



Food & Beverage Manufacturing

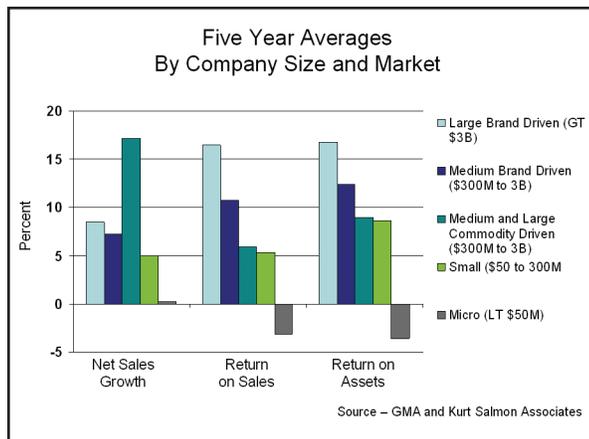
Key Challenges Facing Food and Beverage Manufacturers and What They Must Do To Survive

Olin Thompson

Food manufacturers have a lot on their plates these days: fickle consumers, powerful retailers, increasingly stringent food safety rules, and much more. The food manufacturing industry is the largest industry in the world. Across the EU, food and beverage expenditures average 12.9% of household consumption.¹ And in the U.S., the industry produces one dollar in every six of the U.S. industrial output, generating more than \$700 billion a year in revenue. However, margins are slim and the competition is furious. There are hundreds of product categories, and to compete, firms must constantly innovate. Even industry giants cannot afford to sit back. Given this backdrop, how can the small-to-medium food manufacturer cope in the face of the same external pressures and fewer resources?

Food Manufacturers—The Big Get Bigger and Everyone Else Struggles

The five-year financial analysis of the small-to-medium enterprises in food manufacturing versus larger companies reveals a dim picture. In terms of net sales growth, return on sales and return on assets, the small-to-medium enterprise trails the larger manufacturers. While the small companies (defined as \$50 million to \$300 million USD in the study) are at least close, the micro companies (defined as less than \$50 million USD) lag far behind.



All food companies face the same market pressures, but larger companies often enjoy some advantages. For example, they have more power with major retailers and food service distributors and operators. Their broad product lines, greater geographic coverage, and typically stronger brands result in customers finding it easier and more effective to deal with them than with their mid-size counterparts.

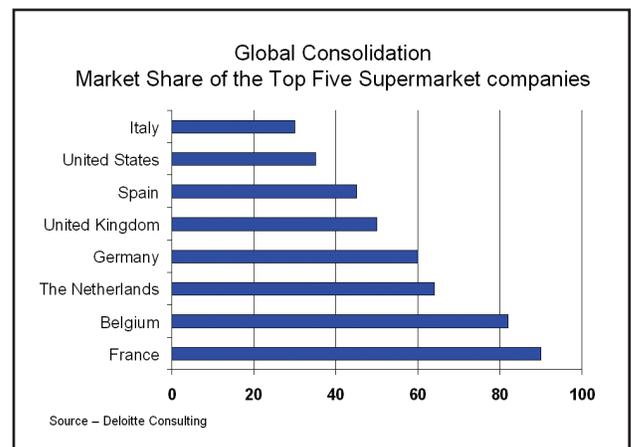
With the large retailers and food service companies demanding specific business process and technology investments, the larger company has the advantage of being able to write off these investments over a larger volume.

With the big guys having many advantages, how does the mid-size food and beverage manufacturer compete? To answer this question, we will examine the major pressures on food manufacturers today, analyze what these pressures mean to the small-to-medium company, and describe the systems that can help meet these challenges.

Retailer Consolidation

Retailer consolidation is an unpleasant fact in most markets. With 90% of the retail market controlled by the top five supermarket companies, France recently passed a law limiting their profits. What we see in most European Union countries is a global trend that affects not just groceries but all retail categories.

One mid-size food processor recently commented that the percentage of business it derives from its four largest accounts continues to rise each year. One of its executives summed up this trend by saying, “The small customers are getting both fewer and smaller while the large are getting fewer and bigger.” The company has organized its business around the four major accounts plus “other accounts” reflecting the concentration of its business.



¹ Eurostat Yearbook, 2005

RETAILER DEMANDS

Consolidation means fewer decision makers with more power. Each controls a greater volume and market coverage. More importantly, a “no-thank-you” from one of the major retailers eliminates the manufacturer from a large segment of the business, with decreasing options to make up the lost opportunity and volume.

The term “channel master” describes the developing role of the major retailers and food service companies. When asked to define the term “channel master,” a VP of marketing at a food manufacturer explained, “When they demand something, the manufacturer just has to say ‘thank you.’” These channel masters control access to the market. The channel master has the power to determine prices, promotions, placement, etc. They also determine the business methods and technologies necessary to do business with them.

TECHNOLOGY HURDLES

In the business press, we frequently see articles about radio-frequency identification (RFID). Major retailers are increasingly setting technical and business process requirements and deadlines for their suppliers. No one doubts that RFID will be an absolute requirement in the future; in fact, the issue is not if, but when. However, RFID is just one element of a continuing process on the part of retailers to drive costs out of the supply chain. Other elements have included electronic document interchange (EDI) and, more recently, data synchronization. These technology-driven requirements represent an ever-higher technology hurdle that manufacturers must clear to participate in the retailer’s sales success.

For many, these technology demands benefit both the retailer and the manufacturer. For example, AMR Research has reported that data synchronization reduces invoice and purchase order errors by more than 40% while decreasing the time to introduce new items by as much as three weeks.

Wal-Mart’s drive toward “everyday low prices” is not new but has clearly helped the retailer become the largest retailer in the world. Wal-Mart continues this quest by leveraging both its size and technology to drive costs out of its supply chain. If a manufacturer wants to do business with Wal-Mart, it has to provide more than just product. It must also meet Wal-Mart’s technology requirements.

Wal-Mart is not an isolated example; it’s just the one we hear about most often. Technology mandates also exist from Marks & Spencer, Tesco, Albertsons, and other major names. Often, a mandate is for the same technology but with individual twists. Meeting Wal-Mart’s RFID requirements is not the same as meeting those of Tesco or Marks & Spencer. The manufacturer needs both the ability to meet the technology requirement and to tailor its response to the demands of the individual retailer.

A mid-sized food company recently had an introductory meeting with buyers from a major retailer. A key part of the meeting consisted of the retailer probing into the food company’s ability to meet the retailer’s technical needs. It was clear that if the food company could not jump over the retailer’s technology hurdle, no second meeting was necessary.

TIGHTER SHIPPING SCHEDULES

Retailers continue to push business practices that cut costs and increase product availability. With those objectives in mind, they insist on tighter shipping schedules. This yields less inventory across the supply chain, which reduces cost and also results in less stock handled, which reduces labor and damage.

Product availability or the elimination of out-of-stocks has a major financial impact on both retailer and manufacturer. Keith Harrison, Global Product Supply Officer for Procter and Gamble comments on the impact of retail out-of-stocks, “Retailers on average lose the sale 41% of the time; P&G loses 29% of the time.”

PRIVATE LABEL

A study by the Gallup Organization found that 75% of consumers believe that store brands have the same quality, guarantee of satisfaction, packaging, taste, value, and performance as national brands. More than 90% of all consumers are familiar with store brands, while 85% say that they purchase them frequently.² Larger retailers have embraced store brands to increase their margins. For example, 50%³ of all grocery sales at Wal-Mart are store brands. In fact, Wal-Mart’s Old Roy dog food is the nation’s top-selling dog food. At Kroger, store brands represent 24% of sales, while Safeway reports that 23% of its sales are store brands.

² The Private Label Manufacturers Association

³ IRI

The drive to private labels has many impacts on the industry. Key among them is the market for branded products. With 50% of Wal-Mart's grocery sales coming from private label products, even those manufacturers that sell branded products through Wal-Mart cannot participate in 50% of Wal-Mart's volume. With both large and other retailers growing their private label business, the competition for the remaining branded business becomes even more heated.

However, for some manufacturers, providing private-label products represents a major opportunity. The competition to supply these private-label products is primarily driven by price and customer service.

PROMOTIONS

No one doubts that promotions are a driving force in the industry. For example, approximately 60% of all chocolate candy is sold on promotion. Even for such stable items as rice and peanut butter, approximately 30% of volume is sold on promotion. For seasonal items, such as stuffing mixes, 80% fourth calendar quarter sales are sold on promotion.

Promotional spending now consumes 54% of food company marketing budgets and represents an average of 17.3% of gross sales.⁴ According to Cannondale, trade spending has jumped 33% in the past five years. Bob Hilarides, a consultant for Cannondale, who likens promotional spending to drug addiction, is not surprised. Manufacturing companies "report earnings quarterly and need to support sales volume. They are not sure shareholder patience will be there. However, by increasing trade spending, they only raise the bar for next year. It becomes a never-ending cycle," he says.

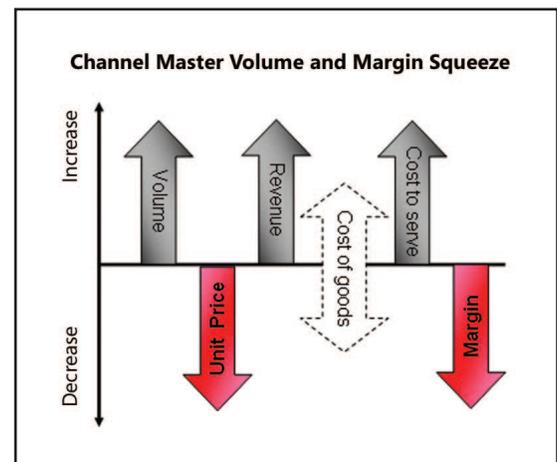
Nevertheless, industry surveys⁵ show that nearly two-thirds of companies believe that the value received for promotion spending is only "fair" to "poor." And 85% of respondents feel that inefficient promotions are a "very important" issue.

THE MARGIN SQUEEZE

What does doing business with a channel master mean to the manufacturer's bottom line? For the most part, it means increased complexity and cost of customer service. Let us look at the impact of channel master volume on margins.

What can a manufacturer do about the decrease in margin per unit? Sure, the manufacturer can accept it as a cost of doing business. But the continued pressure from the channel master for lower prices and greater service means that margins will eventually go negative. The manufacturer can also attempt to address the margin erosion; however, this effort is hampered because the manufacturer does not control many of the determinants of the profit margin. In addition, the manufacturer can attempt to increase volume by using promotions, but only within limits and then only by sacrificing margins. The channel master makes the final volume decision and mostly controls the unit price, with the manufacturer having limited power to increase or maintain prices.

As we can see, the only real variable the manufacturer does control is the cost side of the equation. As a result, maintaining margins is the result of lowering cost.



WHAT CAN THE MID-SIZE FOOD MANUFACTURER DO ABOUT RETAILER DEMANDS?

The consolidation of the retail market means more competition for the channel master's business and fewer places to make up any lost volume. It also means pressure on margins.

Large and mid-size manufacturers with very strong brands can typically push their way in to gain a share of the channel master's business. Mid-size manufacturers with weaker brands have a larger challenge in gaining the channel master's business. Mid-sized manufacturers with weak brands and no brands must rely on smaller retailers and private label.

⁴ Cannondale Associates

⁵ AC Nielsen Trade Promotion Practices Survey

In all cases, the mid-size food and beverage manufacturer must compete on many fronts. A major competitive tool is internal operations based upon strong systems. Reducing costs and improving customer service demands operational excellence. And in today's world, that means having in place systems that increase abilities, not hamper them.

A recent analysis of two food-manufacturing companies found similar situations. Both companies had installed Enterprise Resource Planning (ERP) systems in the early 1990s. Both systems had been excellent choices at the time. However, comparing the impact of these systems on the business was revealing. In both cases, it was necessary to augment the systems with extra efforts by people and side systems. In both cases, the systems had a negative impact on the companies' ability to compete. Even with extraordinary efforts from the staff, gaping holes existed between what customers expected and what could be delivered.

These two systems lacked business process support for many functions. The systems had been designed in the 1980s to meet the needs of 1980s-era food manufacturers; but those needs have evolved, and the systems could not easily handle the new requirements. The base technology supporting these systems has also evolved, making them difficult to use and lacking flexibility relative to newer systems.

When a channel master made demands on these food manufacturers, the manufacturers, of course, said, "thank you." However, meeting these demands with their current systems usually took a significant amount of time and investment or the addition of costly manual steps. These older systems did not provide the foundation required to address the channel master's demands in an effective way.

Common application weak points were customer service and supply chain. In both cases, side systems and manual efforts were required. Even seemingly simple tasks took too long to complete. For example, one of the companies had fast turnaround needs, but its planning system could not produce the purchasing requirements fast enough to fit within the expected lead time. Therefore, Purchasing was forced to order certain items without even knowing the final requirements.

Both companies had decent service levels, but were forced to maintain those service levels with excess inventory. The business process of forecasting to planning to scheduling to production was sub-par, relying on multiple systems with multiple databases and with many manual steps.

In both cases, costing used a standard cost approach with monthly variance analysis. Costing did not provide timely, adequate detail to allow operations to attack costing elements and drive down the company's costs.

Consumer Demands

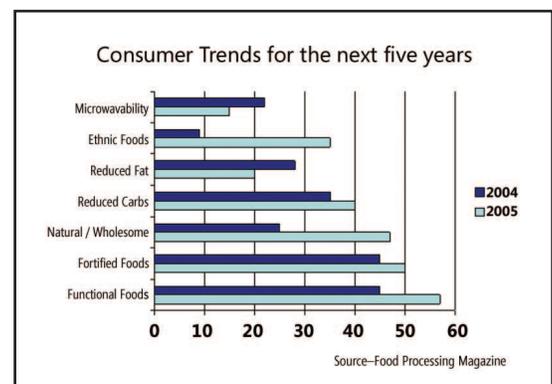
As everyone in the food industry knows, consumers will change their behavior—new preferences and fads dominate many buying decisions. For example, refrigerated meats and poultry products grew their revenue by 21.8% (2003 vs. 2004) while the big losers for the same period were frozen juices (-15.4%), seafood (-6.9%), and dry packaged dinners (-6.9%).⁶

Looking at the consumer demands for the next five years shows us that the rate of change will not slow down and may even quicken.

RISK OF FAILURE IS HIGH

Shifting consumer demands dictate that food manufacturers quickly develop products to meet these demands. Retailers and consumers will not wait, opting instead to switch to products and manufacturers that do meet their needs.

The fact that consumers and retailers will not wait means that time to market is a key to success. Reducing time to market requires that the trend be identified quickly and, perhaps more importantly, the reaction time between the decision to develop a new product and



⁶ Food Institute and IRI

the time at which it hits the shelf be as short as possible. Anyone involved in the food industry knows well that most new products fail. Of all the new products proposed, only 2% make their way to the marketplace. And of these, 50% do not succeed. The risk is high.

WHAT CAN THE MID-SIZE FOOD MANUFACTURER DO TO MEET CONSUMER DEMANDS?

To meet the demands of consumers and retailers for new products, the mid-size food manufacturer must invest in new product development. Consumer and retailer demand will not stay constant, and today's product line will not meet the demands of tomorrow's market. While investments in new product development are required, the mid-sized manufacturer must work harder to leverage these investments into the right product and getting to market at the right time. Today, that means having systems in place that allow both development and commercialization of new products.

Will a new product be good for both the market and the manufacturer? One key to that question is setting the right price—one that the consumer sees as good value and the manufacturer sees as having the right margin. Deciding on a price that provides an acceptable margin should be easy, but too many mid-sized food manufacturers lack the cost information to make informed decisions. Quality costing information means the right pricing decision for new products and the ability to maintain margins on existing products.

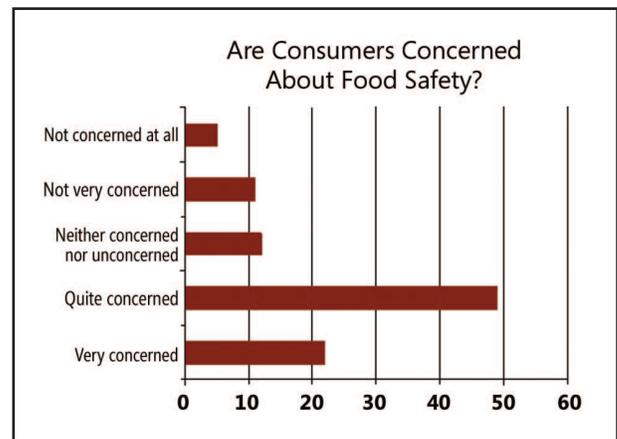
ERP systems play a major role in new product introduction. A mid-sized manufacturer reports that the time between producing an acceptable test batch and reaching full production was 30 to 45 days. The delay resulted from the difficulties involved with gathering all the necessary information, securing appropriate in-house approvals, and establishing the required database (bills of materials, routing, quality, etc.) The combination of workflow systems common to most ERP systems and the improved ease of use of current systems can cut that delay and reduce the overall time to market.

Food Safety and Regulations

Food Processing Magazine's 2005⁷ survey of industry professionals ranked food safety as the number one plant-level concern. Eighty-five percent of food processors reported that they are taking additional steps this year to ensure food safety.

In addition to the public cost, the impact of food safety lapses can be devastating. While many food industry executives think of regulatory penalties as a risk, the major risks are potential shutdowns or, worse yet, damage to brands and companies. The news media is attuned to food safety stories. They know that food safety sells newspapers and generates TV viewers.

Does the consumer care? A survey of U.K. consumers conducted by the Food Standards Agency⁸ revealed that 71% of consumers were concerned about food safety while only 16% were not.



For branded manufacturers, the negative image generated in the media can quickly transform a brand from an asset to a liability. For non-branded manufacturers such as ingredient suppliers or private label manufacturers, a company can become tainted in the eyes of customers.

FOOD SAFETY—A GLOBAL ISSUE

Most countries have some types of food safety regulations. The rules typically cover all food products sold in the country and, therefore, any product imported into the country. The two markets with the most impact worldwide are the United States and the European Union (EU). These markets are among the largest and are major importers and exporters of food.

Core to most regulations is tracking and tracing. Being able to track product "from farm to fork" or "one up and one down" combines the collection of the appropriate information, organizing that information, and then retrieving it as required.

⁷ See Food Processing Magazine, March 2005

⁸ See <http://www.food.gov.uk/>

Regulatory compliance costs money. It includes initial investments in systems, devices, training, etc. Perhaps more important is the ongoing cost of people and the loss of productivity. However, non-compliance can be even more costly. The question is, how much risk is a company willing to take? Non-compliance can lead to fines, shutdowns, loss of market share, or even the end of the company. For most, these risks are overwhelming, and compliance with regulations is mandatory.

WHAT CAN THE MID-SIZE FOOD MANUFACTURER DO ABOUT FOOD SAFETY AND REGULATIONS?

Regulations apply to all companies without regard to size. Therefore, small- and medium-sized companies have the same requirements as large companies, but with significantly fewer resources with which to address them.

Regulations demand the collection, organization, and retrieval of information. For all but the simplest food companies, a manual approach to compliance is difficult, if not impossible. Examples of simple food companies would include a manufacturer with a very limited product line, few ingredients, a simple process, and few customers. The vast majority of food manufacturers do not fit into this definition.

These companies must rely on computerized systems to meet regulations at a practical cost. Computerized systems can assist in collecting the information required, do an outstanding job of organizing data, and producing the information required in a timely and organized fashion. At the heart of compliance is a company's Enterprise Resource Planning (ERP) system.

Large companies can afford complex, standardized, and expensive compliance solutions. Small and medium companies need compliance options that are both affordable and effective. When considering compliance options, consider approaches and suppliers based upon the practicality of the solution, whether the solution work in the environment, and whether the initial and ongoing costs are affordable.

Globalization

The food industry long thought it was safe from the impacts of globalization. It reasoned that the barriers of transportation cost, shelf life, and consumer taste would protect its local markets. These assumptions have proven false. Incredibly, a food processor on the West Coast of the U.S. tells us that his Chinese competitor can deliver product to the West Coast of the U.S. at a lower cost than even he can. Fresh products are now available year-round in most markets, imported from countries once considered to be too far away to compete.

Of course, globalization is a two-way street. Products can enter your market but your products can now enter other markets, a phenomenon once seen as impractical.

OPPORTUNITY AND THREAT

Is globalization an opportunity or a threat? Looking at the entire food industry, the answer is "both." Looking at individual categories, the answer can be yes, no, or even a combination of both.

Globalization clearly provides the opportunity to sell to new markets. Any discussion of globalization must begin with the impact of China. As a market for food products, the Chinese economy has been doubling in size roughly every six years. By some estimates, China could become the world's largest economy by as early as 2015. China's huge population base of 1.3 billion consumers represents a very large opportunity. The challenge is to gain access to this very large market and provide products that the Chinese consumer wants. As other countries expand their middle class, the demand for imported products also grows.

Globalization means the opportunity to source ingredients at a lower price. With control over quality, shelf life, and forward-looking planning systems, global sourcing can lead to lower cost.

Globalization presents the threat of new competitors with cost advantages. Logistics differentials still exist; however, the lower costs of production and processing in other countries more than makes up the difference. Today, food and beverage companies are seeing competition for commodity-driven products, but the future is likely to see competition for value-added products.

WHAT CAN THE MID-SIZE FOOD MANUFACTURER DO ABOUT GLOBALIZATION?

To benefit from globalization or to meet its threat, a mid-size manufacturer must, above all, be prepared. To sell into new markets, the manufacturer needs to be a better partner and collaborate with customers who have different needs than its traditional customers. The mid-size manufacturer has to be able to deal with the increased complexity of a global supply chain. Product development must look at non-local issues such as banned ingredients and local-label statements. To benefit from global sourcing, the mid-size manufacturer requires excellent control over quality, shelf life, and planning systems that are both accurate and proactive.

To benefit from and to defend against globalization, costing systems become even more important. We find that most mid-size food manufacturers fail to have competitive cost tools. Without the right costing tools, pricing and cost-reduction programs are less than effective.

Summary

The pressure is on every food and beverage company worldwide. The small-to-medium food company faces the same pressures as the large companies, but has fewer resources to address them. However, the mid-size manufacturer must proactively address these pressures to maintain or grow market share.

An important part of the strategy must be systems. Can the mid-size food manufacturer keep up without an industry leading ERP system? A manual system, one that is a mix of manual and spreadsheets or an ERP installed for a number of years, does not give the mid-size manufacturer a competitive platform to address these pressures. The lack of a competitive platform means expensive and time-consuming efforts to meet retailer demands, consumer demands, and the growing weight of regulations. The lack of a competitive platform limits a company's ability to benefit from or protect its markets against globalization.

Larger companies are leveraging large, recent investments in ERP to meet the needs of major retailers, increase customer service, cut costs, and grow market share. Industry data tells us that these large companies are succeeding and that small-to-medium food and beverage manufacturers are falling behind. Competing and defending your position means lots of things, but a key strategy is operational excellence, and that means leveraging ERP investments. Can the mid-sized food manufacturer find an ERP system that meets both its business requirements and its budget? The answer is clearly yes. Suppliers that focus on the mid-size food manufacturers provide the business processes required but with a full understanding of the constraints of these companies.



ABOUT THE AUTHOR

Olin Thompson is a principal of Process ERP Partners. He has more than 25 years' experience as an executive working with the food and software industries. Olin has been called "the Father of Process ERP." He is a frequent author, including a columnist for Food Engineering magazine, and an award-winning speaker on such topics as gaining value from ERP, SCP, e-commerce, and the impact of technology in the food industry. He can be reached at Olin@ProcessERP.com.

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