Exclusivity In the Food Manufacturer & Grocer Trade

Reasons Behind the Marketing-Procurement Practice

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Exclusivity is the singling out of a vendor, brand or stock keeping unit (sku) for preferential treatment by the retailer. Exclusive or preferential supplier-distributor arrangements have been in existence for at least twenty-five years. Manufacturers have always sold categories such as spices, batteries and light bulbs, where consumer brand preferences are slight or nonexistent, to major customers under preferred or exclusive vendor agreements. In the industrial market, exclusivity has been common. For example, food manufacturers have exclusive suppliers of tin cans or glass bottles. The auto industry has similar habits, while in durable or non-food consumer goods retail brand focus has been common, e.g. appliances. Coca-Cola has long been the exclusive supplier of soft drinks to McDonalds. These types of relationships are often encouraged in academic journals and are often called alliances.

Exclusivity, like many practices or programs, can vary in its form and execution even within a given retail firm, let alone across the entire industry. Exclusivity can be executed to varying degrees ranging from absolute exclusivity to simple preferential treatment over competing vendors or brands. Absolute exclusivity is the selection of a manufacturer (or supplier) who will be the only vendor in a category listed.

Preferred treatment can be as simple as an agreement to discount or promote only one brand in the category. In this case the competitive brands are simply maintained on shelf and available to consumers.

Both retailers and manufacturers assert that over the past decade this practice has increased materially. In some retail outlets or corporations, the activity is now found in virtually every category. Based on reliable industry benchmarks from the late 1990's it is likely that as of 2001, at least half of major Canadian manufacturers are involved in some form of exclusivity arrangement with Canadian distributors.

The following are some of the reasons behind the practice and why it has grown:

- During the past five to ten years consumer demands have increasingly moved toward fresh foods, overtly nutritious foods (e.g. nutraceuticals), and products with much more convenience (e.g. prepackaged salads, Swifter). Distributors have tried to respond or encourage this change. As a result, the traditional core grocery section has lost its traditional share of store space and, in some cases, has actually been cut back. Most will obviously try to rationalize the spaces for these mature categories to optimize category profitability. As such there is less need for more than one supplier in these mature grocery or packaged goods categories.
- Another reason behind the growth of the practice is the fact that national brand strength is diminishing (witness the growth of private label acceptance among consumers). There is less need to keep more than one national brand on the shelf. This is especially the case when the grocer or distributors' private label brand can take on the role of the "fighter" brand (competition) versus the market leader.
- Exclusivity has grown as a result of the retailer's increasing technological knowledge. Gains in these areas have been acquired from category management disciplines and are simply a necessary condition for competitive survival. In other words, exclusivity has increased as the grocer's knowledge of what sells and what is profitable has increased.
- Limited line retailers, box stores, mass merchants and wholesale club formats have all grown in importance as a channel for moving traditional grocery lines to consumers. Growth came in part from material operating cost advantages over full service retailers and the practice of carrying

only a limited or select brands and skus. These limited assortment retailers often carry less than a quarter the number of products of a full service retailer. As these formats grew in consumer acceptance and resulting market share, the importance to a manufacturer of being the select or exclusive vendor or brand grew. This importance to the manufacturer was in turn reflected in the cost of goods made available to these channels. As a result, the exclusivity or preferred arrangement became the way of doing business in practically every category in these retail outlets.

- For retailers, the cost advantages of having limited lines can be identified most easily in the inventory management and turns of inventory at retail. It was likely this economic ratio that encouraged the first retailers to experiment with this concept. The greater the turns, the greater the efficiencies and profit potential. The cost of carrying all the extra SKU's, product duplications and flavour extensions is measured in inventory turn reduction. The old adage that 80% of the business or sales is done on 20% of the SKU's is more correct than not. It also holds true for profit, as 80% of the profit comes from that 20% of the SKU's. Thus the economic balancing act is defined for all retailers and for those choosing to look at limited lines. The key then is to do as much volume in a retail category on the fewest possible skus thus maximizing the economics. Limited line retailers can more than double the turns of retail inventory at store level with the right pipeline support system for inventory replenishment. This combined with efficient product handling and labour management practices unique to these retailers, can lower the operating cost to half those of a traditional or full service retailer.
- There are other real cost savings associated with limited line retailers that are worked into the economic equation to generate the advantages over full service retailers that need to be noted. Cost of advertising is marginal as most limited line retailers do not participate in regular advertising media and rely solely on word of mouth support. Cost of signage and in store décor is also nil or significantly less than traditional retailers. This is because part of the ambiance of being low cost is looking low cost. In store standards as they relate to product presentation, management and cleanliness are often more cost efficient with limited line retailers. Also the simplicity of the retail operation generally allows for lower labour costs as few if any, skilled retail workers are needed.
- The developments within the limited service channels were a significant accelerating force for full service retailers (ie. traditional supermarkets) to make changes to their way of doing business. At one time the traditional grocery industry believed that consumers would never support limited line retailers with their lower standards of product presentation, packaging and service. Once that view was destroyed by the very success of these outlets, they became widely regarded as a viable means of moving retail goods. The full service retailer sought to embrace this kind of vendor relationship and find a way to execute it in a full service store and yet remain a "full variety" retailer. This now is the common way of doing business in grocery retail. At the same time there is no set model. Instead it has been and continues to be an evolving business practice. It is a state of business to strive for, whether it is truly attainable or not.
- Grocery product manufacturers were intimately aware of the success of limited assortment categories. That is of course because they were enjoying the volume in hand with these new retailers. As such, the value of being the exclusive brand/vendor/SKU in a category became very important to the manufacturer for market share.
- For manufacturers, this access to share and the apparent acceptance by consumers to the limited assortment retail concept paved the way for exclusive arrangements with traditional grocers. It also fostered the ever-increasing acceptance by manufacturers to pay for this share opportunity.
- The manufacturer's willingness to deal with limited assortment outlets in this manner naturally placed considerable pressure on full service grocery retailers. The traditional grocers sought to lower prices and reduce the price gap between themselves and limited line stores. They experimented first with the preferred type of arrangement and slowly transitioned to exclusive arrangements.
- Manufacturers, seeing the opportunity and driven also by competitive pressures, were willing to discount the cost of product and pay considerable sums of money to be the chosen one in each category by the grocer.
- The manufacturer justifies selling at a lower price on several grounds: no advertising or consumer promotional costs are assigned to this business; it may be cheaper to service; brokers may accept a lower commission rate; and logistics costs may be lower. In addition and most likely, the manufacturer is willing to accept lower margins in exchange for getting this business.

In summary, the advent of Costco during the past 15 years pointed out to the industry that it is possible to be successful without carrying a full range of leading brands. The success of No Frills, Food Basics and Price Chopper further strengthens this point. The phenomenal success of Loblaws' Private Label program is the final piece of evidence to show that wide variety within a category is not necessary. All the discounters and others of their class depend on limited variety as the key to keeping costs low. At the same time they can get a better discount from the chosen suppliers for giving them access.

In the case of sole supplier arrangements, transaction costs define a benefit to both the retailer and the manufacturer. From the perspective of the retailer, each additional supplier he takes on results in additional costs in logistics (e.g. another party to coordinate inventory management with) and an additional party with whom he must negotiate. There is thus a natural benefit from having a supplier that provides a broad array of products. This natural benefit includes lower search costs, individual contracts that cover multiple products and only one party to deal with if problems arise. There are particular advantages when the supplier provides an entire category of products (e.g. soft drinks, meat products) because the supplier can take a more active role in inventory management in the store.

For the product manufacturer, each additional customer he must supply entails transaction costs, and the greater the volume of product that can be supplied to a given customer, the lower the per unit transaction costs. So for a fixed volume of product, transaction costs are reduced by supplying a small number of large customers, as opposed to a large number of small customers. Sole-supplier arrangements help assure the manufacturer that he is getting the maximum product volume to a customer. Also, because sales of products within a specific category are related, it can be much easier (and less costly) for the manufacturer to supply the optimal mix of product within that category. For example, if a single supplier provides fluid dairy products to a retailer, it is easier for him to provide the optimal mix of egg nog (a seasonal product) that will appear on the shelf than if a rival supplier also has part of the retailer's business.

Manufacturer-Distributor Issues

All of the various forms of exclusivity are considered to be an agreed to Aperformance@ by the retailer. In other words, the retailer regards exclusivity or preferential treatment as a service or a form of performance. This service in turn is seen and understood as an act that is to be rewarded. The vendors are encouraged to pay for this performance. Payment can be in the form of lump sums, case bill backs or directly reflected in the case cost. Usually the payment involves all three of these as both the retailer and vendor are interested in ensuring that the actual cost of goods is not easily obtainable or understood. For example, if this special financial payment for exclusivity was totally reflected on the invoiced cost of goods, then competitive vendors and retailers could easily become aware of the deal and put pressure on that economic relationship.

The performance criteria associated with these types of relationships can vary but they often include the following:

i. volume commitments or goals
ii. shelf placement in aisle or on display at end of aisle
iii. retail pricing strategies versus competitive national brands and retailer brands
iv. signage and advertising plans
v. role of brand in consumer marketing programs and much more.

The core of the arrangement is always the volume expectations of the vendor and the profitability expectations of the retailer being met.

It is difficult to determine or even estimate what share of the manufacturer's spending with retailers in this area is for the tonnage potential. Both manufacturers and distributors estimate that 80 cents of each dollar spent for exclusivity is for that opportunity and the anticipated tonnage the vendor and retailer expect. The 20 cents balance is likely for the little extras around the marketing of the retailer's category and the role of the brand in that plan.

It may be possible that some retailers do not honour the performance criteria of the deal, but they are likely few and more an exception than the norm. Failing to perform or honour a deal is not what the

majority of retailers want to be known for, and of course that is not a sustainable business practice. While the trade deals and relationships continue to evolve, the fact is that distributors do in fact honour their performance commitments. Most important of these is the volume requirement, which is a part of any properly negotiated agreement. Retailers do pay attention to the performance criteria.

As alluded to above, manufacturers are willing to lower the cost of goods to these limited line retailers for two primary reasons:

- market share lost or gained
- product handling efficiencies.

Let's look at the market share opportunity first. A limited line retailer with a 20% overall retail market share can often have more than that share in a single category. That is due to the impact of carrying limited lines and the over-flow effect of consumer purchasing behaviors. That is, a consumer looking to purchase a carbonated water may not find one in a limited line store so they will supplement that purchase with an extra bottle of carbonated soft drinks for example. Thus that limited line retailer with an overall retail market share of 20% may have a 25% share in the soft drink category. The manufacturers then see this as a full 25% market share prospect provided they can demonstrate to the retailer that their product base is strong enough to carry 100% of the 25% demand share.

For the manufacturer the upside market share opportunity can be significant, as noted in the "Reasons" section above. For example, a manufacturer may normally have a 30% overall market share when competing in the open market against all challenging brands in the category. The opportunity to get 100% of a retailer's category in which that retailer accounts for 25% of the overall market volume would be a significant lift in overall market share to the manufacturer. In this case, on a level playing field with a retailer listing all significant category competition that manufacture would get its normal earned share of 30%. That is, if that retailer's 25% share volume were open to all competition, the manufacturer would get approximately 8% of the retailer's market share slice of pie. Participating in an exclusive arrangement with that same retailer, that manufacturer will get 100% of the 25% the retailers category market share. That is more than 3 times the present earned share.

The degree of the market share opportunity will vary depending on the execution and type of exclusivity arrangement. With that said, it is easy to see that the stakes are very high for manufacturers. A manufacturer that loses an exclusive arrangement or gets pushed aside as another manufacturer wins an arrangement, will have a great deal of work to do to recover the volume. Exclusivity is a double edged-sword. As a result, emotions around these deals run high.

Manufacturer-retailer issues associated with exclusivity can also evolve around costs and trade spending. A manufacturer managing all of a category's sales is usually encouraged by the grocer to look for cost reductions associated with exclusivity. These other cost reductions would likely include areas such as packaging, product and case labeling, product configuration on pallets, frequency of shipment and amount of each shipment, substituting a sku with a more efficiently manufactured sku and rationalizing sizes as related to efficiency. These generally are the opportunities shared by the retailer and manufacturer as they work together to define the costs and support the changes in the business relationship to maximize the savings. This often makes the arrangement more acceptable to the manufacturer who may have struggled with the cost requirements expected during the negotiating process.

As noted above, exclusivity remains a fluid concept in the traditional grocery environment. Grocers need to offer consumers enough choice as a competitive reference to the discounters but at the same time, they need to be price competitive with these entities. Restricted by a commitment to consumers to offer variety, the challenge was to find business approaches that would satisfy both criteria.

The first hurdle was to redefine variety. A good starting question is when is variety actually variety versus product duplication? Category management provides the analytical tools to measure and test these challenges. It quickly pointed out opportunities to reduce listings but not hurt the variety image of a full service retailer. Early rationalization was found in reducing product duplication.

Secondly, it was often found that market share by a brand was not necessarily reflective of product or

brand loyalty but instead was driven by discounting and availability. With this exposed, in some cases retailers discontinued the third and fourth tier brands in categories found to have no real brand loyalty (as measured by the average retail and discounting frequency). Thirdly, when a top tier brand is priced "right" it seemed that consumers had few if any concerns about variety.

Over time the full service, full variety grocer was able to fully test the equation of exclusivity versus variety and consumer purchase behavior. With each decision, category management took on a more exclusive operating style and made available costing equal or closer to the exclusivity costing equations enjoyed by the limited line retailers.

This also evolved to vendors paying to stay. That is, manufacturers needed to put up funds in order not to be de-listed by a retailer but kept on a shelf for a period of time. Smart manufacturers used this time to find answers to the questions raised by category management. They also used this time to respond to these new challenges to their brand. The challenges were delivered by the grocery category mangers that now knew more than the vendors on how consumers would react when faced with the decision of variety versus duplication.

As a final discussion point regarding exclusivity, consider the fact that while exclusivity monies and strategies are important, they are not applicable to all categories and are not the only activities driving change in retail. The following are other forces that placed pressure on the "business-as-usual" model:

i. the development of retailer brands (private label/generic),
ii. the need for region-specific or even store-specific merchandising programs
iii. the desire to cut or at least micro-manage advertising programs
iv. rotating in store features
v. every day low price programs

All of this merchandising change and the pressure to remain revenue neutral meant that traditional or familiar cost incentives from vendors were being threatened. Retailers recaptured many of these old incentives into new or more current business-reflective allowances. As this change transpires or evolves, it can seem as though more was being requested for less by the retailers. While that may seem to be the case, vendors demonstrated they would pay more for activities like exclusivity. This combined with an environment of changing product costs, new competitors, new channels of distribution, every day low prices and costs, elimination of deal cycles and more, made the determination of what was incremental vendor funding very difficult to isolate.

While the surviving manufacturers and/or brands may be funding larger allowances than ever, they are also enjoying the benefits of increased market share and tonnage. This is in addition to the removal of many peripheral brands that often squeezed manufacturing margins by preventing cost increases. The impact of the resulting tonnage increases and efficiencies also help manage the manufacturing costs. The bottom line is that determining just what is incremental revenue by the retailer and what is incremental spending by the manufacturer is most difficult to determine in a retail environment with so many varying strategies.

An interesting corollary or eventual outcome of this practice is that retailers who concentrate on sourcing from relatively few suppliers may find that they inadvertently create an oligopoly of suppliers. In this case the retailers may find they have less bargaining power as a result.

Readers please note that a version of this article first appeared in the June 2001 issue of Grocery Trade Review. If you are interested in a sample copy of Grocery Trade Review, please call the Centre at 519-822-3929 or e-mail at kevin@georgemorris.org