COMPETING MANUFACTURERS AND RETAILERS IN FOOD RETAILING: THE EFFECT CONTRACTUAL DESIGN ON SUPPLY CHAIN PERFORMANCE

Volker Trauzettel
Pforzheim University, Germany
E-mail: volker.trauzettel@hs-pforzheim.de

Abstract

The distribution of fast moving consumer goods (FMCG) via manufacturer-retailer supply chains is analysed. Packaged goods in grocery channels are supplied by manufacturers to retailers selling them on to consumers. The products are standardized and branded so that each manufacturer is in competition with other manufacturers as the products within a category are to some extent perceived exchangeable by consumers. Similarly, the retailers' offerings are composed widely of the same items and brands. This competitive scenario is shaping the contractual relation between each supplier and retailer. In many instances, fierce bargaining is often the reality in the manufacturer-retailer relationship. This paper reviews the setting of the distribution of groceries in European markets. We provide empirical evidence on bargaining processes and the contractual conditions. Furthermore, the effect on supply chain performance is shown by various examples.

Key words: manufacturer-retailer competition, bargaining, contracting, supply chain performance

1. INTRODUCTION

Retailers supply consumers with products. Especially, the supply of daily products to satisfy daily needs like foods, beverages and personal care items is a large industry. In most markets this part of retail business forms the largest portion of national retail market, i.e. in Germany about 41%. Due to large frequency of need the inventory turnover rate is large and these products are called fast moving consumer goods (FMCG).

Food retailers developed into large chains operating hundreds or even thousands of outlets. This happened very often by organic growth as well as mergers, e.g. an unprofitable retailer is overtaken by its profitable competitor. Also the German market has shown large mergers in recent years (e.g. Edeka bought large part of the Tengelmann and Plus chain). Retailers also standardized their processes and multiplied store formats into locations. Many of the chains have a uniform appearance by design of outlets, assortments offered and services supplied to consumers.

Due to growth of retailers the market concentrated to a large extent. For example, the top four retailers in Germany reach a market share of about 67% (Edeka 25.3%, Rewe 15.1, Schwarz 15.0, Aldi 12%). Other European markets show similar concentration.

In order to realize economies of scale logistics processes are standardized. Also, buying is centralized, i.e. the buying headquarter contracts with any supplier on the terms of supply.

But also the products sold by food retailers are standardized, i.e. the food industry supplies standardized items as they are aimed to serve a mass market. Each item is produced unchanged in thousands or millions of units each year and sold to manufacturer's clients, e.g. retailers. This is especially true for processed food items that are supplied in standardized packaging (consumer packaged goods/CPG).

A typical CPG item is supplied to a number of retailers. Hence, many retailers compete by offering same items. A consumer changing store may still have the chance to buy his favourite products at some other retailer. Consequently, price of item will become important for consumers' choice of store.

For the retailers this setting means that pricing of items and product lines is an important part of marketing mix. The consumer price of item – the price a retailer sells an item to consumers – determines the number of units sold. Consumer price minus the buying price – the price the manufacturer receives – forms the unit's contribution margin. So, the attractiveness of each item to the consumer and its buying price are drivers of retailer's profitability (Buzzel & Quelch 1990).

Obviously, food retailers compete on price for store patronage. Therefore, it is not surprising that retailers focus on lowering buying prices in order to sell at low prices (low shelf price of item and/or low promotional prices) and still aiming to realize a high unit margin.

Besides optimizing sales and services to improve consumer response they try to reduce costs. Cost can be reduced by streamlining processes of retail activities and reducing the cost of merchandise. Actually, the largest portion of cost of a retailer is caused by the buying price of items traded. For example, in food retailing the buying cost average 60 to 70 percent of turnover; food discounters cost reach about 80 percent of turnover. Hence, retailer's profit is leveraged by the buying prices. Retail buying is aware of its critical role and tries to reduce total cost of acquiring merchandise, i.e. buying prices, steadily. Furthermore, not only buying prices (retailer's perspective) or wholesale prices (charged by the manufacturer) and rebates thereon are of interest but also other payments, i.e. so-called side payments that the supplier pays for example in exchange for promotional efforts the retailer spends on supplier's product. Also, other terms and conditions of payment like the credit period the retailer tries to prolong in order to reach competitive advantages in buying. Hence, the supply and marketing of manufacturer's goods via the retailer is accompanied by a number of agreements. These conditions have impact on sales performance and profits of the supplier and the retailer. The buying price and its terms are in the center of this paper.

2. THE MANUFACTURER-RETAILER RELATIONSHIP

2.1. Supply Chain Dependency and Conflict of Interest

There is a close relationship between manufacturer and retailer as they are two consecutive members of a value chain. Retailers form the market for manufacturers, whereas consumers form the market of retailers. Any retailer sells the products sourced from suppliers to consumers. Each retailer offers to the consumer a variety of manufacturers' products to select from. Hence, retailers have difficulties to differentiate their offering from competitors. Considering a single product, a retailer can be viewed as interchangeable to any another retailer as long as both offer this item. However, the retailers' offerings differ by services (attractiveness of assortment, helpfulness of salespeople, ease of shopping, etc.). But still a large portion of the value delivered to the consumer results from the product. Also, the product causes a large portion of the cost of the retailer. Therefore, the retailer tries to reduce buying cost of products as much as possible. The bargaining on prices and terms of product supply between retailer and manufacturer became a very prominent part of their relation. Obviously, the manufacturer and retailer depend on each other. However, they are still two different firms that strive to generate profits. Though within the same supply chain there are conflicts of interest. The pricing of products delivered is at the core of this conflict.

2.2. Types of Buying Agreements and Pricing

There is a variety of pricing methods used in retailing of consumer goods (See Bendl, 2000, pp. 69-76; Kunter, 2009). We define a standard price of item as the price the manufacturer charges to the retailer for a unit of product supplied (See Kunter & Guhl, 2010, p. 744). Starting from this standard price a variety of discounts that reduces standard price is applied in practice. It is very common that the set of agreed discounts is applied to all the products the supplier delivers to the retailer. Besides working with a discounted standard price sometimes retailers agree directly on a price of item. In this case the retailer and the manufacturer bargain on each item's price the manufacturer supplies. Generally, the discounts or prices agreed are kept fixed for one year until they are reviewed and subject to a new round of bargaining.

The pricing of items is variable, i.e. it is only applied on delivered and invoiced units. The discounts reducing standard price of item can be viewed as payment of the manufacturer to the retailer. Hence, this part of pricing is variable as it depends on volume.

There are other parts of the tariffs bargained between manufacturer and retailer that are independent of volume delivered. For example, it is very common that the retailer promotes sales of individual products by advertising. Then, the retailer asks for a payment regarding this promotion. This payment can be interpreted as a reimbursement of cost incurred to the retailer, though the costs of advertising incurred by the retailer are not transparent to the manufacturer. Other payments are related to introducing of a new item into the assortment, known as slotting allowances. Or, payments the retailer asks for when opening a new store.

Due to the intermediate position of the retailer between manufacturer and consumer the manufacturer depends on the retailer. This is true in case of concentration in the retail market, i.e. there is less opportunity for manufacturer to reach a consumer if not by this specific retailer. It is reported by industry press that manufacturers complain about increased power of retailers as retailers have grown and retail markets became more concentrated. As a consequence, discounts and allowances are said to be inflated and not related any more to cost or activities of the retailers. Hence, allowances and discounts are profit generating devices that serve to transfer profits from the supplier to the retailer.(See Gomez et al., 2007; Spork, 2006, Miklos-Thal et al., 2010)

3. EMPIRICAL INVESTIGATION OF CONTRACTS

3.1. Description of the Sample

This paper analyses a single retailer. The retailer is a large food retailer in Germany. Its market share is above 15 percent and it operates numerous stores. The stores' formats belong to supermarkets (small to large), hypermarkets and discounters. The formats operate under different brands. Main decisions regarding sales, like assortment and promotions, are taken by national headquarters.

We look at the contracts of this retailer with its suppliers. The sample consists of all the suppliers of a single category, the category of cheese. It contains all suppliers of cheese that reach a minimum yearly turnover of about one hundred thousand EUR. We counted 231 suppliers. We report about the contractual terms before year 2012 for privacy reasons. However, regarding the general setting of the contracts there are no structural changes to today, though there are differences in the size of payments and discounts agreed with suppliers.

As the suppliers considered supply within same category the contractual terms can be compared as the products supplied are competing and close substitutes. So the results are not skewed by cross-sectional effects, e.g. the market of beverages is different from the detergents' market or the market of chees. So, conclusions from the size and type of discounts cannot be drawn in such a case. Also it is a sample of one retailer. Interviews with industry managers and with retail managers revealed also that retailers have different strategies where to put emphasis on. For example, a large competing retailer puts more effort on agreeing net prices combined with less high or no discounts.

3.2. Contractual Structure Observed

The suppliers supply items within the category and some of the suppliers also within other categories. If the supplier covers multiple categories contracting covers the whole supply. The retailer usually starts contracting with a supplier if this supplier reaches a certain turnover and supplies over a longer period. For example, one-shot supply agreements of a new supplier are not subject to extensive negotiations.

Analysing the contracts of the retailer with its suppliers we find a homogeneous structure. The contracts have a similar style and contain similar elements though the agreed size of rebates and payments are not identical throughout suppliers. Hence, regarding the supplier-retailer-relationship we conclude that it is the retailer who has the power in this relationship as the retailer succeeds to contract on certain elements with the suppliers in the same manner. This is contrasting the industrial organisation literature that models Stackelberg games with the manufacturer as leader and the retailer as follower to describe the bargaining relationship. (See for reviews on the literature: Lafontaine & Slade, 1997; Kasulis et al., 1999; Corbet & Tang, 1999; Rey, 2003; Rey, 2012, Rey & Vergé, 2008, Rey & Vergé, 2016)

There are some exceptions to the homogenous appearance of contracts: If the supplier by itself offers certain terms, like rebates on volume, length of payment period or discount for paying within payment period then these offerings are likely to be taken over to the contract. It was expressed by management that these exceptional terms are likely to lead to more favourable discounts for the supplier regarding other terms.

The structure of the retailer's contracts contains the following basic elements:

- General deduction
- Due date for payment/ credit period and prompt payment discount
- Logistical discounts
- Sales-related discounts
- Service-related discounts
- Other discounts (ECR)
- Sales promotion agreements

Hence, each element reduces the payments of the retailer to the supplier. Most parts of these payments are in form of discounts on standard price (list price). Only the promotional agreements are fixed amounts (Euro values).

The largest portion of the discounts is individually agreed between supplier and retailer. The total volume of discounts reaches up to 43 percent of standard price. However, in few instances they are low at about 5 percent. Fixed payments cannot be assessed in their size as total sales were not available for this study. However, according to buyers, the total value of discounts is by far larger than the total value of fixed payments.

We observed that fixed payments are larger for large national suppliers with highly known brands. It appears that they support their brand as retailer's promotion serve to brand building purposes.

The main difference in discounts and payments results from the type of item. Private label items show low discounts. If a manufacturer supplies its national brand as well as private labels, sales of national brand products and retailer's brand item are separated and the conditions turn are set to be different. Though the conditions are different on paper they were bargained within one round together. Discounts on private label items are below 9.5 percent whereas regular discounts range above 20 percent.

Some of the conditions are the almost the same for each supplier. For example, there is a contracted discount for any supplier also having business with the retailer in foreign markets. It ranges from 1 to 2 percent whereas the total discount varies from supplier to supplier, i.e. from 0.8 to 36 percent.

The general retail discount is said to cover the service of del credere and debt collection. It varies strongly within range of 7.2 percent between suppliers.

Logistical discounts serve to compensate for the service that a supplier does not have to deliver directly to stores. They are about 5 percent.

Sales and service related discount serve to refund the retailer to provide in-store inventory and replenishment of shelves. Furthermore, they shall guarantee sales promoting activites.

An interesting part of the sales discount is a discount for guaranteeing a certain number of items in assortment (“core items”) of all stores. However, only 8 percent of suppliers signed such an agreement. This discount on sales is increasing with increasing number of items specified.

3.3. Conclusions on the Power of Retailer

Regarding the category observed we concluded that the retailer exerts power to modify resulting buying prices. The contractual terms appear very homogenous in structure. There almost no individual, supplier-specific elements. Though, the conditions vary strongly in size. One reason is the type of item (private label vs. national brand). Private labels show lower discounts. The second reason is that the retailer takes as starting point the price list handed in by the supplier. Hence, somehow inflated list prices of a supplier are compensated by higher discounts. For instance, the buyer knows of buying prices of competing items within category and bargain to reach similar prices via discounts.

Though the data is not tracked we noticed from interviews that the process of bargaining that starts October each year turns out to be longer with a number of rounds if the suppliers is large. This means that large suppliers have more power to withstand commands of higher discounts. Large suppliers with strong brands (Top ten brands) are able realize lower discounts. We estimate that they have on average 12.7 percent lower discounts.

According to management the general conclusions of the structure of contracts are similar throughout all categories of the retailer. The size of discounts and promotional payments though differs.

4. CONCLUSION

There is little research published on real-life contracts between suppliers and retailers (Bendl, 2000, p.14). Though we do not give individual data on suppliers we could analyse a large sample of contracts of a national retailer within its suppliers of a single category. We showed that within the consumer goods market (CPD) the hypothesis of power on the side of the suppliers is to be questioned. The academic research needs to focus analysing retail power and its consequences. For example, how suppliers can act to reach favourable agreements with powerful retailers.

5. REFERENCES

Biscourp, P., Boutin, X. & Vergé, T. (2013). *The effects of retail regulations on prices: evidence from the loi galland*, The Economic Journal, 123(573), p. 1279-1312.

Bendl, Harald (2000). *Planung, Steuerung und Kontrolle leistungsbezogener Konditionen: eine empirische Analyse zwischen Industrie und Lebensmittelhandel*. Dissertation, Universität Stuttgart.

Buzzell, Robert D. & John A. Quelch (1990). *The costly bargain of trade promotion*, Harvard Business Review 68(2), p. 141-149.

Corbett, Charles J., & Christopher S. Tang (1999). *Designing supply contracts: Contract type and information asymmetry*, In: Quantitative models for supply chain management, Tayur, S., Ganeshan, R., Magazine, M. (ed.), Springer, p. 269-297.

Gómez, Miguel I., Vithala R. Rao & Edward W. McLaughlin (2007). *Empirical analysis of budget and allocation of trade promotions in the US supermarket industry*, Journal of Marketing Research 44(3), p. 410-424.

Lafontaine, F., & Slade, M. E. (1997). Retail contracting: Theory and practice, The Journal of Industrial Economics, 45(1), p. 1-25.

Kasulis, J. J., Morgan, F. W., Griffith, D. E. & Kenderdine, J. M. (1999). *Managing trade promotions in the context of market power*, Journal of the Academy of Marketing Science, 27(3), p. 320-332.

Kunter, M. (2009). Konditionen und Konditionensysteme. Absatzkanalkoordination durch Hersteller-Handels-Konditionen: Eine spiel-und verhandlungstheoretische Untersuchung, Gabler.

Kunter, M. & Guhl, D. (2010). *Die Vorteilhaftigkeit handelsgerichteter Konditionen eines Herstellers-Ein spieltheoretischer Untersuchungsansatz*, Schmalenbachs Zeitschrift für betriebswirtschaftliche Forschung, 62(7), p. 744-769.

Miklós-Thal, J., Rey, P. & Vergé, T. (2010). *Vertical relations*, International Journal of Industrial Organization, 28(4), p. 345-349.

Rey, P. (2003). *The Economics of Vertical Restraints*, Economics for an imperfect world: essays in honor of Joseph E. Stiglitz, Stiglitz, J. (ed.), MITPress p. 247-267.

Rey, P. (2012). Vertical restraints–an economic perspective. Revised draft report, Toulouse School of Economics.

Rey, P., & Vergé, T. (2008). *Economics of Vertical Restraints*. In: Handbook of Antitrust Economics, Buccirossi, P. (ed.), MIT Press, p. 353–390.

Rey, P. & Vergé, T. (2016). *Secret contracting in multilateral relations*. Toulouse School of Economics Working Paper.

Spork, Sven (2006). *Konditionen in Hersteller-Händler-Beziehungen: Instrumente zur Koordination des Absatzkanals*, W. Kohlhammer Verlag.