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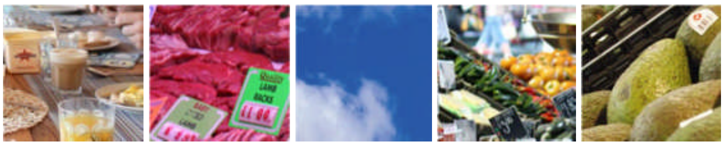


August 2011

A Freshlogic foodcast on Australian and international trends, innovations and other insights relevant to the Australian food market

What we're seeing

In this edition...

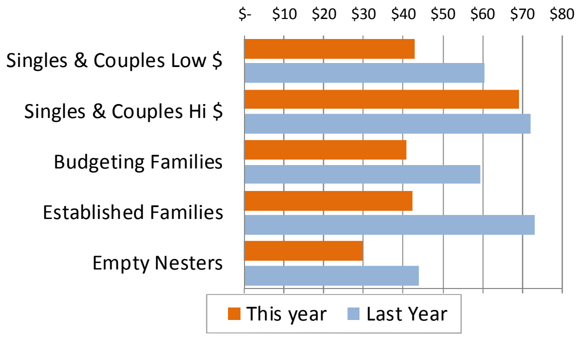
Has food service bottomed? – Our analysis of the changes in spending patterns by households using Mealpulse™ provides a sobering view of the state of the food service market. The comparisons of average spending by households between the June quarter this year and last year showed a **29% fall in spending on meals eaten out of the home**, which suggests significant trading down in meal cost and the migration of more than one meal a week back to the home kitchen.

But the curbing of spending isn't uniform across household types, as high-income singles and couples have largely maintained spending, while Empty Nesters have backed off least (in absolute terms) of the remaining household groups, despite the alleged battering to their savings.

So what has this led to? The meal migration will be **helping grocery stores achieve healthy gains in the sales of meal components** – meat, vegetables, base ingredients – and convenience foods. If there was ever a **time to expand the range of ready meals** through retail stores, this is it, as our tracking of household habits suggests that the demand for convenience has a firm hold on attitudes.

By all reports – and they are anecdotal – while top-end dining is doing very well, takeaway and QSR is holding sway (with some doing much better than others) but the middle of the market must be a black hole. **Spring will be the acid test** – warmer weather and people being couped up in cold and gloomy sentiment for months may see a break-out and a loosening of the purse strings.

Average weekly spend - eating out
by household segment (June Qtr 2011 v 2010)



Volume share is continuing to move back to grocery stores as the tighter spending regime hurts eating out.

Expect a protracted grocery price battle – With the grocery arm-wrestle the main game in town, the release of annual financial results and accompanying performance indicators a week apart made for a busy finish to August. The state-of-the-game suggests the **price-based competitive tension between the two major retailers will continue** for the foreseeable future. A number of factors point to this:

- Consumer sentiment and the flow-on into discretionary spending isn't likely to pick up any time soon;
- While the improved margins and returns will be pleasing to Wesfarmers, its result presentations outline the gap in the return on investment earned by Coles versus other business units;
- Coles' refreshed store formats seem to be providing much more sales traction than those of its larger rival, yet both groups are in the early stages of refreshments which have proven essential to sustained sales growth;
- Regime change is occurring at Woolworths, and coupled with the distraction of a stalling EBIT margin in food and the deeper investment in home improvements, Coles has the opportunity to continue to pressure by leading in the implementation of tactics.

The food market is locked in a prolonged value spiral. Consumers are cautious and on the lookout for savings – a feeling being amplified by greater prominence placed on "value" in messages being aimed at them.

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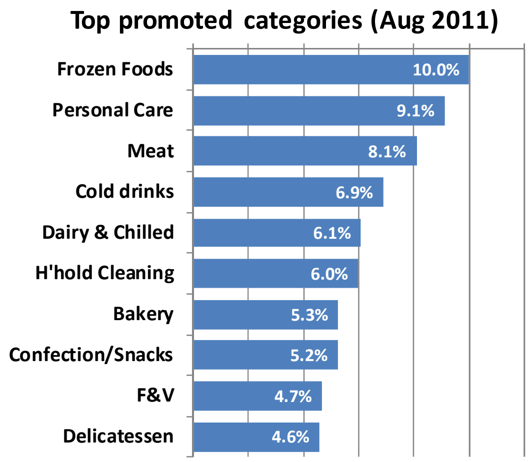
Full year results released by the owners of the two major supermarket groups show some interesting contrasts and the usual varying degrees of disclosure of the performance of the food business. Both grocers continue to grow trading margins, at a time when some significant reshaping of the mix of sales within food categories is underway, with cheaper private label lines winning and holding favour with shoppers.

Major grocers' financial performance year to June 2011		
	Woolworths	***Coles***
Food & liquor EBIT	7.4% (+0.2%)	4.2% (+0.5%)
4th Qtr same store sales growth	3.3%	5.2%
Overall annual sales growth	4.3%	6.3%
Food & liquor ROCE	75.7%	7.8%
Sales per $ of capital used	$10.60	$2.15

The majors are running fundamentally different financing models these days as shown by the sales churn from capital employed. The potential cash windfall from realising the capital investment in its store network beckons for Wesfarmers as it builds the strength of its Coles business.

Tight supply chain margins will remain a feature while we have a depressed retail sales environment.

August promotional activity – Freshlogic's tracking of retailer printed promotional activity using Adwatch again showed subdued activity in the promotional space with overall volumes of ad placements by grocers well below their average for the year to date, as the focus of promotions narrowed and the depth of discounts stayed firm.



Seasonal and meal-convenience issues have influenced the **category priorities** this month, with the lingering winter conditions keeping frozen food lines highest on the agenda, while the pressure being placed on specialist butchers continued with high involvement of meat in the month, as shares of weekly meals continues to drift to eating at home. The looming spring season pushed spring cleaning products into the mix and lifted cold drinks into the top 10 chart.

Far and away, the **highest promoted brand** this month was Coles, well ahead of major brands Nestle and Cadbury, pushing its private label adverts to levels twice that of Woolworths. Australian Grown was the 4th place-getter, as prominence of the debate about the pressure on local food processing businesses echoed around the media.

The promotional messages reaching shoppers have a huge sway on week-to-week spending choices, and can help explain patterns that exist in the data – not only between brands but also between competing food and drink categories.

The consumer

Value in the app – We might spin the growing importance of digital technologies in this publication, but the latest results of the leading pizza chain show how the innovations are delivering for them. Domino's Pizza is gaining a big break through the use of online technology. Domino's reported same store sales rose 11.5% in 2010/11, with Australia and New Zealand stores posting a 13.2% increase and its European network a rise of 5.9% . Online and mobile orders contributed 40% of sales, or $152 million in 2010/11, up 44% on 2010 results. CEO Don Meij said that some weeks saw $1 million in sales from mobile devices in Australia, allowing additional business at a lower handling cost.

Meij outlined that while the technical gimmickry was paying off you have to make good pizzas to keep people coming back. Innovative product launches and a commitment to improving the quality of ingredients helped draw and hold higher customer counts. The company now expected digital orders to provide 60% of the business in the next two and a half years.

Domino's lifted full year profit by 20% and expects another 15% rise this year, while revenues increased 4.5% to $247 million.

The use of technology has now become mainstream for agile QSR operators. Those not harnessing the tools or backing the offer with reliable products will be quickly losing share in an unforgiving market.

NY fast food customers heed information – According to the British Medical Journal, one in six fast food customers in New York State used calorie information and, on average, bought food with lower calories since the 2008 introduction of a new labelling system. In 2008, New York became the first state in the US to require chain restaurants with 15 or more outlets nationally to post calories on menus and menu boards.

The study examined lunchtime purchases at 11 fast-food chains in 2007 and 2009, surveying nearly 16,000 customers. Analysis of data from each restaurant revealed significant reductions in several of the major chains – McDonalds down 5.3% and KFC by 4.6%. About 20% of customers at Subway paid attention to the calorie counts, compared to the overall average of 15%. All three restaurant chains introduced healthier choices around the time the new calories labelling law was passed.

This research shows that calorie labelling systems accompanied by certain healthier transformations in the food supplied by major food outlets, can impact the food that consumers purchase and consume.

Making news

Online grocery claims given greater airplay – Increasing attention is being given to the role that online shopping is playing in the grocery market. Woolworths valued its online sales at 1% of turnover, while Coles says their online food sales were comparable to sales through 5 of their stores.

Woolworths released a new shopping app for iphones, with reports that more than 400,000 downloads were recorded in the first week of release. Taking the luxury of watching other tools out in the market, the app offers additional features. Users can personalise the device to their local “Woolies” and use an aisle-ordered shopping list with a barcode scanner, making it easier to navigate the store. It adds the features of hundreds of recipes (into an app world where shoppers are being drowned in recipes!), as well as other functions which include a Store Finder, My Specials, Product Finder, and a Weekly catalogue. Coles boasts 500,000 downloads of its app, according to media.

The online sales may be small but the influence of tools in selecting meals is growing. Big retailers with deep property investments and their suppliers can’t afford not to be tuned into the innovations.

A discount for turning up – A number of new incentives have been announced to harness the highly popular Facebook “check-in”, which is being hyped-up by its promoters as being a novel way for “bricks and mortar” retailers to hold their sales against the drift towards online retail. The publicity around the move suggests that a number of larger brands including, 7-Eleven and Westfield, have already adopted the innovation, providing digital coupons for users who check-in to outlets and/or shopping centres. Checking in at any of the 7-Eleven stores around the country on Facebook in August offered users a 450ml Coke for $1. This is part of a wider consumer trend towards such coupons, and confirms these discounts are now being targeted towards smaller geographical locations and individual stores.

The innovations might be one way that smaller or independent retailers can help protect business, but may also add to the confusion and clutter in a very busy social media space.

Global food retail

Food vans are rolling up – One of the exciting innovations to reach city streets in some Australian cities is the food van. The food van is a serious culinary trend in the US, drawing large followings in many major cities, providing a wide range of culinary options. Innovators in Melbourne include the popular Beatbox Kitchen and Taco Truck.

The trend is slowing gaining some ground here, with some pioneers getting some good coverage in recent food media. The business model is based on a low capital outlay, roving street-side locations, offering gourmet takeaway food (burgers, Mexican, BBQ, etc.) and use of Facebook and Twitter to announce where they will pop-up next. It has flourished in the US as it meets a lower price point, while giving chefs a low-risk way of getting back into the market. Diners are attracted to them because there is at least some drama getting to the van, and they value scarcity and novelty over the sameness.

The novelty of the food van movement will expand and will gain a wider following in major cities due to the excitement of the pop-up approach, the low-cost entry for operators and the appealing social aspects of the format.

The Waitrose miracle – While all other grocers about them are struggling, UK’s premium grocer Waitrose has been growing sales and profits. UK retailer Waitrose said sales for the first half of 2011 had risen by more than 8%. Waitrose said its sales increased 8.7% in the first 26 weeks of the year and that all its food categories experienced growth in the period, led by chilled, fruit, vegetables and horticulture, bakery, which was up 9.4%. The company, meanwhile, said sales at its online division were up 15.9%.

Others in the UK have struggled in a market that has been scorched with the "value" promotion, and are finding it very hard to get traction with subdued consumer sentiment and rising unemployment. Analysts Kantar said their most recent data has Waitrose growing at twice the market rate, with "budget own label" showing only muted growth of 2%, while premium own-label is growing at more than 8%, confirming that despite economic pressures, low-price is not the only motivation in this market.

This shows that the premium end of the food market remains robust – even in the UK – and continues to support growth for this unashamedly higher-priced, higher quality grocery chain.

The smaller footprint getting large investment – Several major food retailers are focusing on expansion in the parts of the market that have long remained under their radars. The small store format is the latest me-too trend to engulf food retail in the northern hemisphere, with plans that will certainly saturate the UK, and can only cannibalise existing large store sales. Tesco pioneered the convenience store concept in the 90's with its Metro sub-brand (copied here by Woolworths), and Marks & Spencers extended the model to commuter traffic zones with the innovative ready-meal Simply Food stores. The UK's Waitrose is now well underway with a plan to roll-out 300 stores of varying small formats in the UK and launched a sub-brand "Little Waitrose" earlier in the year. Wm Morrison is pouring over the books of the small-format Iceland group which has 750 stores. Walmart's ASDA plans to speed up the roll-out of its plan after the existing business again put in a poor showing.

Walmart is also rolling out a smaller convenience store model in the US as it seems the superstore footprint has run out of puff. It has been reported as taking this course in response to Tesco's US small-store chain Fresh & Easy, although results from Tesco haven't been too inspiring.

The smaller format gives large retailers, which have grown up on the back of the large full-service supermarket model, the chance to "back-fill" their network to plug any gaps in coverage that remain for convenience players. The extent of the UK investment however spells a train wreck - at least for some.

Given that most grocery retail innovations are eventually copied in this market, how long will it be before we see this gap filled?

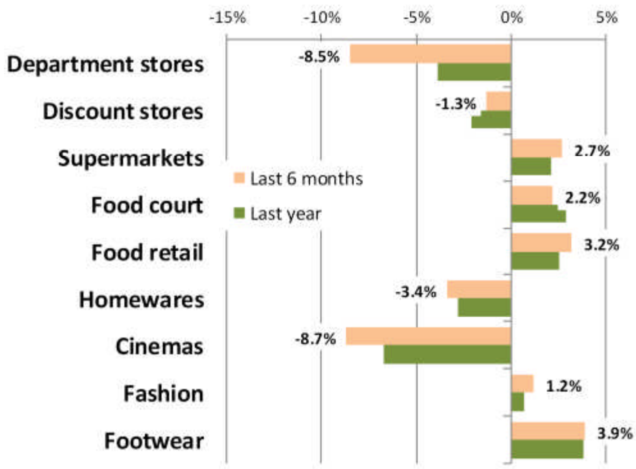
Other things of interest...

Food groups splitting for a better focus – US-based Kraft Foods has unveiled plans to split in two. Kraft is still digesting the hotly-contested purchase of Cadbury made in 2009, and will give birth to two companies - a North American grocery products business - which makes up about a third of its overall sales turnover - and a global snack maker. The timing is interesting, but gives an insight into how the global landscape has forced a redesign of one of the biggest food groups in the world, which itself was spawned from a split several years ago.

Planeloads of strategy consultants have feasted on helping big food companies decide on which is the better model – flip-flopping between the "diversified conglomerate" and a narrow focus. The vogue in the past decade has been diversification, with a stake in many food sectors to protect against exposure to specific sectors of the economy or geographic regions. The likes of Kraft, Nestle, Unilever and General Mills follow this model and, between them, dominate supermarket aisles whether in developed or developing economies.

Westfield gives up some detail

The latest results from Westfield give some insights as to how the respective retail markets are doing inside their centres within Australia.



Kraft isn't alone in revamping its structure. A spate of "unbundlings" may create new companies and keep the advisory houses feasting on huge fees. Sara Lee (with frozen food units under a cloud in Australia), Pepsico and possibly others are working on plans for either a breakup or the sale of major units. CCA no doubt queries the merit of its SPC purchase.

There are common intentions behind these changes. The aim is to ensure things are made simpler for investors to understand and to ensure managers are able to gain better focus. Time will tell if that theory holds before we see the next fad emerge.

The phone becomes a wallet – New technologies are being trialled to further reduce the paper in shopping purchases. Google Wallet uses a technology called short-range Near Field Communications that can transmit secure credit card data within a range of about four centimetres, allowing a smartphone to become a virtual credit card or prepaid cash card. The new Google service, one of several that aims to turn smartphones into payment devices, will initially be available to a select group. However, Google hopes to gradually extend that audience to other phones, wireless carriers and credit card companies.

The Google Wallet will ultimately bundle payments with online discount offers and loyalty programs. Google has refused to outline plans to extend its contactless payment trials outside of the United States, but has not ruled out the possibility of its move to Australia in future.

The roll-out into Australia may suffer from the fact that this market is too small to warrant the investment…but the passion for credit, the high penetration of mobiles and the rapid growth in market share for the Android platforms must increase the appeal.

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