

Working paper on grocery wholesalers

Introduction

1. A concern raised with us by the Association of Convenience Stores (ACS) and the Federation of Wholesale Distributors (FWD) is that the viability of the grocery wholesale sector is threatened by the exercise of buyer power by supermarket chains combined with the reduction in the number of convenience stores served by the grocery wholesalers.
2. The problem foreseen by the ACS and the FWD is that as the number of convenience stores served by grocery wholesalers declines, the average costs of supplying these stores increases. This, in turn, may force wholesalers to increase their prices to the extent that a significant number of these convenience stores are unable to operate profitably and therefore close. Accordingly, a tipping point might be reached beyond which, as a result of the closure of a certain number of convenience stores, the grocery wholesale sector is no longer economically viable, leaving the remaining convenience stores without a functioning supply chain.
3. In this paper we set out the current structure of the grocery wholesale industry. We then consider the extent to which there has been any weakening in the grocery wholesale sector in recent years and examine the sensitivity of the grocery wholesale sector profitability to reductions in the size of its customer base.

Structure of the grocery wholesale industry

4. Turnover among grocery wholesalers supplying convenience stores was £16.8 billion in 2005,¹ an increase of 0.6 per cent on 2004, and 9.8 per cent on 2000.² Approximately 45 per cent of this revenue was earned by delivered wholesalers,

¹This includes turnover from the food service industry.

²IGD, *UK Grocery Wholesaling: A Strategic Guide*, March 2006.

which primarily supply convenience stores that are members of symbol groups (such as SPAR and Londis), while 55 per cent was earned by cash-and-carry wholesalers, which primarily supply convenience stores that are not affiliated to symbol groups. In terms of volume, we estimate that the supply of groceries from wholesalers account for between 15 and 20 per cent of total UK grocery supply.³

5. The two largest grocery wholesalers in the UK are Palmer & Harvey (delivered) and Booker (cash-and-carry). These two wholesalers account for 40 per cent of all grocery wholesale revenues and individually over 30 per cent of revenues in their respective sectors. Although there are over 400 grocery wholesale firms in the UK, the 16 largest wholesalers (set out in Table 1 below) account for around 80 per cent of grocery wholesale revenues.

6. The decline in the number of unaffiliated convenience stores⁴ has resulted in some cash-and-carry and delivered wholesalers developing their own symbol groups so as to protect their customer base.⁵ For example, Booker has recruited almost 2,000 independent store owners to its Premier fascia, which has helped it build a base of core customers worth about £800 million in annual revenue. This has led to some blurring between the cash-and-carry and delivered wholesaling segments as cash-and-carry operators diversify into delivery services. Table 1 lists the largest wholesaling companies in the UK, along with their own symbol group facias.

³Assuming average non-multiple retail gross margins of 20 per cent and total UK retail sales of £120 billion.

⁴From 2000 to 2006, the number of independent outlets fell from 35,500 to 25,893.

⁵A symbol group is a form of franchise in the retail sector; a wholesaler usually acting as the franchisor. The franchisor does not own or operate stores, but acts as a supplier to independent grocery retailers which trade under a common banner (symbol).

TABLE 1 Major grocery wholesalers in the UK

<i>Company</i>	<i>Principle mode of operation</i>	<i>Turnover (£m)</i>	<i>Symbol group</i>	<i>Buying group</i>
Palmer & Harvey McLane	Delivered	3,533	Mace, Mace Express, Super Shop	
Booker Ltd	Cash & carry	3,228		Premier
Bestway Cash & Carry Ltd (inc Batleys)	Cash & carry	1,600	Best One	
Makro Self Service Wholesalers Ltd	Cash & carry	1,100		Nisa Today's
Costco Wholesale UK Ltd	Cash & carry	953		
A F Blakemore and Son Limited	Delivered	622	SPAR	SPAR
Londis (Holdings) Ltd	Delivered	527	Londis	Nisa Today's
James Hall And Company (Holdings) Ltd	Delivered	314	SPAR	SPAR
Dhamecha Foods Ltd	Cash & carry	271		Nisa Today's
Capper & Co Ltd	Delivered	253	SPAR	SPAR
C J Lang & Son Ltd	Delivered	237	SPAR	SPAR
Henderson Wholesale Ltd	Delivered	233	SPAR	SPAR
A G Parfett & Sons Ltd	Cash & carry	219		Landmark
Woodward Foodservice Ltd	Delivered	148		
J W Filshill Ltd	Delivered	147		Key Lekkerland
Appleby Westward Group Plc	Delivered	142	SPAR	SPAR

Source: IGD and Companies House.

7. Most wholesaling companies are affiliated to one or more of the buying groups operating within the sector. These buying groups are coalitions of one or more wholesalers set up in order to obtain from suppliers more favourable terms than each wholesaler could obtain on its own. In other words, buying groups utilize the combined scale of their members, or affiliates, to obtain lower prices from suppliers. Of these, Nisa Today's, SPAR and Landmark are the largest. In most cases buying groups do not physically handle the products as they usually go directly from suppliers to members of the buying group.⁶

8. There have been some moves towards consolidation in the wholesale industry recently including Bestway's acquisition of Batley's Limited in 2005. Recently there was a proposed merger between Nisa Today's (a buying group) and Costcutter (an operator of convenience stores).⁷ Nisa Today's has also revealed that it would join forces with Makro. Booker told us that these mergers were a sign that the sector was

⁶Usually buying group companies do not own significant warehousing assets. However, Nisa Today's told us that its principle activities involve the collection of annual retrospective discounts and advertising support from suppliers for onward distribution to members and the operation of a central distribution service for the supply of goods purchased for members.

⁷Bestway has also expressed an interest in the parties.

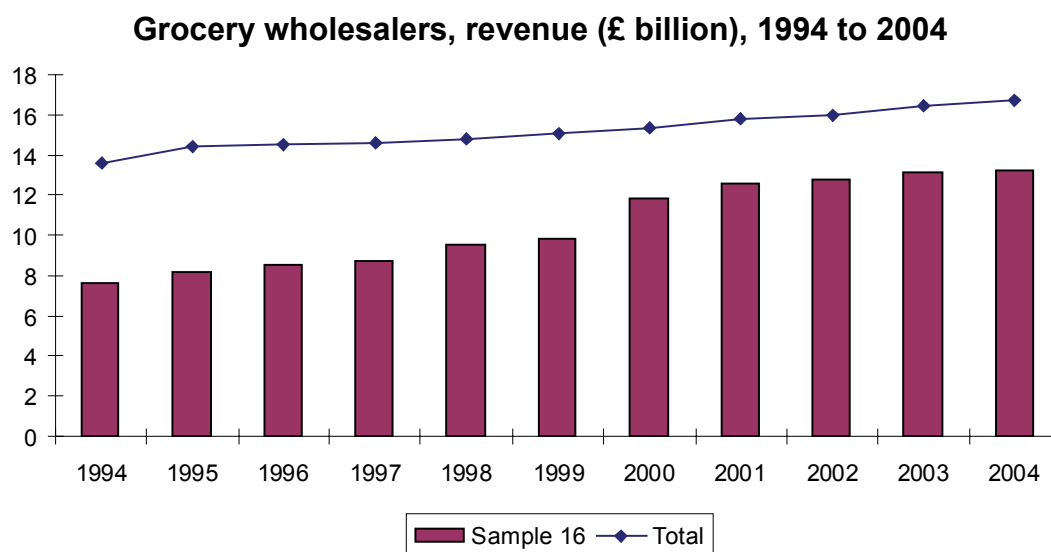
in decline and that operators were trying to maintain critical mass. Palmer & Harvey, however, told us that further consolidation within the cash-and-carry sector was both likely and desirable as it would both increase efficiency and improve the product offer of cash-and-carry operators.

Financial performance of grocery wholesalers

Industry turnover

9. Between 1994 and 2004, turnover for the 16 largest grocery wholesalers increased from £7.6 billion to £13.2 billion,⁸ against total wholesale industry turnover which increased from £13.6 billion to £16.7 billion (see Figure 1). The 16 companies accounted for 56 per cent of total turnover in 1994, but by 2004 accounted for around 79 per cent of total turnover. The narrowing of this gap suggests consolidation in the sector over the period.

FIGURE 1



Source: IGD, Companies House.

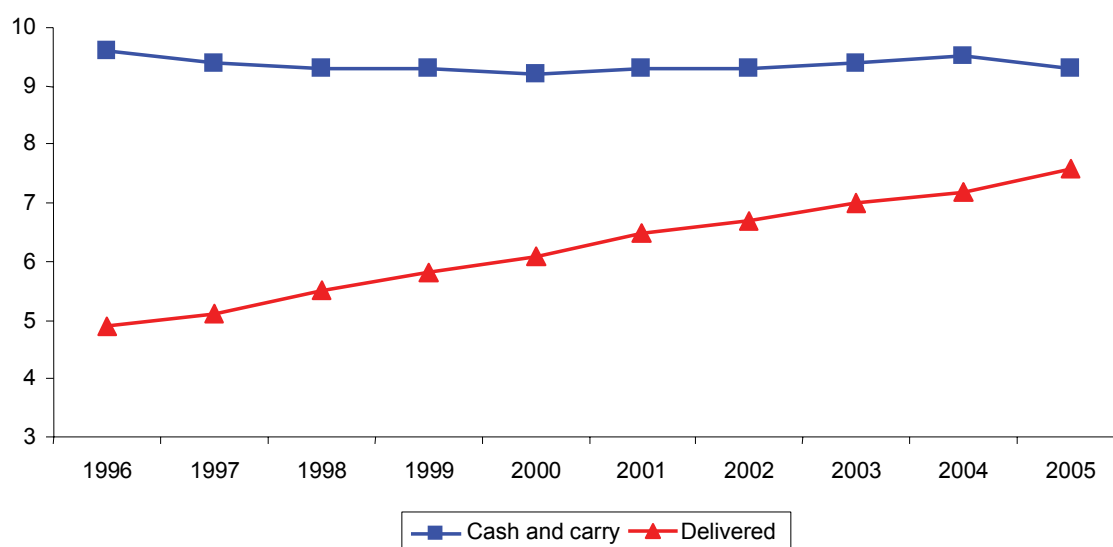
10. Figure 2 compares turnover in the cash-and-carry and delivered wholesale sectors over 1996 to 2005. This shows that turnover in the cash-and-carry sector

⁸The profitability analysis assumes that all revenue and costs fall in the calendar year which the majority of a company's financial year is attributable to. For example, a company's accounts that are compiled for the year ended 31 March 2005 will be allocated to the 2004 calendar year.

experienced a decline of 3 per cent over the period compared with growth of 55 per cent in the delivered sector. The relative lack of revenue growth in cash-and-carry wholesaling compared with delivered wholesaling has been attributed to, among other factors, the decline in the number of unaffiliated convenience stores, which are generally served by cash-and-carry wholesalers.⁹

FIGURE 2

Grocery wholesalers, revenue, cash and carry versus delivered wholesalers (£ billion), 1996 to 2005



Source: IGD.

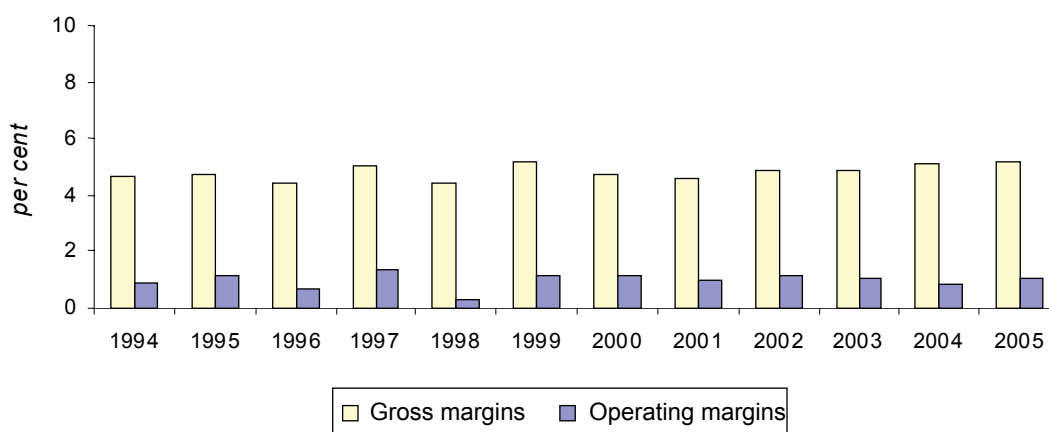
Industry profitability

11. Figure 3 shows average gross and operating margins for the 16 largest grocery wholesalers from 1994 to 2005. Collectively, these firms earned gross margins of 4 to 5 per cent in the period 1994 to 2005, and operating margins have fluctuated around the 1 per cent mark. There does not appear to be any sign of declining margins in the sector as a whole.

⁹IGD, *UK Grocery Wholesaling: A Strategic Guide*, March 2006.

FIGURE 3

16 largest grocery wholesalers, gross and operating margins, 1994 to 2005

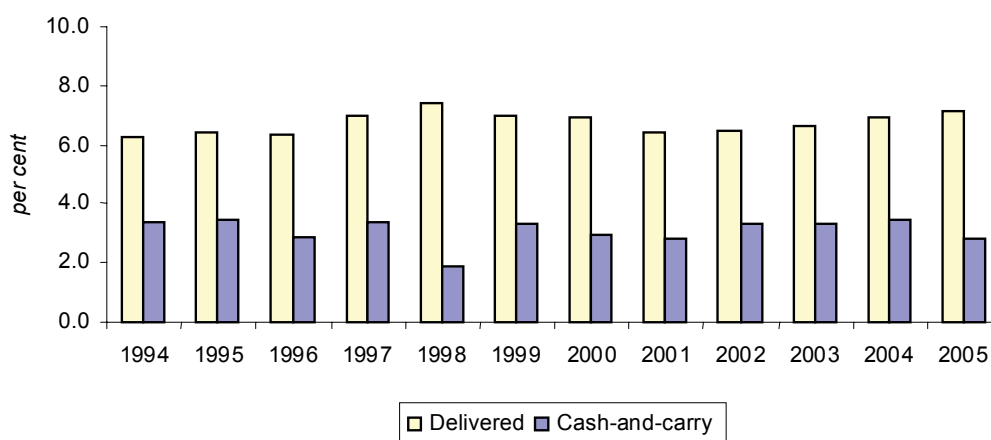


Source: Companies House data.

12. A comparison of gross margins between cash-and-carry and delivered wholesalers (see Figure 4) shows significant variance between the two sectors. The higher gross margins in delivered wholesaling are accounted for by the provision of delivery and other support services. These services are incorporated in the price charged by delivered wholesalers which results in higher gross margins. At the operating level, after operating costs are deducted, margins are more comparable between delivered and cash-and-carry wholesaling (see Figure 5).

FIGURE 4

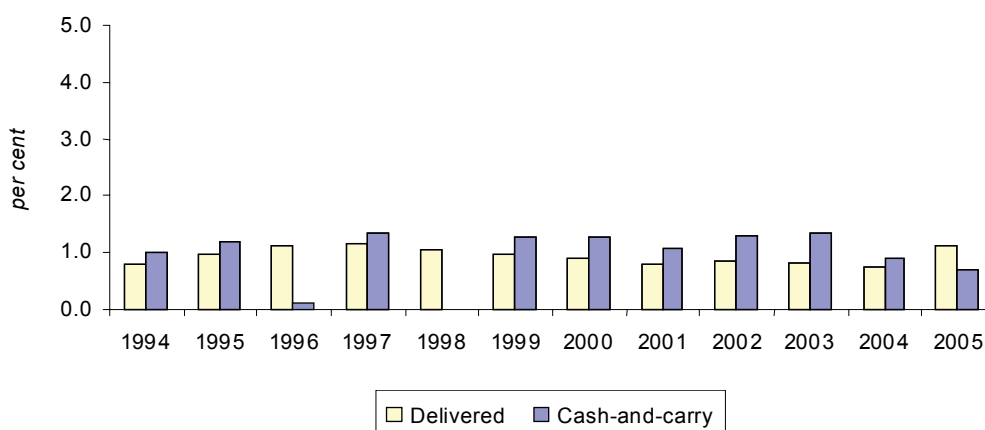
Grocery wholesalers, gross margins, cash-and-carry versus delivered wholesalers, 1994 to 2005



Source: Companies House data.

FIGURE 5

Grocery wholesalers, operating margins, cash and carry versus delivered wholesalers, 1994 to 2005

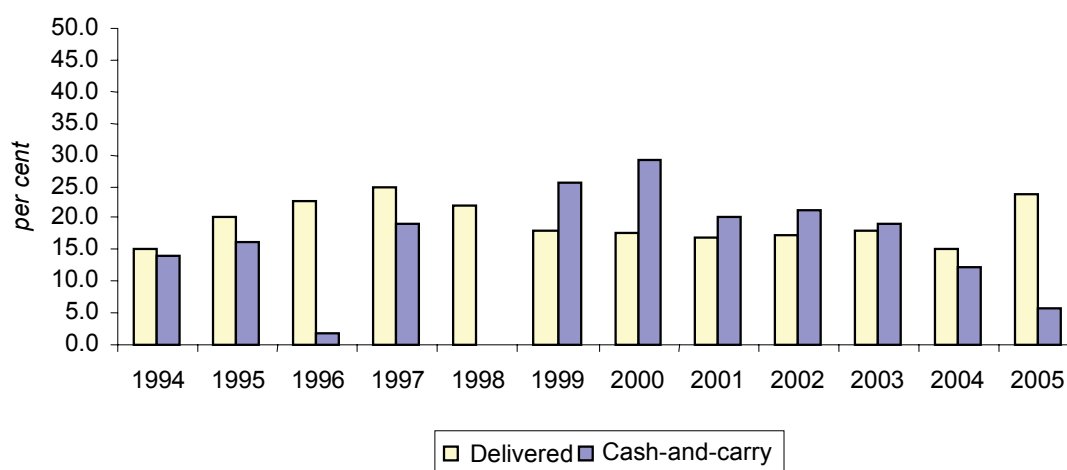


Source: Companies House data.

- The largest variances between the two sectors' operating margins were in 1996 and 1998 when two of the largest cash-and-carry wholesalers, Makro and Booker, experienced operating losses. In the case of Booker, this arose from difficulties associated with the integration of recently acquired businesses as well as the implementation of a new central distribution system.

FIGURE 6

Grocery wholesalers, return on capital employed, cash-and-carry vs delivered wholesalers, 1994 to 2005



Source: Companies House data.

14. In terms of return on capital employed (ROCE), Figure 6 shows steady returns for delivered wholesalers, with an upward spike in 2005, while cash-and-carry wholesalers have experienced declining returns since 2000. In 2004, however, cash-and-carry wholesalers still derived an average ROCE of more than 12 per cent compared with an average [X] per cent for grocery retailers in that year (see Table 4, Annex 1) indicating that returns may still have been at an acceptable level.¹⁰ In 2005, however, the ROCE for cash-and-carry wholesalers declined to 5.9 per cent, primarily due to the performance of the two largest cash-and-carry wholesalers, Booker and Makro.
15. While our analysis above has focused on the 16 largest grocery wholesalers, the industry research organization, IGD, also notes that there are a significant number of smaller, regionally focused wholesalers which continue to thrive. However, it adds that this number is in decline. It has attributed their resilience and success to low-cost environments, and a strong culture of group trading in which smaller operators combine to form buying groups in order to realize the scale and characteristics of the larger national competitors.¹¹ As a result, it does not appear that smaller wholesalers are intrinsically less profitable than the larger wholesalers discussed above.

Wholesaler vulnerability to declining trading volumes

16. We have considered the extent to which wholesalers would be vulnerable to declining trading volumes that might be associated with the loss of a large number of convenience store customers. Some wholesalers have told us that as a large proportion of their cost base is fixed, a decrease in sales volumes below a certain critical mass would make their businesses no longer viable.

¹⁰Wholesalers usually have lower operating margins compared with retailers but comparable ROCEs. This is consistent with wholesalers having a higher asset turnover.

¹¹IGD, *UK Grocery Wholesaling: A Strategic Guide*, p26, March 2006.

17. Of the largest cash-and-carry operators, Makro told us that a [x] per cent reduction in turnover would make its business unprofitable, while Bestway estimated this figure at [x] per cent (although it told us that this estimate was based on a very simplified calculation). Costco told us that, based on central costs remaining fixed, a drop in turnover of about [x] per cent would make its business unprofitable. It added, however, that the business would become unviable at a much smaller decline in turnover as shareholders would demand an adequate return on investment.
18. Palmer & Harvey provided its own break-even analysis and calculated a decline in turnover of [x] per cent based on current volumes and fixed costs. However, it argued that this estimate was highly judgemental and, in the event of such a reduction in turnover, the business would be restructured to handle lower volumes.
19. We considered the likelihood of turnover declining by 20 to 40 per cent in the foreseeable future. The IGD, contrary to the arguments put to us by a number of wholesalers, predicts modest growth for the wholesale industry. In its recent publication on the grocery wholesale industry,¹² it forecast that the grocery wholesale industry would grow to £18.4 billion by 2010 (up 9.5 per cent on 2005 levels), representing an annual growth of 1.6 per cent over the next five years.
20. The IGD expects that the delivered sector will continue to fare better than the cash-and-carry sector. Delivered wholesale, which is expected to benefit from the anticipated ongoing growth of related symbol groups, is expected to grow to £8.9 billion in turnover by 2010 (from the current level of £7.6 billion) while cash-and-carry is expected to remain stable at about £9.5 billion. In its 2005 group annual accounts, Palmer & Harvey, the largest delivered wholesaler, stated that it had a sound long-term independent future with 10 per cent turnover growth over the three

¹²IGD, *UK Grocery Wholesaling: a strategic guide*, 2006.

years to 2004, more than 2.5 times the rate of growth for the total wholesale grocery market.

21. The IGD cautioned that these forecasts are vulnerable to future acquisitions in the convenience sector by the grocery retail chains, which could potentially undermine the wholesaler's customer base. Accordingly, there is some uncertainty over the future performance of wholesaling sector. However, even if the customer base for grocery wholesalers was to reduce, either through acquisitions by grocery retail chains or by market exit, we consider it unlikely that a tipping point will be reached where the total grocery wholesale industry no longer becomes viable. A more likely scenario in the event of a contraction of the customer base would seem to be consolidation within the sector resulting in fewer grocery wholesalers but with their scale maintained. This would be consistent with the ongoing trend towards industry consolidation that has been observed since 1994 (see Figure 1).
22. The FWD argued that a decline in the wholesaling industry might happen at a regional level and that convenience stores in remote locations would be more likely to suffer from a lack of wholesaler choice. It gave the examples of Oswestry and Monmouth—remote locations that recently lost independent wholesale operators and are now serviced solely by Booker. If the tipping point scenario was to take effect, it would be felt initially by depots that were remotely located and owned by small operators.
23. In order to consider the vulnerability of small individual depots, we analysed the management accounts of one of the smaller cash-and-carry operators (Parfett's) and in particular the cost structure of each of its depots. Parfett's has five established

cash-and-carry outlets in the North of England.¹³ Contrary to the views of some wholesalers (see paragraph 16 above), we found that only a very small proportion of costs are fixed, ie not related to turnover. Fixed costs (rent, utilities and management fees) for each depot ranged from £[redacted] million to £[redacted] million a year, depending on depot size. Each depot's variable costs (stock, wages, and bad debts) account for about [redacted] per cent of turnover, leaving a margin of about [redacted] per cent of turnover to cover fixed costs. Table 2 shows the calculations of reductions in turnover required for each of the depots to become loss making. The reductions range from 15 to 45 per cent.

TABLE 2 Calculation of break-even level of turnover, 2005

	£ million				
	Aintree	Anfield	Stockport	Somercoates	Halifax
Sales					
Cost of sales					
Other variable costs					
Total variable costs					
Variable costs % of sales (%)			[redacted]		
Variable margin (%)					
Fixed costs					
Break-even sales					
Fall in sales required for break even (%)					

Source: CC calculation based on Parfett's management accounts.

24. These calculations should be viewed with some caution as they assume that all variable costs have the same linear relationship with turnover. Also, the calculations do not take into account the economic break-even point, ie the level of turnover reduction required to reduce profits below an adequate ROCE for investors, which would be lower than the percentage figures shown in the table. Parffets argued that the above calculations overestimated the fall in sales required for these depots to become unviable. However, despite these shortcomings, the figures show that the smaller depots have a smaller critical loss percentage relative to the larger depots,

¹³Two others, Sheffield and New Mills, are relatively new [redacted].

which suggests that they are more vulnerable to any reductions in their customer base.

Financial data for grocery wholesalers

TABLE 1 **Sample of top 16 wholesale firms—financial summary**

	<i>£ million</i>										
	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004
Turnover	7,581	8,212	8,544	8,763	9,579	9,822	11,869	12,577	12,758	13,144	13,249
Gross profit	352	392	382	443	427	508	566	574	621	647	676
Operating profit	71	91	59	117	28	112	132	121	140	136	111
Fixed assets	511	558	582	913	914	1,093	1,121	1,106	1,155	1,163	1,075
Capital employed	470	503	530	534	553	548	604	675	760	809	832
Gross margin (%)	4.6	4.8	4.5	5.1	4.5	5.2	4.8	4.6	4.9	4.9	5.1
Operating margin (%)	0.9	1.1	0.7	1.3	0.3	1.1	1.1	1.0	1.1	1.0	0.8
ROCE (%)	15.1	18.1	11.1	21.8	5.1	20.4	21.9	17.8	18.4	16.8	13.3
Fixed assets as % of turnover	0.1	0.1	0.1	0.1	0.1	0.1	0.1	0.1	0.1	0.1	0.1

Source: Companies House.

TABLE 2 **Cash and carry vs delivered turnover**

<i>Turnover</i>	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005
Cash and carry	9.6	9.4	9.3	9.3	9.2	9.3	9.3	9.4	9.5	9.2
Delivered	<u>4.9</u>	<u>5.1</u>	<u>5.5</u>	<u>5.8</u>	<u>6.1</u>	<u>6.5</u>	<u>6.7</u>	<u>7.0</u>	<u>7.2</u>	<u>7.6</u>
Total market	14.5	14.5	14.8	15.1	15.3	15.8	16.0	16.4	16.7	16.8

Source: IGD.

TABLE 3 **Cash and carry vs delivered—financial summary**

	<i>£ million</i>										
	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004
<i>Cash and carry</i>											
Turnover	4,218.7	4,471.7	4,668.6	4,780.1	5,348.8	4,990.5	6,691.0	6,955.6	7,029.0	7,276.9	7,226.2
Operating margins	1.1	1.2	0.3	1.5	-0.3	1.3	1.3	1.1	1.3	1.2	0.9
Gross margins	3.3	3.4	2.9	3.5	2.1	3.4	3.1	3.1	3.6	3.5	3.6
ROCE	15.0	17.0	4.5	20.2	-4.6	22.7	25.4	18.5	19.2	16.1	12.4
<i>Delivered</i>											
Turnover	3,361.9	3,740.6	3,875.4	3,983.2	4,229.7	4,831.0	5,177.8	5,621.7	5,728.7	5,867.3	6,022.3
Operating margins	0.8	1.0	1.1	1.2	1.0	1.0	0.9	0.8	0.9	0.8	0.7
Gross margins	6.3	6.4	6.4	6.9	7.4	7.0	6.9	6.4	6.5	6.6	6.9
ROCE	15.2	20.2	22.5	24.9	21.9	17.9	17.5	16.8	17.1	18.1	15.0

Source: Companies House.

TABLE 4 **Average ROCE* for major grocery retailers, 2000 to 2005**

	<i>per cent</i>					
	2000	2001	2002	2003	2004	2005
Tesco†	(
Sainsbury's‡						
Asda§				✂		
Morrisons						
Waitrose						
Somerfield						
Weighted average	12.8	12.5	12.5	11.7	7.2	7.1

Source: Companies House data.

*Total assets less current liabilities used as a proxy for capital employed

†Tesco Stores Ltd.

‡J Sainsbury's plc.

§Asda Stores Ltd.