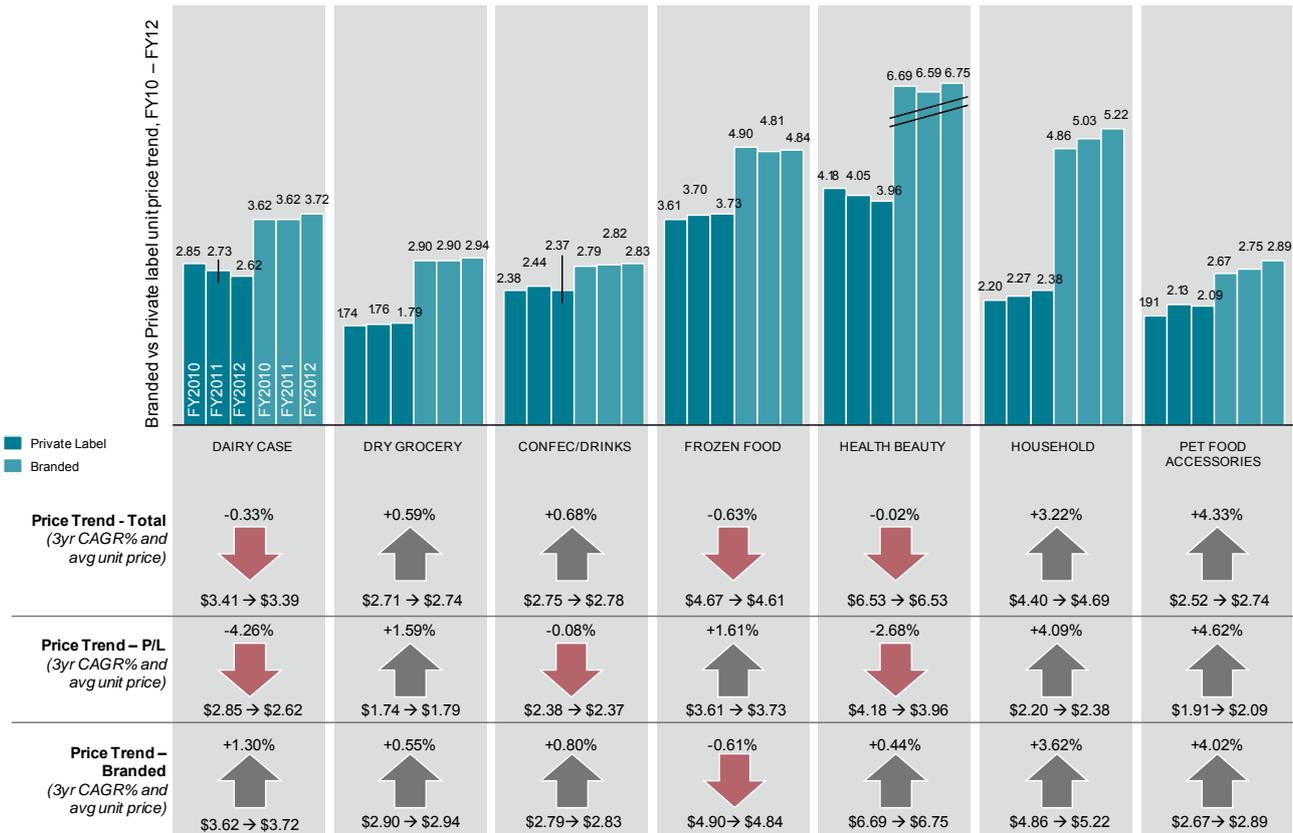
At the category level, it appears that growth in private label has not hindered overall category performance. In fact, generally categories experiencing Private Label growth also experienced growth in Branded products.

Price point comparison for Branded and Private Label is shown in Figure 7.

Key fact

Departments experiencing growth in Private Label have also seen growth in Branded products

Figure 7: Branded vs Private Label - Price Trend, FY10-FY12 (\$)



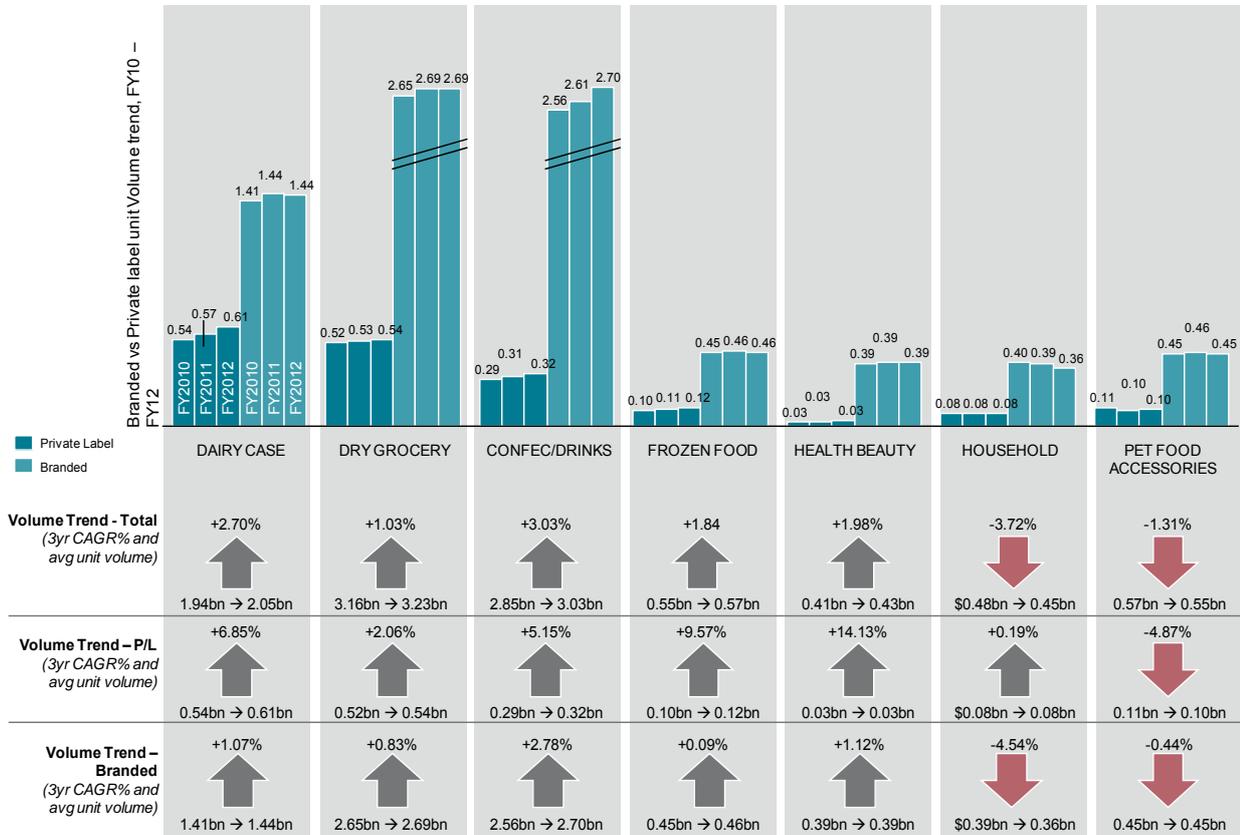
Although for most categories the Private Label unit price is significantly lower than the branded unit price, there are a couple of departments where pricing is similar i.e. Confectionary/Drinks and Pet Food Accessories. The largest difference between Private Label and branded pricing is in the Household department.

The pricing gaps are closing in some departments i.e. Dry Grocery, Frozen Food, Household and Pet Food Accessories whereas in others the gap is widening.

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Figure 8 highlights the volume trends between Private Label and Branded products.

Figure 8: Branded vs Private Label - Volume Trend, FY10-FY12 (billion units)

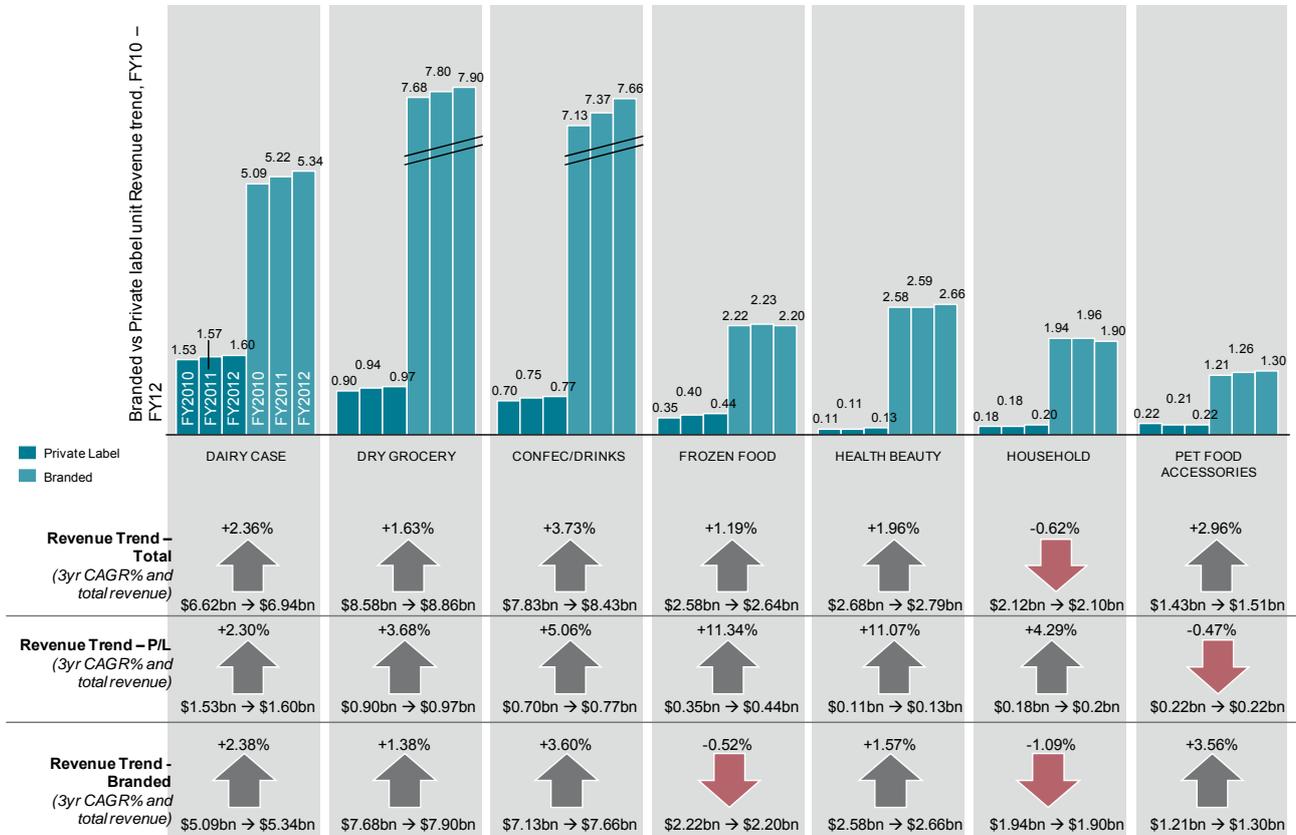


Volume in all departments apart from Household and Pet Food Accessories show signs of growth. It is clear to see that Private Label is growing at a stronger rate than Branded, albeit from a relatively low base.

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Figure 9 shows the revenue trends for Private Label and Branded products.

Figure 9: Branded vs Private Label - Revenue Trend, FY10-FY12 (\$ bn)

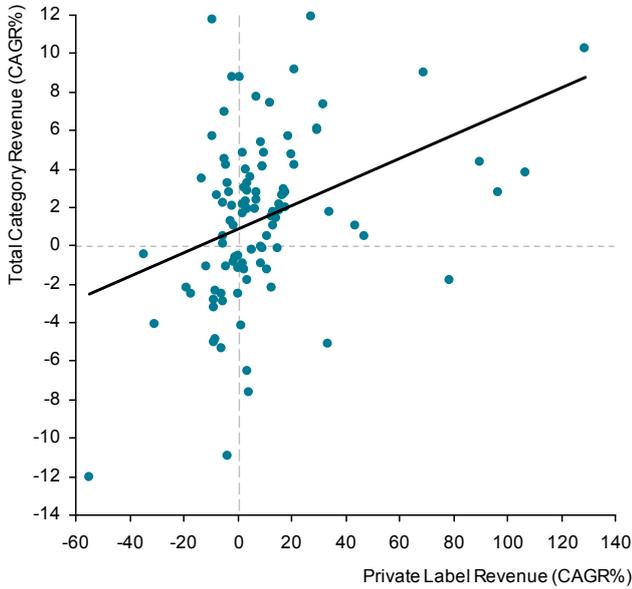


Private Label has had a far higher revenue growth compared to Branded products in all departments apart from Pet Food Accessories and Dairy Case. Double digit Private Label growth can be seen in Frozen Food and Health Beauty although as a department category these are two of the smaller departments for Private Label penetration.

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The following figure highlights the correlation between Private Label performance within a category and the overall category performance (Private Label and Branded products).

Figure 10: Correlation between Private Label and category performance



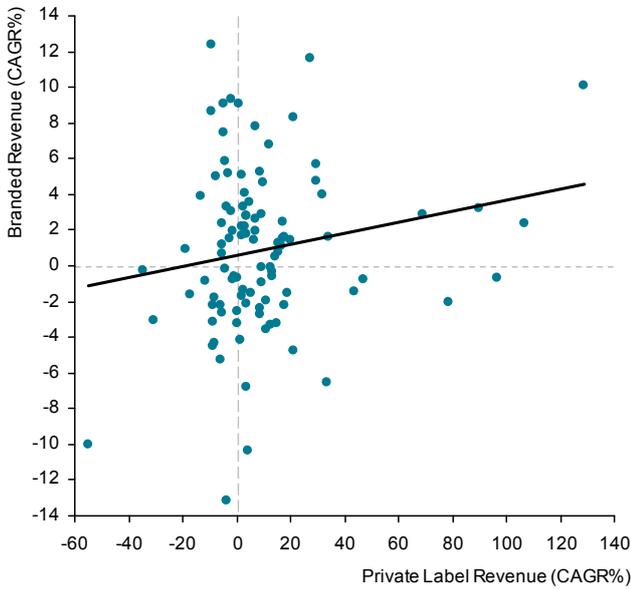
Source: The Nielsen Company, September 2012 and KPMG analysis

For the majority of cases, where Private Label has increased in revenue over the past three financial years 2010 to 2012 the total revenue for that category has also increased. It can also be seen that in many instances where Private Label has decreased in revenue the overall category has suffered.

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The following figure highlights the correlation between Private Label performance within a category and Branded product performance.

Figure 11: Private Label vs. Branded category performance

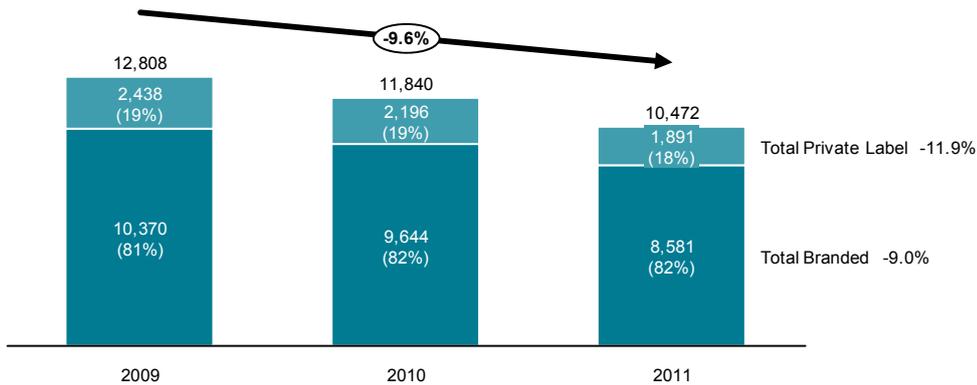


Source: The Nielsen Company, September 2012 and KPMG analysis

As with the correlation between Private Label and the overall category performance, similar trends exist when comparing Private Label directly with Branded.

When comparing the SKU trend of the participating companies for Branded products and products produced under Private Label, the trends show that total SKU's have decreased between 2009 and 2011 by 9.6% however Private Label has decreased by a faster rate than Branded Products.

Figure 12: SKU trend of participating companies Private Label and Branded products, 2009 – 2011



Source: Participant data, KPMG analysis

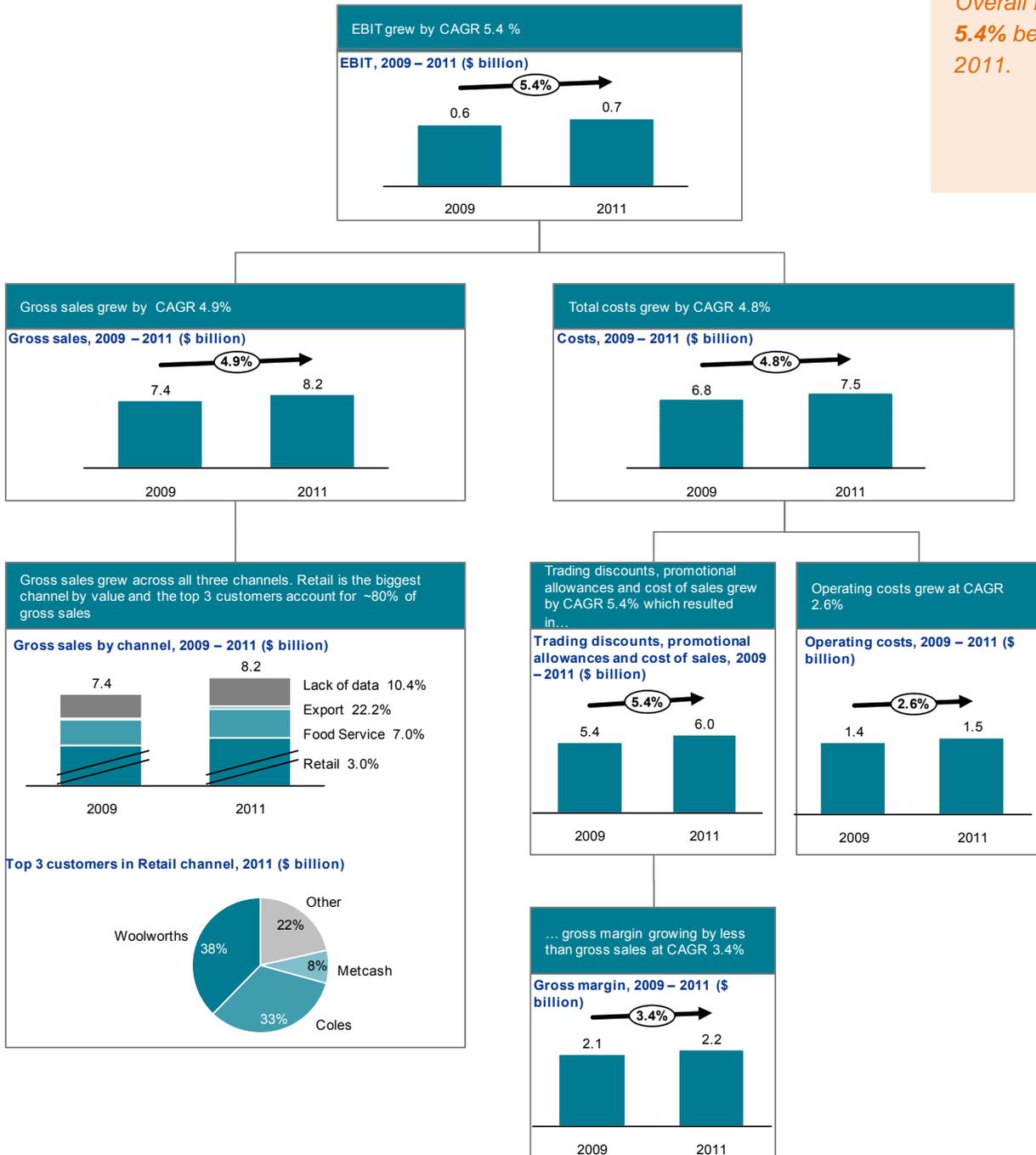
Private Label SKU's have been decreasing within the participating companies however these may have been taken offshore or produced elsewhere

7 Performance of participants

7.1 Overview⁴

The following shows an overall consolidated financial summary of the seven companies that participated in the detailed industry analysis (“participants”).

Overall EBIT grew by **5.4%** between 2009 and 2011.



⁴ Refer to Appendix 10.1 for table of analysis for key income statement items

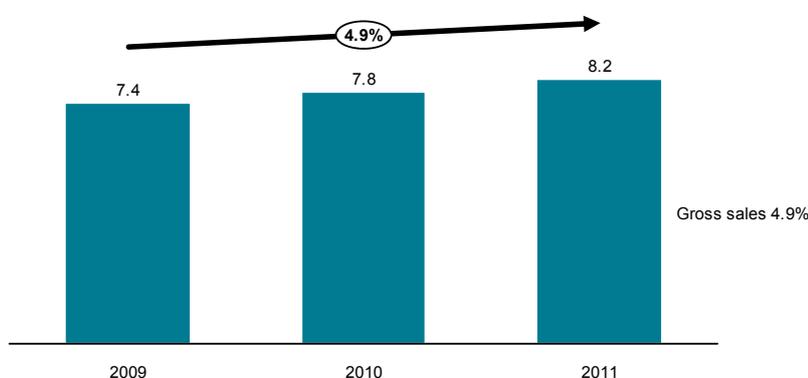
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The participants represent only a small proportion of the total value of the market when compared against other market data sources. For example, according to the Australian Bureau of Statistics, the industry in 2011 was valued at \$110.7 billion. Based on the cumulative gross sales from the Retail channel for the participants in 2011 of \$5.5 billion, they represented approximately 4% of the total market size.

7.2 Gross sales

Gross sales increased by CAGR 4.9% from \$7.4 billion to \$8.2 billion between the 2009 and 2011 period as is highlighted in Figure 13. Food Service and Export channels primarily drove this growth which suggests that participants are increasing their investment in non-Retail channels.

Figure 13: Gross sales trend, 2009-2011 (\$billion)



Source: Participant data. KPMG analysis

The increase in gross sales over the 2010 to 2011 period contrasts against the contraction observed in the market by the Australian Bureau of Statistics (ABS) over the same period. This suggests that the participants outperformed the industry over that period.

Volumes were flat at best between 2009 and 2011.

7.2.1 Gross sales by channel

There are three key channel classifications, Retail, Food Service and Export which have been analysed at the gross sales level. 15%-16% of gross sales could not be allocated to a channel due primarily to two factors:

- insufficient sample size to preserve anonymity; and
- data gaps from the information provided by participants.

The following figure illustrates the gross sales by channel between 2009 and 2011.

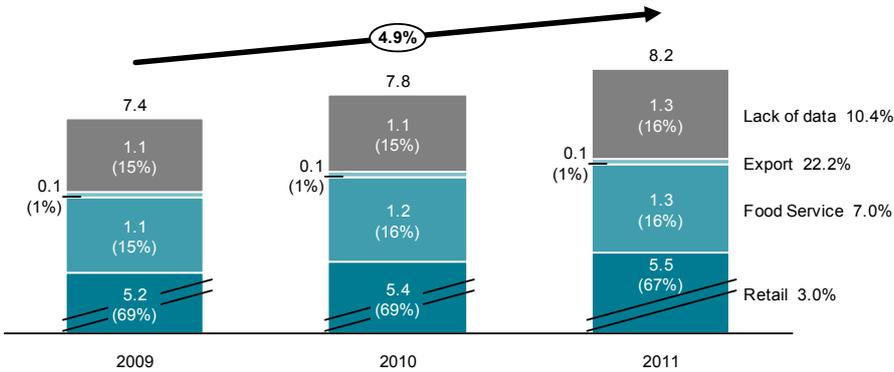
Gross sales increase in the industry was driven through non-Retail channels.

Key fact

The Retail channel grew by just 3% between 2009 and 2011 with its share of overall channel revenue dropping from 69% to 67%.

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Figure 14: Gross sales by channel, 2009-2011 (\$billion)

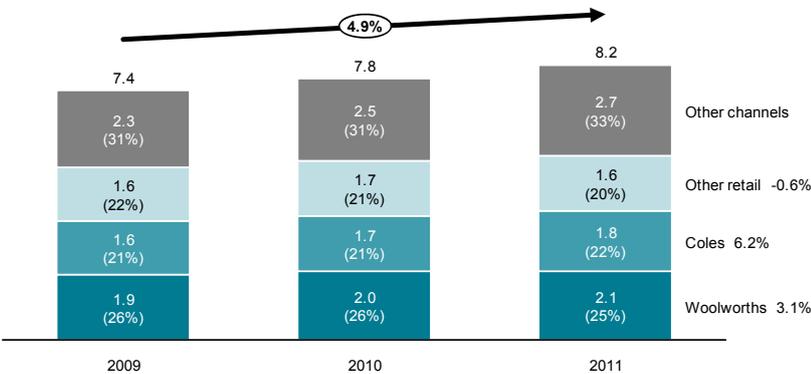


Source: Participant data, KPMG analysis

Export is the smallest category by value with 1.0% of gross sales contribution. However, it grew at CAGR 22% from \$0.07 billion to \$0.1 billion between 2009 and 2011. Food service grew by CAGR 7.0% from a base of \$1.1 billion in 2009 to \$1.3 billion in 2011. The food service channel accounts for approximately 16% of gross sales.

The Retail channel grew by CAGR 3% from \$5.2 billion in 2009 to \$5.5 billion in 2011. Despite being the largest customer channel by value, it has seen its share of gross sales decline from 69% in 2009 to 67% in 2011. Given the significance and the high-level of scrutiny faced by this channel, key customer analysis of this channel was undertaken, highlighted in Figure 15.

Figure 15: Retail sales by key customer, 2009 – 2011 (\$ billion)



Source: Participant data, KPMG analysis

Sales to Coles grew by more than sales to Woolworths between the 2009 to 2011 period

Drawing from the total size of the retail channel of \$32.6 billion in 2011 as estimated by Nielsen, the participant group could represent up to 16% of the total retail channel. However, the actual share of the participant group as a proportion of the total retail channel is likely to be lower than 16%. This is due to the inclusion of departments and categories not covered by The Nielsen in participants' gross sales from the retail channel of \$5.5 billion. For example, no coverage is provided for fresh department or categories such as frozen savouries, frozen/chilled desserts, baby case and kitchen towels. To preserve the anonymity of the data, the actual

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representation of participants' gross sales as a proportion of the market is unable to be provided.

Coles and Woolworths were the top two customers in the Retail channel by value across the period of analysis. Excluding "Other" retail customers, the Top 2 collectively grew by CAGR 4.5% from \$3.5 billion to \$3.9 billion over 2009 – 2011.

Further analysis of the top three customers reveals that despite being the largest customer by value, representing 26% of gross sales, Woolworths recorded the smallest growth over the period. Gross sales contribution grew by CAGR 3.1% from \$1.9 billion to \$2.1 billion. This growth is significantly less than its closest peer, Coles. In addition to growing at CAGR 6.2% from \$1.6 billion to \$1.8 billion over the three-year period, Coles increased its contribution to the participants' gross sales from 21% in 2009 to 22% in 2011.

The remaining contribution of gross sales in the retail channel consists of a relatively long tail of customers such as Metcash, Franklins, Independents, Route Trade, Discount retailers, etc. These customers as a group contracted by CAGR 0.6% as well as reducing their contribution to gross sales for the retail channel from 22% to 20% between 2009 and 2011 as the two big retailers increased their market share.

Based on a smaller sub-set of participants that provided both gross sales and net sales, there is evidence that although these participants enjoyed growth in gross sales from Coles and Woolworths, this did not translate to any increases in net sales.

7.3 Costs

Total costs represent between 90% and 92% of gross sales and grew by CAGR 4.8% from \$6.8 billion to \$7.5 billion between 2009 and 2011. This was less than CAGR of 4.9% achieved by gross sales over the same period.

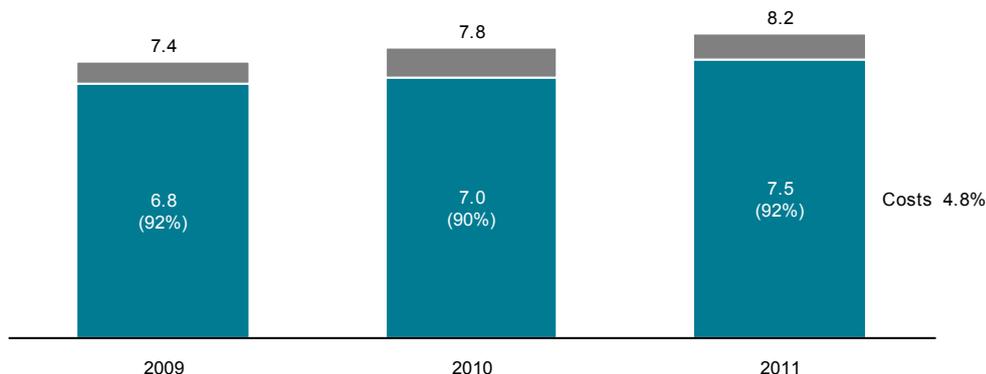
Total costs have been segmented into three broad categories for the analysis:

- Trading Discounts & Promotion Allowances;
- Cost of Sales; and
- Operating costs.

The following figure illustrates costs as a % of gross sales.

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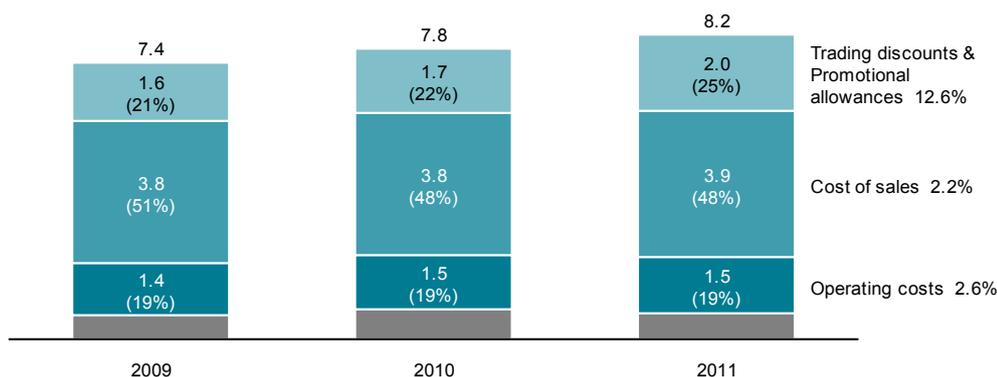
Figure 16: Total costs as a proportion of gross sales, 2009 – 2011 (\$ billion)



Source: Participant data, KPMG analysis

The following figure breaks down the individual cost elements showing their individual trends.

Figure 17: Key cost categories as a proportion of gross sales from 2009 – 2011 (\$ billion)



Source: Participant data, KPMG analysis

- Trading discounts and promotional allowances are retailer claim backs from the supplier; trading discounts generally comprise of longer term trade spend such as rebates, settlement discount and supply chain charges whereas promotional allowances are shorter term retail claims that among other items, can comprise of product markdowns, scan deals (supplier support for products on sale) or catalogue support.
- Cost of sales capture cost items that relate to the manufacture of finish goods such as cost of materials and conversion costs which includes cost items such as direct labour, raw materials, packaging, waste, etc.
- Operating costs are costs items that do not fall in the above two categories such as supply chain, marketing, royalties, salaries, corporate depreciation etc.

Figure 17 shows that each cost area contributed to the growth in costs at an absolute level. Despite growing over the period, the respective shares of gross

Total costs have grown at almost the same rate as gross sales between 2009 and 2011

Key fact
Trading discounts and promotional allowances grew 12.6% between 2009 and 2011 compared to operating costs 2.6% and cost of sales 2.2%

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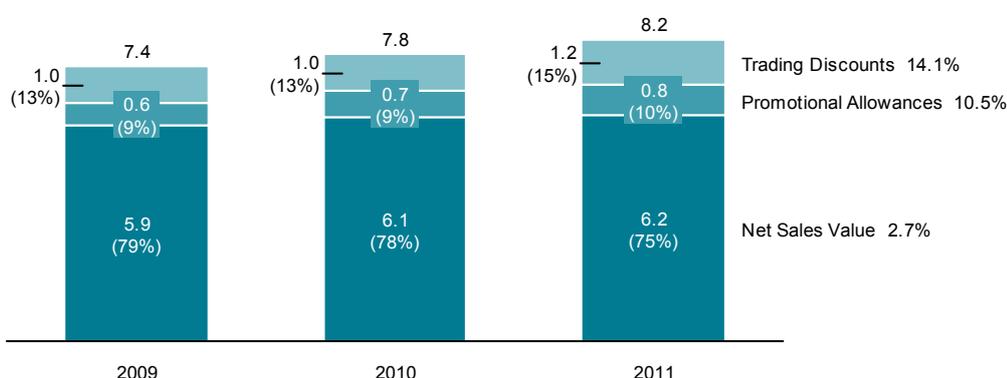
sales for both Cost of Sales and Operating costs declined between 2009 and 2011. Cost of sales grew by CAGR 2.2% from \$3.8 billion to \$3.9 billion however its share of total gross sales declined from 51% to 48% over the 2009 to 2011 period. Similarly, Operating costs grew by CAGR 2.6% from \$1.4 billion to \$1.5 billion however as a proportion of total gross sales it remained flat at 19% over the same period. Trading discount and promotional allowances drove the majority of growth in costs growing by CAGR 12.6% from \$1.6 billion to \$2.0 billion. In addition, this category of costs increased its share of total gross sales from 21% to 25% over the same period.

7.3.1 Trading discounts and promotional allowances

Net sales fell as a proportion of gross sales from 79% to 75% despite growing by CAGR 2.7% from \$5.9 billion to \$6.2 billion between 2009 and 2011. This growth is less than the CAGR 4.9% achieved by gross sales over the same period.

This relatively low growth in net sales was a result of strong growth in Trading Discounts and Promotional Allowances offered by participants to their customers. Trading Discounts and Promotional Allowances increased at CAGR 14.1% and 10.5% respectively as can be seen in Figure 18. This has resulted in the value of trading discounts and promotional allowances increasing from \$1.0 billion and \$0.6 billion in 2009 to \$1.2 billion and \$0.8 billion in 2011 respectively.

Figure 18: Share of trading discounts, promotional allowances and net sales as a proportion of gross sales, 2009 – 2011 (\$ billion)



Source: Participant data, KPMG analysis

The high growth achieved meant that as a proportion of gross sales, each have increased their respective share of gross sales, Trading Discounts grew from 13% in 2009 to 15% in 2011 whilst Promotional allowances grew from 9% to 10% over the same period.

The trend observed in declining share of net sales whilst increases in gross sales occur suggests that participants are maintaining price increases however this is being partially offset by the increasing amounts of trading discounts and promotional allowances that are being handed back to their customers.

Further evidence that support the view that participants were under pressure from their customer group can be seen from the analysis of working capital. Despite

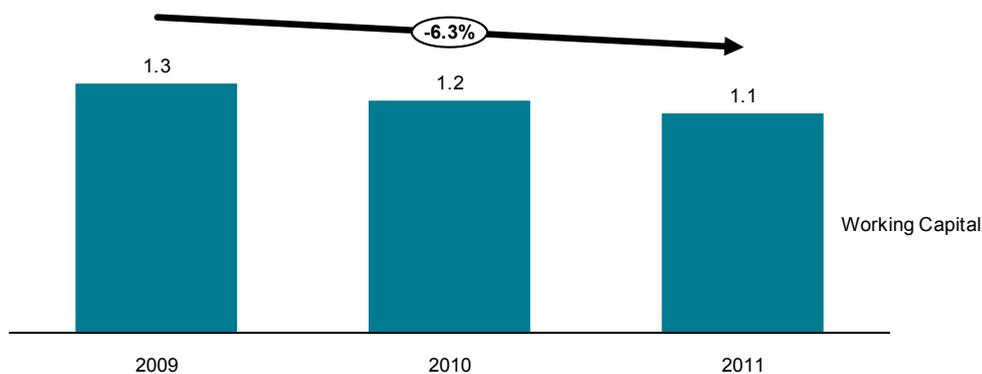
Data suggests price increases are being realised however are then offset by trading and promotional discounts

Working capital analysis shows that not only are suppliers pressured through trading and promotional discounts, payment terms are also being extended by their customers

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working capital decreasing by 6.3% between 2009 and 2011, this was largely due to a contraction by CAGR 10.0% in inventory and an increase in creditors by CAGR 6.5% over the period. Trade debtors, however, increased by 5.3% from \$1.9 billion in 2009 to \$2.1 billion in 2011. The growth of trade debtors is greater than net sales which could imply that payment terms are being extended.

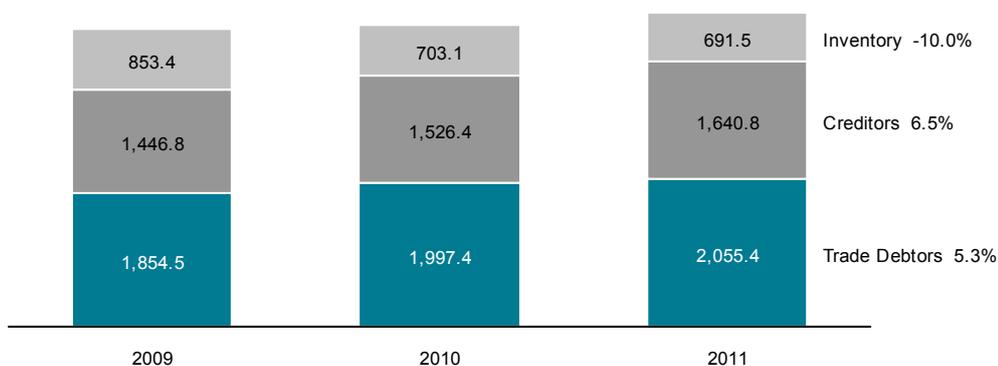
Figure 19: Working capital (excluding cash), 2009 – 2011 (\$ billion)



Source: Participant data, KPMG analysis

The following figure provides a breakdown of the components of working capital. It shows that there has been a focus on reducing capital tied up in inventory between 2009 and 2011. There has also been work on increasing the time frames to pay suppliers which has helped increase creditors over the period, however this has been counteracted by the increase in trade debtors.

Figure 20: Components of working capital, 2009 – 2011 (\$ million)



Source: Participant data, KPMG analysis

7.3.2 Cost of sales

Cost of sales increased by CAGR 2.2% from \$3.8 billion to \$3.9 billion between 2009 and 2011.

Cost of sales can be disaggregated into two main components – cost of materials and conversion cost:

- Cost of materials encompass cost of commodities, other raw material, packaging, waste and stock write-offs/variances from standard cost; and

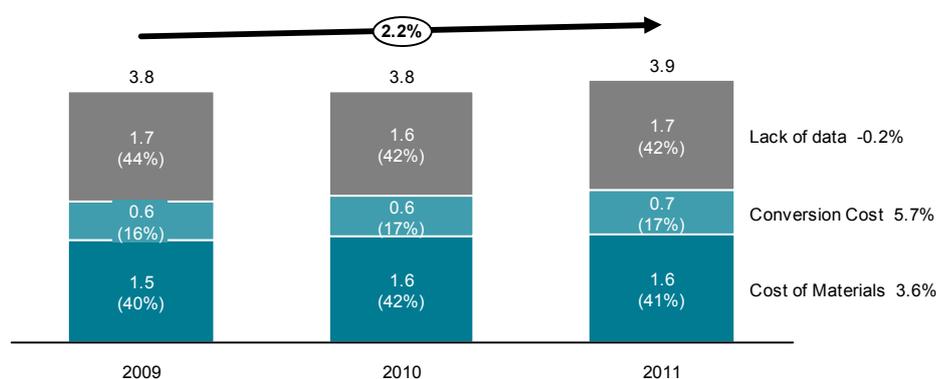
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- Conversion cost related to costs that are involved in the conversion of materials into finished goods such as direct labour, utilities, manufacturing related depreciation and other manufacturing costs.

More detailed analysis of cost of sales was not able to be completed due to lack of data and sample size restrictions. Between 2009 and 2011, over 40% of the cost of sales were not able to be split into their cost of materials and conversion cost components.

Figure 21 breaks down the cost of sales between 2009 and 2011.

Figure 21: Share of conversion costs and cost of materials as a proportion of cost of sales, 2009 – 2011 (\$ billion)



The individual elements of cost of materials and conversion costs could not be presented or analysed at an in depth level.

Of the available data, conversion cost drove most of the growth achieved by cost of sales:

- Representing only 16% and \$0.6 billion of cost of sales in 2009, conversion cost grew by CAGR 6% to represent 17% and \$0.7 billion of cost of sales in 2011.
- Of the participants that submitted data at a more detailed level, the main drivers were utilities and manufacturing related depreciation with each recording CAGRs greater than 5% between 2009 and 2011.
- Direct labour costs within the conversion costs increased by approximately 0.3% between 2009 and 2011. This small rise is not a reflection low pay awards to direct labour as business changes and productivity improvements implemented over that period would have impacted direct labour costs.

Cost of materials comprise of approximately 40% of cost of sales growing by CAGR 3.6% from \$1.5 billion in 2009 to \$1.6 billion in 2011.

Of the participants that submitted data at a more detailed level, the main driver the of cost of sales increase was due to increasing commodity prices but this was countered by improvements in stock write-off/mfg variances and a reduction in packaging costs.

Key fact

Conversion costs increased by **5.7%** between 2009 and 2011 compared to cost of materials which increased by **3.6%**

Despite rising by CAGR **6.6%** between 2009 and 2011, Utilities only equate to approximately **1%** of overall costs.

Key fact

Commodity prices rose by approx **14%** between 2009 and 2011.

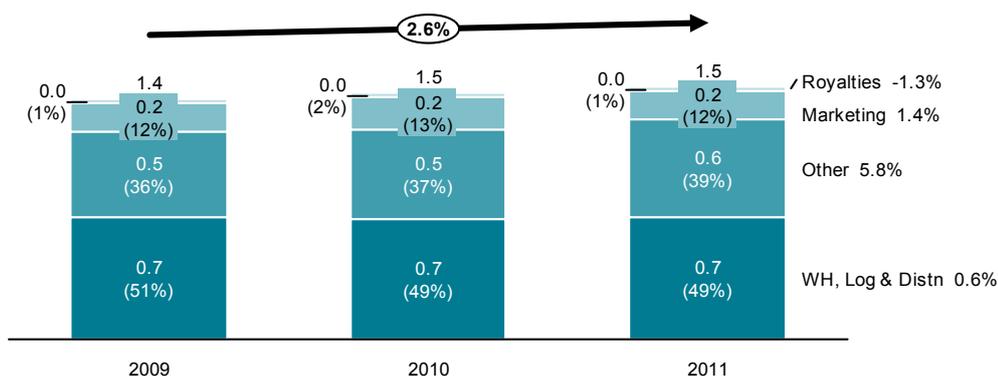
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7.3.3 Operating costs

Operating costs accounted for approximately 20% of the overall cost base in 2011. Total Operating costs grew by CAGR 3% from \$1.4 billion in 2009 to \$1.5 billion in 2011.

Figure 22 shows the breakdown of these operating costs into four areas.

Figure 22: Break down of operating costs, 2009 – 2011 (\$ billion)



Source: Participant data. KPMG analysis

The four areas operating costs have been broken down into are: warehousing, logistics and distribution, royalties, marketing, and other with growth occurring primarily in the 'other' category.

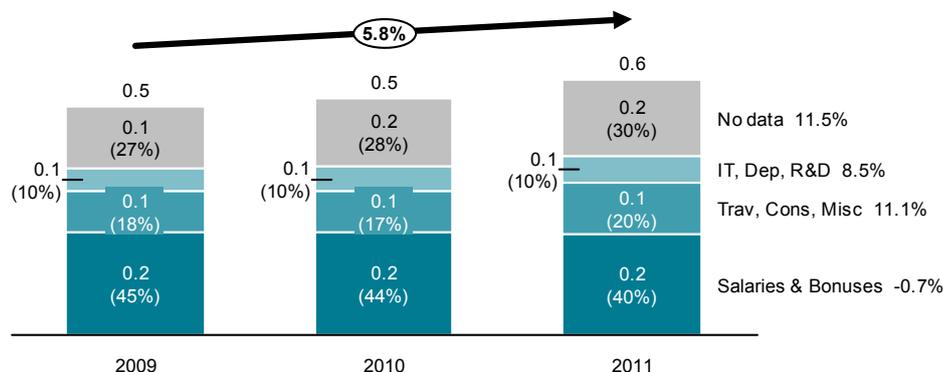
- Warehousing, logistics and distribution have seen flat growth and its share of total operating costs reduce slightly from 51% in 2009 to 49% in 2011.
- Marketing represents 12% of total operating costs and grew by CAGR 1.4% over the 2009 – 2011 period.
- Royalties are the smallest operating cost area accounting for just 1% of operating costs in 2011. CAGR reduced for this area by 1.3% between 2009 and 2011.
- Other increased its share of total operating costs from 36% to 39% and grew by CAGR of 5.8% from \$0.5 billion to \$0.6 billion between 2009 and 2011. Other costs include Salaries & Bonuses, Travel, Consultants & Miscellaneous as well as IT, Depreciation and R&D. Figure 23 explores the breakdown of these other costs in more detail.

Key fact

Warehousing, Logistics & Distribution are approximately 10% of the overall cost base however these costs are not increasing at the same CAGR as some of the other overhead areas

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Figure 23: Break down of Other, 2009 – 2011 (\$ billion)



Source: Participant data, KPMG analysis

Lack of complete data provided meant that some data had to be grouped as ‘no data’ within the “Other” area as it was not able to be disaggregated into its component parts for comparability purposes.

Of the available data, the majority of “Other” costs were comprised of Salaries and bonuses.

- Salaries and Bonuses equate to an estimated 6% of overall costs in 2011 (not all companies provided this data so it has been estimated based on available information) Over the 2009 to 2011 period, Salaries and Bonuses has experienced a slight decline in growth and seen its share of total operating costs fall from 45% to 40%.
- IT, Depreciation (corporate) and R&D grew by CAGR 8.5% from a relatively low base of \$0.1 billion. The increase is driven by depreciation / amortisation but given that total fixed assets declined over the period, this could suggest that the companies are undertaking write-offs within these businesses – in the form of increased amortisation.
- Travel, consultants and misc grew by CAGR 11.1% and increased its share of operating costs from 18% in 2009 to 20% in 2011. This growth was largely driven by large increased in miscellaneous expenses.

7.4 Profitability

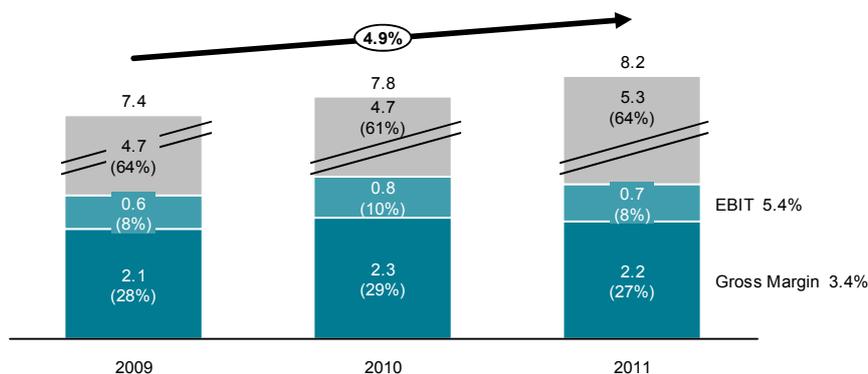
The analysis of revenues and costs in sections 7.2 and 7.3 provides insights into what drove growth in the respective areas over the 2009 to 2011 period. This section covers the impact of revenue and costs on the profitability – both gross margin and EBIT on the group of participant firms.

The following figure shows the share of EBIT and Gross Margin of Gross Sales between 2009 and 2011.

At an absolute level Salaries and Bonuses have reduced by almost 1% between 2009 and 2011 whereas direct labour costs have gone up by 0.3% during the same period.

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Figure 24: Share of EBIT and Gross Margin of Gross Sales, 2009 – 2011 (\$ billion)



Source: Participant data, KPMG analysis

Gross margin increased by CAGR 3.4% from \$2.1 billion to \$2.2 billion and saw its share of gross sales decline from 28% in 2009 to 27% in 2011 after having increased to 29% in 2010. In analysing why gross margin CAGR was lower than gross sales CAGR of 4.9% and its slight decline in share of gross sales, consideration is required with respects to trading discounts, promotional allowances (Section 7.3.1) and cost of sales (Section 7.3.1).

Although cost of sales increased over the period, its growth of CAGR 2.2% was below gross sales growth. A more likely driver of lower gross margin growth relative to gross sales was due to significant growth in trading discounts and promotional allowances of CAGR 14.1% and 10.5% respectively.

However, earnings before interest and tax (EBIT) grew by CAGR 5.4% from \$0.6 billion to \$0.7 billion over 2009 to 2011. This rate of growth exceeds that of gross sales over the same period. Furthermore, despite gross margin falling in its share of gross sales, EBIT has maintained its share of 8% between 2009 and 2011 with a slight increase to 10% in 2010. To explain these statistics, it is necessary to look at cost items that fall below the gross margin line – Operating costs (covered in Section 7.3.1.3).

Despite gross sales increasing by CAGR 4.9% between 2009 to 2011, Operating costs only increased by CAGR 2.6% that were driven primarily by “Miscellaneous” cost items that were skewed by a handful of participants with large increases in 2011 and “Depreciation and Amortisation”⁵.

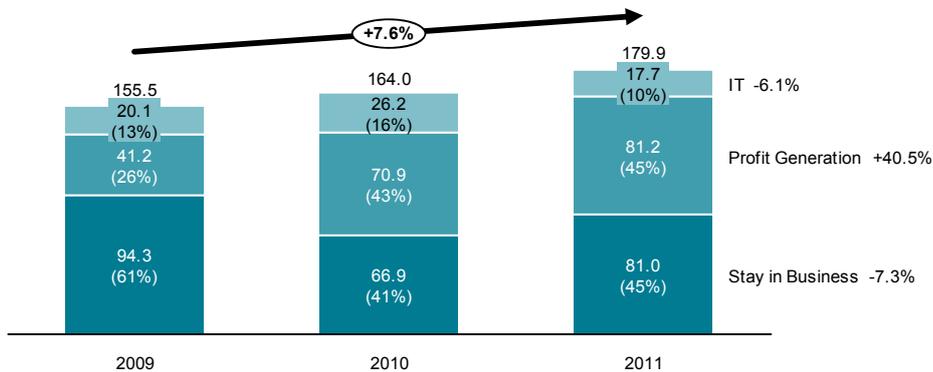
In explaining the trends observed, participants’ capital expenditure data was analysed to determine if there was an increase in spend on profit generation initiatives. Analysis reveals that from 2009 to 2011, total capex spend increased by CAGR 7.9%, driven solely by an increase in profit generation activities. Spend on profit generation activities increased by 40.5% over the period from \$41.2 million to \$81.2 million. This can be seen in Figure 25.

Significant growth in trading discounts and promotional allowances were the key drivers of low gross margin growth.

⁵ excludes growth of the “no data” category

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Figure 25: Split of capex spend by type, 2009 – 2011 (\$ million)



Source: Participant data, KPMG analysis

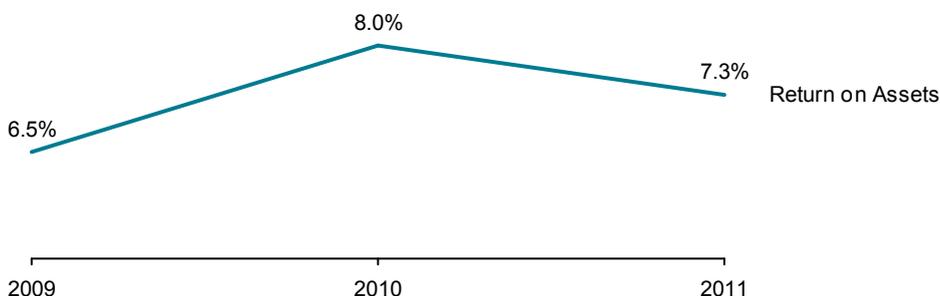
During the period of this study, some clarification on what these profit generation activities might entail was sought through conversations with participants. The focus of spend on these activities can be largely attributed to cost reduction and efficiency gains through product improvement, automation, integration of businesses, and direct labour and raw material mix.

From the description of initiatives provided, there is evidence that participants were actively trying to manage their “controllable” costs such as corporate salaries, marketing, logistics and distribution to defend against the growth in their “uncontrollable” costs such as cost of materials, trading discounts, promotional allowances etc.

The impact of this increase in spend on profit generation activities on both gross margin and EBIT can be seen particularly in 2010 where as a proportion of gross sales, both gross margin and EBIT increased by 1% and 2% respectively. Despite a further increase in spend on profit generation initiatives between 2010 and 2011, albeit by a smaller amount compared against 2009 and 2010, the improvements gained in share of gross sales by gross margin and EBIT in 2010 were lost.

Evidence suggests active management of controllable costs between 2009 and 2011 – including Salaries, Marketing and Logistics and Distribution.

Figure 26: Return on Assets, 2009 – 2011 (%)



Source: Participant data, KPMG analysis

Even though EBIT share of gross sales in 2011 returned to 2009 levels of 8%, return on assets (ROA) improved over the period. ROA increased from 6.5% in 2009 to 8.0% in 2010 before contracting slightly in 2011 to 7.3%. This net increase in ROA

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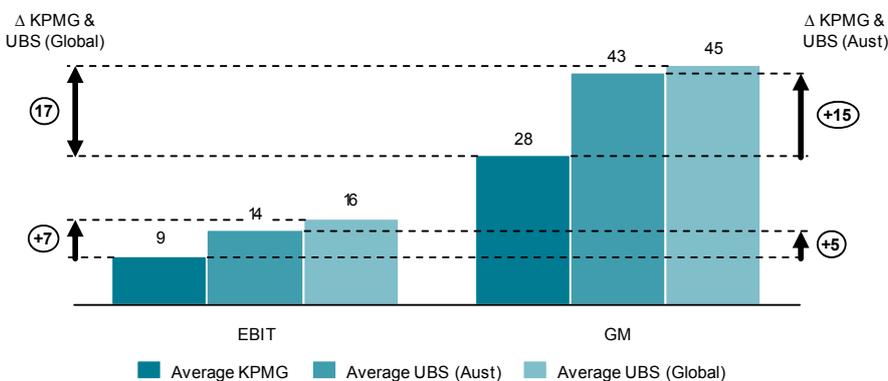
was driven primarily by the EBIT growth as opposed to significant reduction in the total assets base⁶.

Prior to this study, UBS Global Equity Research (UBS) in their paper titled, “Exploring Treasure Island”, November 2011, explored the profitability of the Australian operations of multi-national FMCG manufacturers against their offshore operations. The seven multi-national companies were Heinz, Unilever, Colgate Palmolive, Kraft, Kellogg, Campbells and Nestle. Gross margin as percentage of gross sales and EBIT as a percentage of gross sales were the two profitability measures used. Their paper finds that for these multi-nationals, both the gross and EBIT margins from Australian operations are lower than their global average.

By contrast, this report has a different sample set of companies of which only two are comparable multi-nationals to UBS sample companies. Comparing the profitability measures of the firms in the UBS paper against those in this report, KPMG sample companies have lower profitability both at the gross and EBIT margin level. For gross margin, the difference between KPMG and UBS sample companies in Australia is 15% with average gross margin as a proportion of sales of 28% against 43%. Similarly, the Australian operations of UBS sample companies outperform the KPMG sample companies by 5% with average EBIT margin as a proportion of gross sales of 9% against 14%. At a global level, the gap increases slightly by 2% for each of gross margin and EBIT.

UBS Exploring Treasure Island report shows average EBIT and Gross Margin to be higher than what companies are actually achieving.

Figure 27: Average EBIT and Gross Margins between KPMG and UBS sample companies^{7, 8, 9}(%)



Source: Participant data, KPMG analysis

The gap between the UBS sample companies and KPMG sample companies is not reflective of the fact the profitability margins achieved by UBS sample companies are the market norm. In a follow up paper by UBS titled, “Exploring Treasure Island – Mach II”, a survey of 24 Australian FMCG suppliers on the findings from their first

⁶ Growth in total asset base was relatively flat over the period

⁷ Average KPMG EBIT & GM was for 2009 – 2011

⁸ Average UBS(Aust) EBIT was for 2010/2011 and 2008-2011 for GM

⁹ Average UBS(Global) EBIT and GM was for 2008-2011

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paper was conducted and the survey results indicated that only 25% of surveyed firms matched or outperformed in profitability of the UBS sample companies.

However, what it does suggest is that there is still scope for profitability increases particularly at the gross margin level for the majority of Australian FMCG suppliers.

8 Future of the Industry

This economic analysis highlights the impact of three of the eight forces, outlined Section 2 that are influencing the performance of the Australian food and grocery sector – the historically high Australian dollar, labour scarcity and high commodity prices.

The key highlights of this analysis are as follows:

- the food and grocery sector is on the wrong side of the so called 'two speed economy'. Like most manufacturing sectors, the mining boom is having a detrimental impact on the sector;
- the short-term impacts of the mining boom, as evidenced by high commodity prices and expanded investment in production capacity have negatively impacted on all 11 food and grocery sectors contained within the model, with sugar production (-1.6%) and grain milling (-1.1%) experiencing the greatest fall in output;
- the fall in the sector's export competitiveness is the primary drag on overall output – the sector's relative position in the local market and its competitiveness is likely to have less of an impact;
- even when the investment component of the mining boom subsides, a continuation of historically high commodities prices would prolong the external pressure on Australia's manufacturing sectors, including the food and grocery sector;
- the modelling results (particularly scenario 2) highlights the considerable potential relief the sector may experience if the record high commodity prices moderate in the medium term;
- the analysis above only highlights the need to respond through innovation. An analysis of the productivity improvements available through innovation (scenario 3) shows that a 5% improvement could expand output by around 2%, with most of the improvements likely to come from enhanced export competitiveness.

8.1 Introduction

Using a detailed model of the whole Australian economy, the KPMG economics team has simulated the following three scenarios and examined the effects on the food and grocery sector:

- short-term impact of a mining / mining construction boom – what Australia has experienced over the past 10 years;
- long-term effects of a permanently expanded mining sector – what would happen to the Australian economy if the boom continued; and
- productivity improvement through innovation – why proactively responding to the challenges of the two scenarios above, using innovation, is so important.

About the model

KAGEM is KPMG's comparative static computable general equilibrium model of the Australian economy. The model:

- uses detailed data derived mainly from the ABS Input Output tables, showing flows of goods and services between businesses and final uses such as consumption, investment, government and exports;
- features many industries and other economic agents whose behaviour is responsive to prices and who face constraints; and
- interaction between sectors and other agents is governed by the operation of economy wide constraints on income and factor scarcity.

These models are useful for examining the detailed impacts of changes in one area of the economy on other sectors and agents. For example, quantifying how the recent increased investment in the mining sector has impacted on the food and grocery sector.

The results of the model include macroeconomic indicators such as Gross Domestic Product (GDP) and employment as well as detailed industry level results for employment, value added (the value of industry output excluding intermediate inputs), taxes and prices.

The short run closure of the model (economic environment) assumes that:

- additional investment is financed by foreign borrowing;
- the capital stocks of industries are fixed, but their investment activity is driven by current profitability;
- real wages are fixed; and
- other macroeconomic expenditure aggregates such as real consumer spending are fixed.

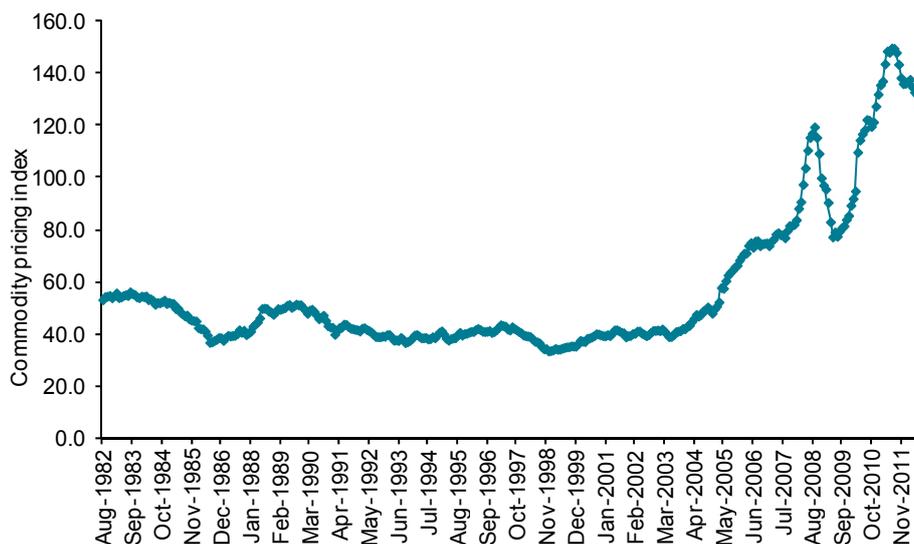
8.2 Economics Analysis

8.2.1 The short-term impact of a mining/ mining construction boom

This simulation shows the short-term effects of a large mining boom in coal and iron ore prices. This scenario has been modelled by increasing the foreign price of these commodities by 20% while at the same time increasing investment in those sectors by 100%. The following figure highlights the extent of the commodity price boom over the past 10 years, and shows why a 20% price increase is a plausible and conservative assumption for this scenario.

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Figure 28: Commodity price index (December 2008 index 100)



Source: RBA

This scenario illustrates the experience of the Australian economy in recent years. Mining activity has increased, but the real expansion in the mining industry has been through increased investment in capacity – actual investment new mines to expand output. To this end the mining boom is really a construction boom.

Results

This simulation increases GDP and employment significantly but pushes up the cost of investment and other prices in the economy. Despite the boom in mining exports, overall export volumes fall in this scenario because the real exchange rate appreciates sharply.

As will be clear from an examination of the industry results, this means the general “good news” story for the Australian economy is not good news for many industries, including food and grocery related industries.

Table 1: Percentage changes for key macros in the short run mining boom simulation

Macro	% change for simulation 1
Aggregate employment	1.139
Real appreciation	2.076
Investment price index	2.644
Consumer price index	0.624
Real wage	0

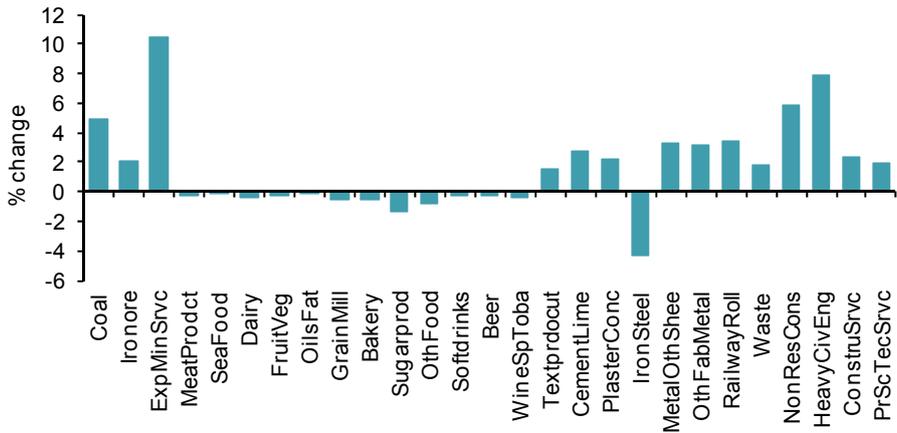
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Macro	% change for simulation 1
Real GDP	0.617
Capital stock, rental weights	0
Investment expenditure	4.45
Export volume index	-1.8
Government demands	0

The impact of this scenario on industry output is mixed, illustrating the nature of the two-speed economy. It is worth noting that these sorts of results are common in this type of modelling - most changes that help one sector of the economy hurt others.

In this case investment in mining industries expands the construction industry and those that supply it.

Figure 29: Industry output of selected industries for simulation 1

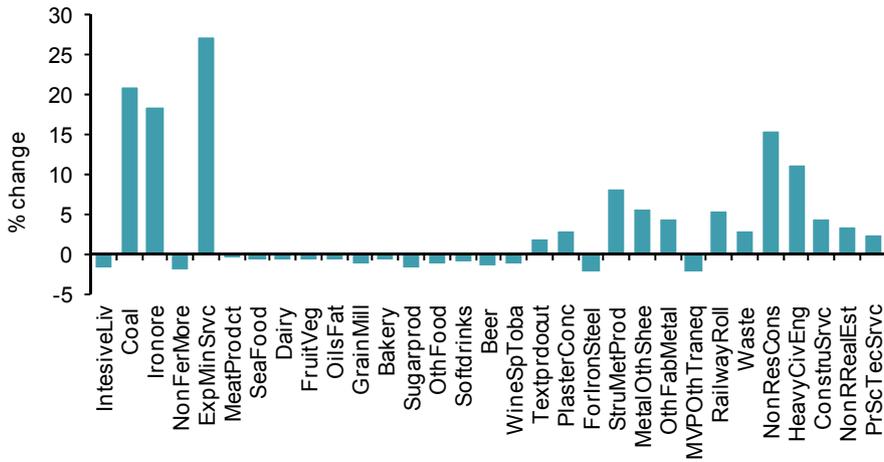


Source: KPMG model estimates

Results for industry employment follow a similar pattern although given industry-specific capital stocks are fixed in the short run, employment varies by more than output.

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Figure 30: Employment by industry of selected industries for simulation 1



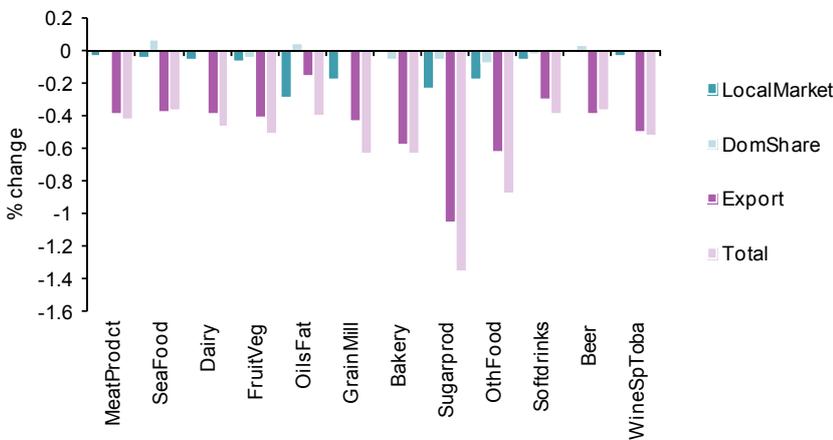
Source: KPMG model estimates

A useful way of understanding these results is to separate them into three components:

- the size of the local market;
- the domestic industry’s competitive position in the local market; and
- changes in exports due to movements in international competitiveness.

This analysis shows that the sales performance of a domestically produced commodity depends on the health of the Australian market and how competitive local products are both against imports and in export markets. Looking at these results tells us which is the more important cause of the overall result for this simulation.

Figure 31: Local, domestic and export market share contributions to commodity output results for simulation 1



Source: KPMG model estimates

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For most food and grocery industries, all these effects are negative. The degree of damage is primarily driven by trade exposure: domestic variants of commodities are under greater pressure from import competition and export markets are similarly undermined by both costs and exchange rate issues. The local market is getting a little smaller and the high dollar is hurting the competitive position both domestically and in export markets.

8.2.2 The long-term effects of a permanently expanded mining sector

This simulation examines the long run effects of 20% higher prices for coal and iron ore. Although commodity prices have risen by more than this in recent times, it is likely that prices will subside in the longer term as mining supply from around the world increases and developing countries demand for resources slow.

Results

This simulation shows the impact on the economy of commodity prices (coal and iron ore) persisting as historically high levels.

Caveats: particularly for the mining industry, long run simulations represent a very long period of adjustment (say 15 - 20 years). Other changes not accounted for in this simulation – such as growth in consumer spending – would have a positive effect on the food and grocery industries over this time frame.

It is also important to note that there are limited stocks of minerals associated with the current expansion of mines and that though greatly increased mining activity would occur in the long-term it would still be temporary.

Table 2: Percentage changes for simulation 2

Macro	% change for simulation 2
Aggregate employment	0
Real appreciation	9.543
Investment price index	7.252
Consumer price index	7.713
Real wage	4.658
Real GDP	2.109
Capital stock, rental weights	4.714
Investment expenditure	4.113
Export volume index	-0.305

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Were the international prices of coal and iron ore to increase by 20% there would be a significant positive impact on Australian GDP in the long run – GDP would be 2.1% higher (compared to the impact of 0.6% in the short run).

Australian total consumption would also be considerably higher (3.4%) due to foreigners' willingness to pay more for Australian produced commodities.

The long run labour market closure in this model is that economy wide employment is unaffected and any change in labour market conditions occurs through changes to real wages. In this scenario real wages increase by 4.7% which would have an impact on consumer spending.

This large long run increase in real wages combined with a large change in the real exchange rate reflecting the increased foreign willingness to pay for coal and iron ore is what drives industry results.

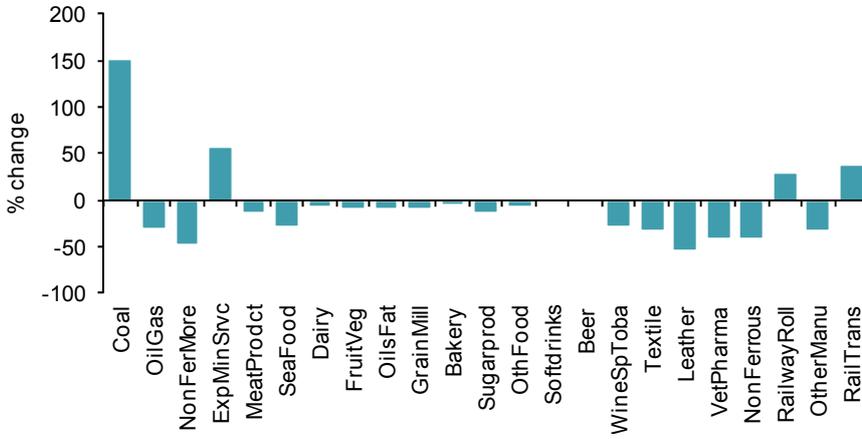
The large expansion (>150%) of the coal and iron ore sectors is driven entirely by exports. This drives up the real exchange rate and makes other exports significantly less competitive. In addition, the higher real wage driven by increased employment in the booming sectors and the more capital intensive nature of the Australian economy overall drives up costs for other industries. This further damages international competitiveness, both for export-oriented and import-competing industries, particularly those that are relatively labour intensive.

The performance of food and grocery related industries is similar to that of most trade exposed industries. Apart from those that supply inputs to the mining sector (such as rail transport), the only industries insulated from the impacts of the mining boom are service industries that face little international competition, particularly those largely financed by government (such as health).

It is important to note that other changes like increased income will drive consumption over that timeframe, however this simulation only focuses on the effect of the mining boom.

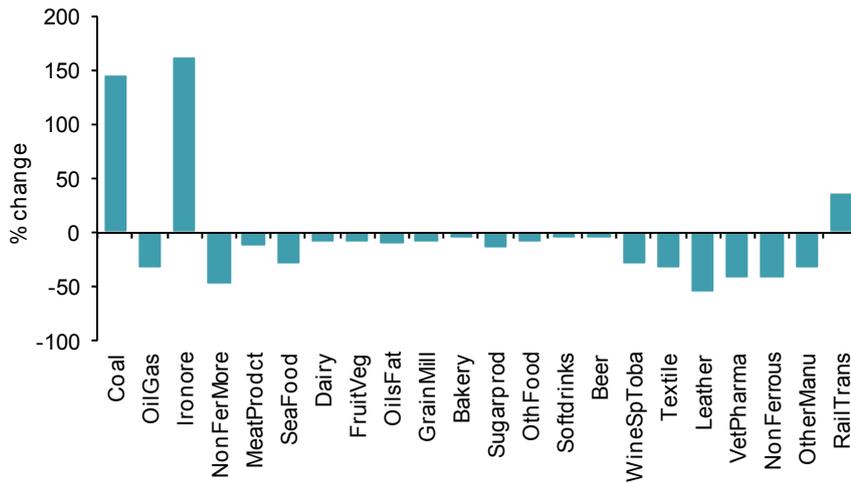
Australian Food and Grocery Council

Figure 32: Industry output of selected industries for simulation 2



Source: KPMG model estimates

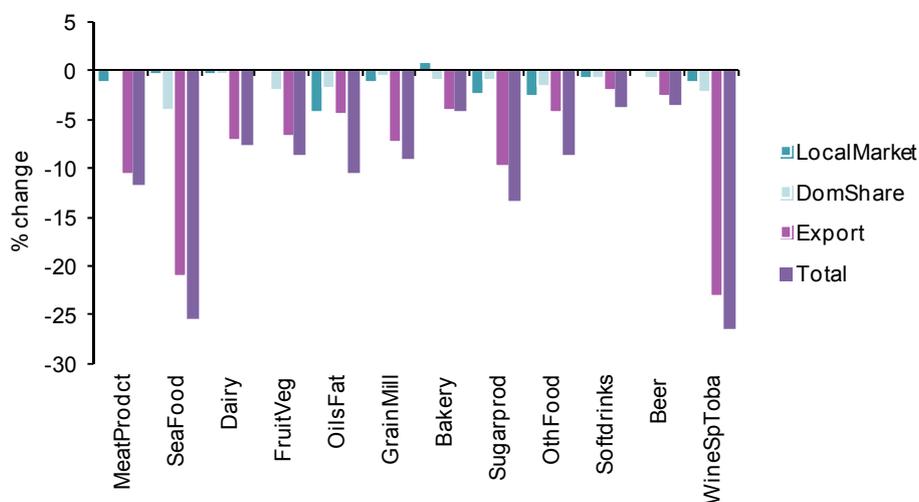
Figure 33: Employment by industry of selected industries for simulation 2



Source: KPMG model estimates

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Figure 34: Local, domestic and export market share contributions to commodity output results for simulation 2



Source: KPMG model estimates

8.2.3 A productivity improvement through innovation

This simulation is an illustration of the importance of innovation and productivity in the food and grocery sector. As an example, the meat products industry was selected and the productivity of all primary factors (labour and capital) was improved by 5%.

Results

The macroeconomic effects of this shock are rather small – it adds only 0.01% to GDP in the short run and 0.02% in the long run – but the impact on the industry itself and its suppliers and customers is significant.

Table 3: Percentage changes for simulation 3

Macro	% change for simulation 3
Aggregate employment	-0.017
Real appreciation	0.001
Investment price index	0.004
Consumer price index	0.001
Real wage	0
Real GDP	0.008
Capital stock, rental weights	0
Investment expenditure	0

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Macro	% change for simulation 3
Export volume index	0.045
Government demands	0

Part of the productivity improvement flows through as increased output of the meat products industry¹⁰, with output increasing by 2% in the short run and 3.5% in the long run. The long run expansion of output is greater because an industry is better able to adjust its input bundle to minimise costs in the long run, whereas in the short run it can only change labour and intermediate inputs.

That the industry expands by less than the 5% improvement in productivity indicates two things:

- That it will release resources to the rest of the economy, since it can now produce 5% more output with the same primary factor inputs; and
- That the benefit of the productivity improvement in meat products will be passed down the supply chain to buyers of meat products in the form of lower prices.

Those industries that supply important inputs to the meat products industry experience output gains due to the expansion of the industry (intensive livestock, and further up the chain, broadacre agriculture).

Those industries where inputs from the meat products industry are an important part of costs (Leather) gain due to the reduction in input prices.

The extent to which the meat products industry expands is governed by the price sensitivity of the markets in which they operate. To the extent that the meat products industry sells into highly internationally competitive markets, small cost advantages lead to significant volume changes. In addition, the extent to which cost advantages provided to customers in the form of lower input prices allow them to sell into internationally competitive markets will drive the performance of those industries, both in terms of exports and import competition. However less related industries, including other food and grocery industries have their competitiveness slightly undermined as the success of the meat products industry slightly drives up the exchange rate and erodes their competitiveness.

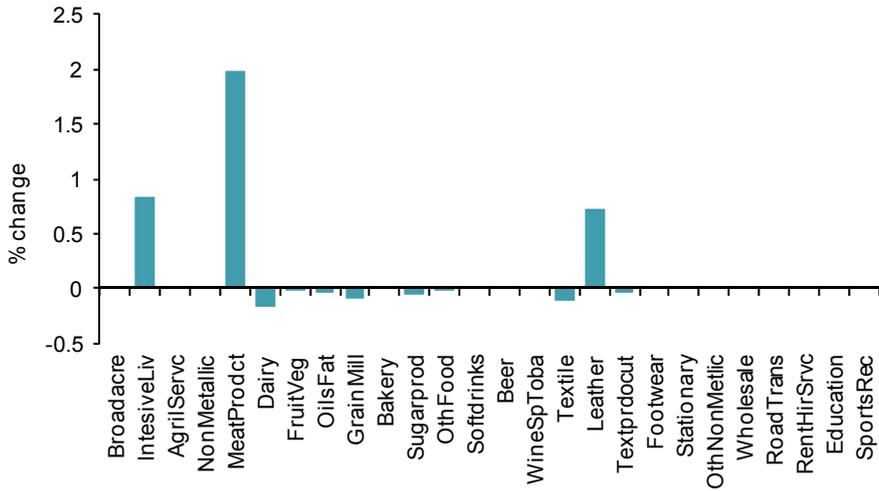
The key message from this analysis is that innovation and productivity growth is important, particularly in the face of the challenges presented by the mining boom (as outlined in scenarios 1 and 2).

¹⁰ Note that results for the meat products industry are not quite the same as for the meat products commodity. This is because of multiproduction in the KAGEM database that comes from underlying ABS data: the meat products industry makes small amounts of other commodities and other industries (leather, oils and fats) make small amounts of meat products.

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To some extent productivity efforts in any food and grocery sector complement those in any other (ie to the extent they use each others' products as inputs) but to some extent they compete (a competitive advantage for one food and grocery sector slightly undermines the position of the others).

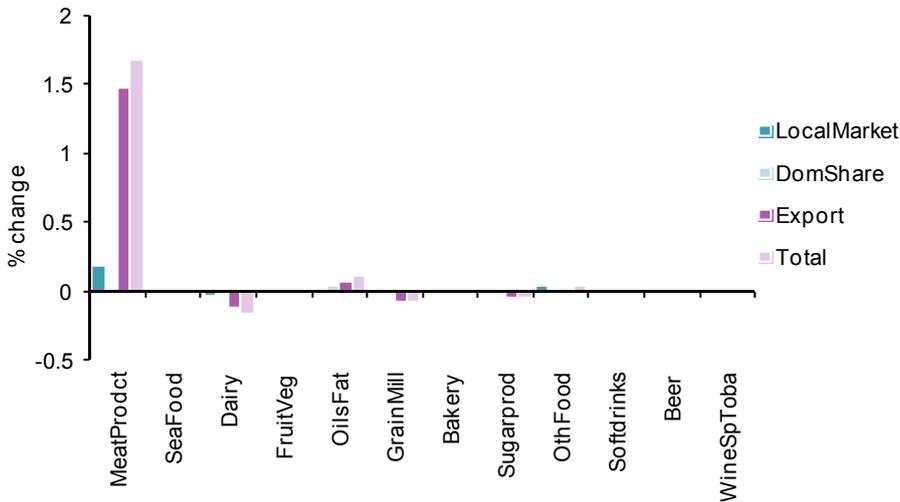
Figure 35: Industry output of selected industries for simulation 3



Source: KPMG model estimates

The following figure shows that an improvement in productivity will slightly enhance consumption in the local market, but most of the sector's growth will come from increased exports.

Figure 36: Local, domestic and export market share contributions to commodity output results for simulation 3



Source: KPMG model estimates

9 Conclusion and next steps

This report presents a fact base analysis of where the Australian food and grocery industry is currently positioned, key insights and possible future drivers.

In reviewing consumer and competitive trends, business model drivers and economic drivers the report highlighted that the industry faces some key challenges, specifically:



Despite these challenges overall industry EBIT grew by 5.4%, total sales grew by 4.9% from \$7.4 billion to \$8.2 billion and exports grew at a relatively high rate of 22% to \$0.1 billion between 2009 and 2011.

This study was based on a small sample of AFGC board members. These board members represented approximately 7% of the overall Australian Food and Grocery Industry. To understand whether the insights drawn from this study are an accurate reflection of the overall industry further evidence would be needed.

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10 Appendices

10.1 Table of Key Items

Key Income Statement line items	2009		2010		2011		% year-on-year Δ		
	\$b	% of GS	\$b	% of GS	\$b	% of GS	2010	2011	CAGR 09-11
Gross Sales (GS)	7.4	100.0%	7.8	100.0%	8.2	100.0%	4.9%	4.9%	4.9%
Trading Discounts	1.0	12.8%	1.0	12.9%	1.2	15.1%	6.4%	22.3%	14.1%
Promotional Allowances	0.6	8.7%	0.7	9.4%	0.8	9.6%	13.6%	7.4%	10.5%
Net Sales	5.9	78.6%	6.1	77.7%	6.2	75.3%	3.7%	1.7%	2.7%
Cost of Sales	3.8	50.7%	3.8	48.5%	3.9	48.2%	0.3%	4.3%	2.2%
Gross Margin	2.1	27.9%	2.3	29.2%	2.2	27.1%	9.8%	-2.6%	3.4%
Operating costs	1.4	19.4%	1.5	19.0%	1.5	18.6%	2.5%	2.7%	2.6%
Warehousing, Logistics & Distribution	0.7	9.8%	0.7	9.3%	0.7	9.0%	-1.2%	2.4%	0.6%
Royalties ²	0.0	0.3%	0.0	0.3%	0.0	0.2%	34.6%	-27.6%	-1.3%
Marketing	0.2	2.3%	0.2	2.4%	0.2	2.2%	10.4%	-6.9%	1.4%
Other	0.5	7.0%	0.5	7.0%	0.6	7.2%	3.8%	7.9%	5.8%
EBIT	0.6	8.4%	0.8	10.2%	0.7	8.5%	3.8%	7.9%	5.4%
Other items									
Capital expenditure (\$ million)	155.5	2.1%	164.0	2.1%	179.9	2.2%	5.4%	9.7%	7.6%
Total Assets (\$ bn)	9.6	n/a	9.9	n/a	9.5	n/a	3.0%	-4.1%	-0.6%
Return on assets (%) ³	6.5%	n/a	8.0%	n/a	7.3%	n/a	n/a	n/a	n/a

10.2 Glossary of Terms

Item	Description
F1	Refers to the Detailed Income Statement Data Request
F2	Refers to the Balance Sheet Data Request
N1	Refers to the Channel / Customer Information Data Request
N2	Refers to the Product Information Data Request
N3	Refers to the Headcount Information Data Request
KPI	Refers to the KPI Information including Productivities Data Request
Add	Refers to the Additional Import / Export Data Data Request

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10.3 Assumptions

Area of analysis	Assumptions		
General	<ul style="list-style-type: none"> ■ There is no significant variation in aligning different firm year ends <ul style="list-style-type: none"> – Due to lack of monthly data and differing participant year-end periods, KPMG was unable to match time-series data accurately ■ Comparison of participant data against ABS data was used primarily to illustrate directionally, the representation of the participant group against the total market size as determined by ABS <ul style="list-style-type: none"> – KPMG did not seek to assess accurately whether the methodology used by the ABS to size the market was comparable 		
Participant data	<ul style="list-style-type: none"> ■ Data provided by participants are correct <ul style="list-style-type: none"> – Although some data validation were performed that resulted in re-submission of data, it was assumed that data submitted by participants are correct 		
Estimated data	<table border="0" style="width: 100%;"> <tr> <td style="vertical-align: top; width: 50%;"> <p>Gross sales</p> <ul style="list-style-type: none"> ■ No variation between trading discounts and promotional allowances for years which gross sales are estimated <p>Overheads</p> <ul style="list-style-type: none"> ■ No variation in the proportional split of the individual constituents of overheads </td> <td style="vertical-align: top; width: 50%;"> <p>Gross sales by retail channel/customer</p> <ul style="list-style-type: none"> ■ No variation in trading discounts and promotional allowances between channels and between retail customers </td> </tr> </table>	<p>Gross sales</p> <ul style="list-style-type: none"> ■ No variation between trading discounts and promotional allowances for years which gross sales are estimated <p>Overheads</p> <ul style="list-style-type: none"> ■ No variation in the proportional split of the individual constituents of overheads 	<p>Gross sales by retail channel/customer</p> <ul style="list-style-type: none"> ■ No variation in trading discounts and promotional allowances between channels and between retail customers
<p>Gross sales</p> <ul style="list-style-type: none"> ■ No variation between trading discounts and promotional allowances for years which gross sales are estimated <p>Overheads</p> <ul style="list-style-type: none"> ■ No variation in the proportional split of the individual constituents of overheads 	<p>Gross sales by retail channel/customer</p> <ul style="list-style-type: none"> ■ No variation in trading discounts and promotional allowances between channels and between retail customers 		
Nielsen data	<ul style="list-style-type: none"> ■ Key points to be considered with Nielsen data: <ul style="list-style-type: none"> – Data is for Retail channel only; – In relation to volume, all units of measure have been bundled together (i.e 1 each = 1 pack = 1 kg = 1 litre); – Department structure is based on the Nielsen Company structure which differs from the members' category structure; – Where there is no data supplied, it has been assumed that Private Label does not participate in this category ■ Comparison of Nielsen data against IBISWorld data was used primarily to illustrate the size of the private label market as reported by other sources of information <ul style="list-style-type: none"> – KPMG did not seek to validate whether the methodology used to determine market value was consistent 		

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10.4 List of data sources

- ABS catalogue number 8221.0 and 8159.0
- “Exploring Treasure Island”, UBS, November 2011
- “Exploring Treasure Island”, UBS, May 2012
- Nielsen Company, September 2012
- G5111 Supermarkets and Other Grocery Stores in Australia, IBISWorld, June 2012
- Participant data