

Agenda

Advancing economics in business

Private labels: a useful ingredient in the food industry?

What effect do private labels have on the food supply chain? Dr Frank Bunte, Wageningen University, the Netherlands, sets out the main findings of a report for the European Commission on the increase in the number of private labels. The report found high levels of innovation in the European food supply chain, with new product introductions (under both industrial brands and private labels) continuing to rise in most European countries

In March 2011 the European Commission published a report on the impact of private labels (also known as retailer own-brands) on the competitiveness of the food supply chain.¹ The underlying study was carried out following one of the recommendations made by the High Level Group on the Competitiveness of the Agro-Food Industry.² In the Terms of Reference for the study,³ the Commission expressed its concern with respect to the possible impact on small and medium-sized enterprises (SMEs) and innovation.

The European food supply chain is less innovative and productive than the food supply chain in competing economies such as the USA, Canada and Brazil.⁴ One of the reasons may be retail concentration and buyer power. Retail buyer power deteriorates the bargaining position of the food processing industry and the industry's ability to innovate. Growth in private labels may be expected to raise the leverage of retail buyer power.

Private labels and innovation

Economic theory provides reasons why the development of private labels may foster, but also harm, innovation. For example, such development may have significant cost advantages over industrial (ie, manufacturer-owned) brand development, in that a ready-made channel for marketing and distributing the goods is available through the retailer. In this way, many of the marketing costs incurred by brand producers can be avoided. With retailers' support and sponsorship, private labels offer processors of non-branded food goods an inexpensive means of entering markets, as they can supply retailers without having to go through the lengthy and expensive process of developing branded goods of their own. With the scale efficiencies offered by supplying large retailers, and without the need for brand marketing support, private-label producers can operate at lower

costs than brand producers, and provide their retail customers with a basis on which they can afford to offer good value for money to consumers and undercut the prices of the leading brands.

Retail strategies to favour private labels may reduce consumer choice, however—in particular in the case of outright brand foreclosure, and through disincentives for brand investment by brand owners due to the 'hold-up' and related problems. Because of uncertainty surrounding orders, payments and so on, suppliers face uncertainty with respect to the pay-offs from the investments. This makes them reluctant to make such investments in the first place, potentially leading to underinvestment, and more generally to distorted investment patterns among suppliers. This underinvestment problem is likely to be most acute for small suppliers, which are least able to resist the buyer power of large retailers and are likely to be the most vulnerable to changes in contract terms (eg, due to financial constraints, tight cash flow and economic dependence on a limited number of key retail customers). Thus, not only can retrospective changes cause considerable uncertainty for suppliers and act as a disincentive to investment and innovation, but they may also increase barriers to entry for small suppliers and make it harder for them to compete on effective terms with larger suppliers, with consequent impacts on innovation and product choice for consumers.

Hypotheses

Based on an assessment of the state of the art in the economic literature, and the market structure in the food supply chain, the research group formulated and tested empirically two hypotheses:

- H1A Consumer choice increases
- H1B Consumer choice decreases

The reasoning behind the first hypothesis is that private labels add a new brand to the shelves. Private labels offer consumers value-for-money. Nowadays, retailers also develop premium private-label products. The counterargument is that private labels merely replace industrial brands. Moreover, if the private-label share becomes substantial, there is no choice left to consumers except for the range of lookalikes that the retailer puts on the shelf.

- H2A Sales and profits of suppliers of private labels grow
- H2B Sales and profits of suppliers of private labels and industrial brands fall

The growth of private labels offers a new opportunity for the food processing industry. Private labels give private-label suppliers access to the shelves and the opportunity to realise economies of scale, because of the size of retailer demand. Food suppliers are also able to benefit from the new labour division between food processors and retailers. Processors can focus on product development and production. Retailers take care of product marketing.

On the other hand, the fact that retailers own the brand enables them to switch easily from one supplier to another, thereby reducing suppliers' margins. Industrial brands may see their market share and sales shrinking. Moreover, their major customers (the retailers) have also become their major competitors. This may have a negative impact on the incentive of industrial brands to innovate. The study provides empirical evidence with respect to all four hypotheses.

Number of SMEs

First, the number of food suppliers indeed decreases over time, but at a normal pace. In countries where product differentiation is traditionally strong (France and Italy), the number of food suppliers actually went up between 2002 and 2007.⁵ This held for both the total number of firms and the number of SMEs. Moreover, the number of suppliers in the EU went up in most

sub-sectors producing consumer goods contrary to sub-sectors producing food ingredients. While the number of firms went down in oil and fats, sugar and milling, it went up in sectors such as processed fruits and vegetables, margarine, ice cream, biscuits, and condiments and seasonings. Meat processing is an exception. The number of firms fell by 10–25% in EU meat processing.

Profitability

Second, profitability at the industry level remains more or less constant in both food processing and food retail. Profitability is not unsustainably low in food processing, and has not increased over time in food retail. This result also holds for SMEs in the food processing industry and most sub-sectors. Of course, there may be large differences between individual businesses.

Private labels and industry structure

Third, more specific evidence on the relationship between private labels and industry structure shows that private-label growth may actually favour the position of SMEs. In France, the share of SMEs in private-label production exceeds their share in industry turnover. Moreover, their share in private-label production increases, while their share in industry turnover falls. Private labels contribute to the survival of SMEs. Of course, this may make SMEs more dependent on retailers. In terms of investment, SMEs perform equally as well as large companies.

In Italy (see Table 1), the numbers of both brands and suppliers have increased over time for dairy and cereal products, except in the case of homogeneous products such as butter and whole yogurt. In France, the market share of both private-label and the top four suppliers increases, to the detriment of suppliers of secondary brands. The top four suppliers gain market share in the more innovative and niche segments, where total sales are growing and private labels are less present. Private-label market share has increased steadily due

Table 1 Numbers of brands and suppliers in Italian supermarkets

	Brands			Suppliers		
	2004	2008		2004	2008	
Refrigerated milk	368	413	+	148	182	+
UHT milk	398	433	+	181	211	+
Butter	333	314	–	50	46	–
Whole yogurt	366	345	–	187	197	+
Functional yogurt	44	102	+	30	66	+
Breakfast cereals	215	244	+	130	178	+

Note: Functional yogurt refers to yogurt with added nutritional value.

Source: Calculations of the Italian part of the research team on the basis of IRI Infoscan. European Commission, DG Enterprise and Industry (2011), op. cit., pp. 87–8.

to the extension of private-label product lines and the decrease in relative prices.

New product introductions

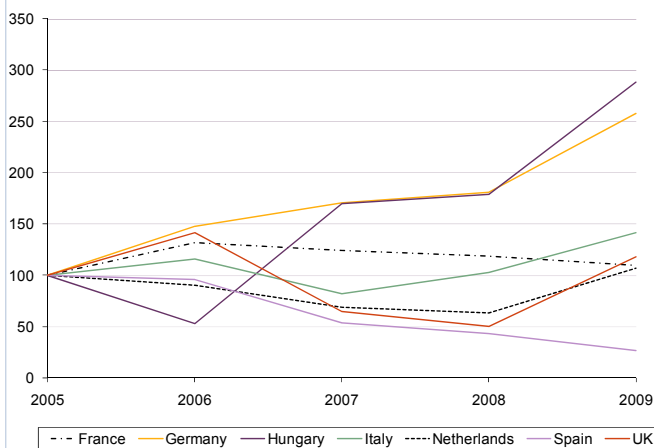
Fourth, the number of new product introductions is still growing in most of the countries analysed. It is true that most product introductions involve private labels, but there is also growth in new industrial brands.

The number of new product introductions was obtained from the Innova database.⁶ Innova has a panel of 700 professionals in 74 countries collecting data on innovations in a selected number of industries, including food and beverages. On average, Innova covers 90% of all innovations in the market. Although the database is not complete, it is possible to identify trends in product introductions.

Analysis was carried out for bakery and cereal products, dairy, and processed fruits and vegetables, including fruit juices. The analysis showed that the number of new product introductions increased from 2005 to 2009. Figure 1 depicts the development of new product introductions for the dairy industry. In absolute numbers, the increase in the number of products introduced was for both private labels and industrial brands.

There was one major exception in the analysis: in Spain, the number of new product introductions decreased during this time. While the number of new industrial brands introduced dropped sharply, the number of private-label introductions remained constant. In Spain, retail chains that offer a small number of stock-keeping units, notably supermarkets and discount retailers, gained market share at the cost of hypermarkets. This implies that it is very hard for brand suppliers to penetrate the Spanish retail market—about 50% of this market is very hard to access.⁷

Figure 1 New dairy products introduced (2005 = 100)



Source: Author's calculations based on www.innovadatabase.com.

Spain differs in this respect from two other major European economies. In Germany, the number of new products introduced is growing because product variety and quality have gained importance over time as a competitive instrument in addition to price. In the most mature private-label market studied—the UK—private labels lost ground over the period in terms of product introductions relative to industrial brands. This may be explained by the high share of private labels in new product introductions at the start of the period considered.

The results of the analysis on the basis of the Innova database are confirmed by European research and development (R&D) data.⁸ R&D expenditure in the European food and beverage industry is still rising: it grew by 80% in Germany between 2002 and 2007, by almost 20% in France and the UK, and on average by 40% in the eight small countries for which there was data available. R&D expenditure in Spain was stable between 2005 and 2007.

Interview results

This empirical evidence is confirmed by the results of 40 interviews held among food processors and retailers throughout the EU. Retailers contribute to product innovation by creating or stimulating the creation of additional product lines. They generate employment in their own R&D, marketing and design departments, and enable their suppliers to grow, to invest and to innovate. Retailers also spur on suppliers of industrial brands in their innovation efforts. Because private labels constitute a major challenge to industrial brands, and private-label growth leads, by definition, to a decline in shelf space for industrial brands, brand suppliers have to make even greater efforts to retain their space on the retailers' shelves.

However, retailers also apply business practices that are likely to have a negative impact on suppliers' innovation efforts. According to one of the brand suppliers interviewed, a retailer used the information on a new product given by the supplier to develop a private-label product rather than listing the industrial brand. In this example, the retailer confounded its roles as customer and competitor. More generally, there are two business practices applied by modern retail that have a negative impact on suppliers' viability and their ability to innovate. First, retrospective and late payments create uncertainty and constitute unexpected risks and costs. Second, retailers also shift risks to suppliers even if suppliers are no longer able to influence these risks. This holds, for instance, for payments for bad performance after delivery has taken place. The buyer power that retailers are able to exert depends on their control over shelf space, their multi-product nature, and their dual role as customer and competing supplier to industrial brands.

Concentration as such is not the issue, because both food processing and food retail are concentrated.

Conclusion

Because private labels have both positive and negative effects on innovation, it is not possible to give the net impact of private-label growth on innovation at the industry level. This is also not possible because it is very difficult to assess product quality—ie, what makes

a new product a better product than an old product. The results of the interviews point out that most innovations in food have an incremental nature. The food industry remains the most important driver behind technologically driven innovations; retailers have a key role in introducing convenience and sustainable products.

Frank Bunte

¹ European Commission, DG Enterprise and Industry (2011), 'The Impact of Private Labels on the Competitiveness of the European Food Supply Chain', March. The study was conducted by a team from Wageningen UR (Netherlands), AKI (Hungary), INRA (France), the Catholic University of the Sacred Heart (Italy) and Competition Analysis Ltd (UK). A separate study, carried out by Oxera for the European Retail Round Table (ERRT), considered the economic benefits of own-brands. The results of this assessment were summarised in Oxera (2010), 'Correctly Labelled? The Economic Benefits of Retailer Own-brands', *Agenda*, October.

² High Level Group on the Competitiveness of the Agro-Food Industry (2009), 'Report on the Competitiveness of the European Agro-Food Industry', report for European Commission, DG Enterprise and Industry, March 17th, p. 51.

³ European Commission (2009), 'The Structure of Retail and Production along the Food Supply Chain in the EU. The Impact of Private Labels (Retailers' Own-Brand Products) on the Competitiveness of the SMEs', specifications, call for tenders no ENTR/09/031.

⁴ European Commission, DG Enterprise and Industry (2007), 'Competitiveness of the European Food Industry: An Economic and Legal Assessment'.

⁵ Eurostat, Structural Business Statistics.

⁶ Available at www.innovadatabase.com.

⁷ Berasategi, J. (2011), 'Competition Law in the Grocery Retail: Caring About Consumers?', Seventh Symposium on Trends in Retail Competition: Private Labels, Brands and Competition Policy, Oxford, June 3rd, slide 18.

⁸ Eurostat, Structural Business Statistics.

If you have any questions regarding the issues raised in this article, please contact the editor, Dr Gunnar Niels: tel +44 (0) 1865 253 000 or email g_niels@oxera.com

Other articles in the August issue of *Agenda* include:

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