CHAPTER 3

RELATIONSHIPS BETWEEN FOOD MANUFACTURERS AND RETAILERS: CONTRIBUTING TO RISING FOOD PRICES?

3.1 Introduction

Based on various rounds of interviews with retailers and food manufacturers, the Food Pricing Monitoring Committee (FPMC) gained the impression (rightly or wrongly) that there are several factors and practices within the supplier-retailer relationship (mainly the large retail chains) that have the potential to contribute to inefficiencies and extra costs to the consumer, and, thus, making food more expensive. These include the following:

- Confidential rebates
- Returns on no sales and in-store breakage and losses
- Poor management of the cold chain for perishables (temperature regulation in delivery areas, shelves, fridges)
- Poor management and care of supplier packaging material (such as crates) and thus losses to suppliers (could be as high as 10c/l of milk for example)
- Long periods before payment
- Price being the only issue in the relationship – no quality, collaboration in product development and other soft issues are considered which could be important in establishing long term and sustainable supplier-retailer relationships.

It was hypothesised that these factors might increase the cost of food since suppliers usually factor all these cost items into their costing of different products. The Committee was, therefore, interested to know from food manufacturers whether they could indicate the potential cost savings to the consumer - or alternatively, decreases in the list prices of the main food lines – and if supplier-retailer relationships could become more long-term and sustainable irrespective of the mentioned costs.

The Committee, then, invited submissions from various food manufacturers on indications of how improved relationships and greater efficiency and a reduction in losses and wastage could be to the benefit of consumers, suppliers, retailers and the South African economy as a whole. Manufacturers/suppliers were also invited to provide the Committee with their vision of the ideal and most beneficial supplier-retailer relationship. A recent article by Norbert Diamant in Food Review (October 2003) touches on the same issues. The Committee has used some of his findings based on a 2-year study to illustrate the not-so-apparent factors behind food inflation.

Very few of the manufacturers provided an indication of how much could be saved if the aspects listed above were not present in current transactions. In some communication it was indicated that there could potentially be cost savings in such a scenario.

The research by Mr. Diamant, however, does provide some numerical data, which are discussed below. Most of the written submissions merely discussed suppliers' perceptions and concerns regarding some of the current practices by retailers. From this side, thus, no concrete data were provided, and this section merely presents a summary of the views of suppliers.

3.2 Views on confidential rebates

It is widely known that manufacturers sell goods to retailers and wholesalers on a negotiated rebate basis. A rebate is a discount negotiated between the supplier and the retailer and is usually based on the volume of business. It is meant to cover the support that retailers offer in terms of advertising, shelf space, listings, etc. The concept of rebates is not unusual, and most large manufacturers nowadays accept that confidential rebates (or part thereof) generally form part of a retailer's margin. They believe that the current practice of confidential rebates is both sound and ethical and should not be tampered with. Some suppliers argue that rebates ultimately become part of the value chain, and that a reduction in the level of these rebates would probably not save any money. This is based on the premise that if an industry were to take away rebates, retailers would compensate for their loss through taking higher profit margins on their products. In many cases, however, the starting point for the negotiations increases annually and is an extra cost that gets factored into the selling price.

The view of small suppliers to the large retail stores differs from the large suppliers. They point out that in some instances where primary industries are weak, and very fragmented, and have little negotiating power, the rebates can be quite high. Confidential rebates are sometimes as high as 12%-15% (maximum levels). This makes it very difficult for small suppliers to stay in business because these rebates cannot be easily recovered from list prices.

Despite confidential rebates, retailers can, from time to time, discount product prices (even at "loss levels") in order to attract consumers to a particular outlet. This is usually done out of the supermarket's own pocket.

It was also pointed out that the practice of confidential rebates is not conducive to competitiveness since rebates are normally granted to the large retailers who have the necessary bargaining power to negotiate them. Thus, it makes even more difficult for small retailers to compete with the larger supermarkets.

3.3 Returns and losses

In South Africa, the corporate supermarket chains expect suppliers to unconditionally guarantee their products. This, according to Diamant (2003), means that they must accept all returns, no matter the reason, except where they can prove that the supermarket was at fault. In the US when stores buy a product, it is theirs.

In some places returns have become somewhat of a cult with them being top of the list when suppliers negotiate their deals with retailers. The magnitude of returns and wastage is often grossly underestimated and can vary between 1 and 15%. With better merchandising controls, however, returns can be reduced to below 1% (Diamant, 2003). The message is that if returns are not controlled and are left "open-ended" the general result is that 1-10% of all products are being returned.

Policies and arrangements differ between manufacturers. Some have a "sell-or-return" others a "no-return" policy. In the case of "sell-or-return" the supplier carries the cost of the damaged and/or expired product. In the case of "no-return", the retailer has to carry the cost of the damaged and/or expired product. The manufacturer/suppliers argue that in either case these costs will be taken into account in establishing the price – whether at wholesale or retail level -, and in the end the customer will pay. The manufacturer/supplier is, however, of the opinion that a "sell-or-return" policy is the better option because it allows retailers to cut their mark-ups to the bone since what they buy will be what they sell and no additional mark-up will be necessary to recover the cost of damaged or expired goods. This statement is made in the light of the fact that suppliers are generally in a position to recover a considerable portion of the loss by repackaging or reselling the damaged goods to low-income markets.

Some suppliers also point out that a "return on no-sales" policy can lead to abuse by retailers since they might over-order and then return the balance as "no sales". On the other hand, it is also very difficult to maintain a "no return" policy since retailers sometimes threaten de-listing if their terms are not accepted.

A number of suppliers feel that greater efficiency can be gained by having a 'no-returns' policy in place that allocates the responsibility for control to the party that actually controls the product at any given time. This sprouts from the fact that suppliers generally dictate the "sell-by" or "best before" dates implying that goods can be inspected upon delivery and returned if not acceptable since the retailer has the right of refusal at the point of delivery.

In general, suppliers feel that "returns" are a direct result of poor purchasing and ordering together with poor management of the cold chain and poor hygiene, mostly at the premises of the retailer. Because of the fact that "returns" result from the actions of the retailer, and that suppliers generally has very little control over the level of "returns", some suppliers feel that a maximum "returns" allowance should be negotiated.

With regards to losses, suppliers note that in-store breakages and losses can give rise to substantial losses, which are recovered through higher prices. Suppliers ascribe these substantial losses to the fact that little emphasis is placed on the proper handling of goods because retailers are not responsible for any losses incurred through their negligence. Once again, it is felt that problems with products resulting from retailers conduct (breakages, rotation, over-ordering, etc.) should be at the retailers' cost.

3.4 Management of the cold chain

The cold chain is a major problem. The study by Diamant (2003) found that the temperature of some refrigerators were consistently at 9° C or over when they should be less than 3° C. This causes spoilage and increases returns, as well as customer dissatisfaction. Freezers, too, are often too warm – with temperatures fluctuating between +3° C and –15° C. Some suppliers point out that the majority of retailers have very poor receiving areas, which is not conducive for managing the cold chain effectively. The delivery of perishable goods could and should happen more effectively. This could be done at night as few hold-ups and congestion at the receiving bays will be experienced. In so doing, substantially cheaper and more efficient delivery services to customers will be guaranteed and fewer out of stock situations will occur. These will be added, but major benefits.

Customers are also to blame for wastage and losses. They collect cold meat or other perishables in their baskets, then change their minds and leave them, for example, in the clothing department of the supermarket. Or they leave their food in the car boot for a few hours. When then the food has 'gone off' they return it to the store, which passes it back to the supplier.

3.5 Management and care of supplier packaging material

Primary producers supplying directly to retailers are of the opinion that consumer prices could be lower if retailers took greater care of the supplier packaging material (trolleys), and would be held responsible for mishandling products in their stores. Suppliers point out that retailers seldom take good care of the supplier packaging material, and in industries where the supplier packaging material is a very large cost component, poor care for the packaging material can be very costly. Suppliers are of the opinion that retailers regard crates as a cost to the supplier despite the fact that retailers tend to use these crates for their own storage purposes.

It is also pointed out that there is currently no deposit system in place, and that if a deposit system were to be imposed, retailers could simply deduct the deposit from the invoice, which is a good incentive for taking care of packaging material.

As a result of the poor care that is given to packaging material and the resultant losses, some suppliers build into their cost structure the annual cost of replacing a proportion of their containers. Even so, this cost is still considerably less than switching to non-returnable containers.

One supplier noted that, in general, neither retailers nor wholesalers nor distributors put any emphasis at all on "caring" for the suppliers packaging material. The result is that, monthly, in some industries approximately 2% of the packaging material is lost. It was suggested that retailers should either pay for the packaging material in the form of a deposit or retailers should, on receipt, return crates on a one-on-one basis.

3.6 Payment terms

Generally, payment terms vary considerably and stretch from 7 to 90 day credit terms. Manufacturers point out that, in general, they finance inventory (either in partially finished or finished goods form) while retailers continue to order products as and when they consider this to be in their interests. This is done because retailers take into consideration the benefits of pre-stocking before notified price increases as well as periodic promotional activities undertaken by each manufacturer.

The general view is that manufacturers do not experience many problems with credit payment terms. Some manufacturers do, however, point out that there are problems with some, very specific, retailers where payment may take up to 60 days.

A certain supplier pointed out that slow repayment is a problem but it is not common for all retailers. This supplier is of the opinion that goods should be paid for no later than when they are sold. Some suppliers are of the opinion that all perishables must be paid for in full in cash while other goods should be paid for in full no later than when they are sold.

Suppliers commented that some retailers are open to negotiation with regards to the payment terms while others coerce suppliers into agreeing to less than favourable terms of payment for the suppliers through a "take it or leave it" attitude. One supplier noted that the payment period is a commercial issue, and that it is best left to the individual businesses, suppliers and the customers to resolve the terms and conditions of the transactions and the payment thereof.

3.7 Relationships

The relationships between manufacturers and their retailers and wholesalers has, historically, been characterised by hard negotiations with each party pursuing their respective interests. Suppliers do, however, point out that in recent times relationships between manufacturers and their market retailers and wholesalers have matured into practical relationships governed by a more open and constructive atmosphere dealing with many more issues than just price and credit terms. In the fast paced and extremely competitive consumer goods market, retailers and wholesalers are increasingly recognizing that the development and maintenance of sound relationships with key suppliers is in their own best interests.

Some producers in the primary industries do, however, feel that they are treated with very little respect by major retail and wholesale groups. A major objection is the fact that suppliers have very little choice other than to accept the terms of the retailers or face de-listing.

Suppliers are of the opinion that it is indeed possible to build long-term relationships with retailers that would be to the benefit of the shareholders of the retail company, to the benefit of the shareholders of the supplier and to the benefit of the consuming public as a whole.

3.8 Government intervention

Direct government intervention is generally viewed as unnecessary over and above the fact that there is probably very little that the Government can do to improve the supply chain efficiency. One manufacturer pointed out that the Government could contribute through controlling theft and armed robberies. It is felt that crime adds to costs through security costs, ever increasing insurance costs and through the fact that losses incurred in this way must be written off.

3.9 Concluding comments

From the many responses that were received from various food manufacturers, a clear dichotomy has emerged. For the major food companies in South Africa there does not seem to be much of a problem. Relationships with the large chain stores have matured and they are working together to achieve good, efficient supply chain management or effective consumer response (ECR). Negotiations are tough but the relationships have matured and are much more cordial.

However, the small suppliers have different views, with many of them complaining about the practices of the supermarkets discussed above. Many of them find it difficult to survive financially because of the 'unfavourable' terms at which they need to trade. Many of the smaller suppliers sent anonymous submissions to the Committee because they fear being "de-listed" or "blacklisted" if the retailers they deal with would find out. This clearly illustrates a relationship that is not built on partnership but on antagonism.

There seems to be substantial evidence that suggests that practices by retailers act as an entry barrier for many smaller suppliers. This situation can potentially lead to greater concentration in the food manufacturing and retail sector, which might become a concern for consumers and Government. It could well act against the Government's objectives of to promote small-scale business, and it could become a major challenge to Black Economic Empowerment.

Against this background, there is an obvious task for Government to continue to monitor prices but also to monitor the specific nature of the manufacturer-retail structure that might limit competition and participation in the economy.