fresh*Incite*

February 2011

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

What we're seeing

The shifting share of spend – Freshlogic's tracking of household spending through Mealpulse shows some continuing value shift in spending by consumers between major channels. Over the 2010 calendar year, the weak seasonal pattern in total spending was barely evident, indicating even greater caution towards the end of the year. Over the year there has been a continuing shift in share of spending in favour of the supermarket from "eating out".

This curbing in spend makes nonsense of the ABS numbers which continued through 2010 to show "eating out" tracking well above the same time in the prior year. We obtained some data on dairy product sales – a useful indicator of channel volume activity – which showed that non-grocer volumes were *flat at best* through to the end of the year.

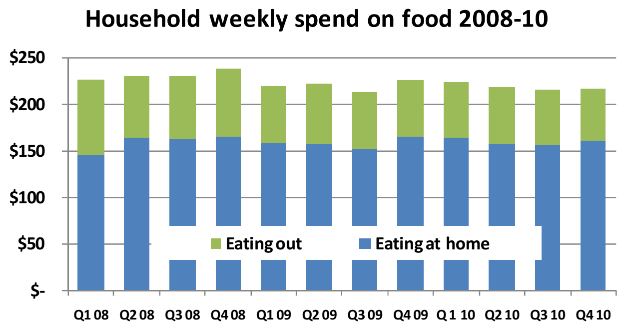
Why the lingering caution? – the latest sentiment indicators suggest people are feeling a little more confident but are still fairly sensitive to the cost of their mortgage, while shaky housing markets in several capital cities will be adding to that feeling. Employment may be more secure, but cash flow and debt exposure seem to matter most. Westpac's confidence barometer remains 8.9% below its level of one year ago, and 6.3% below 2010's average level.

- *The caution has different implications for categories within the take-home food spending and eating-out.*

Supermarkets lift share of fresh sales – The analysis of the data from our Mealpulse panel in late 2010 confirms that the major supermarkets have won fresh fruit and vegetables market share from greengrocers and markets. These changes have been reflected in the retail outlets that consumers have patronised for primary fresh produce shopping trips and the extent to which those consumers shopping in supermarkets have also purchased fresh lines elsewhere.

The extent of share capture equates to 1-1.25% of the fruit and vegetables alone, which equates to national weekly retail sales of $2.4-$2.8m. This share increase drift has been fuelled by substantial investments by the major supermarkets in their retail stores combined with a sharper focus on these products in their promotional activity.

- *The greengrocer is under some pressure as supermarkets are winning support from consumers with investments in their stores and adjusted promotional priorities.*
- *The sales of food through grocery, specialists and eating out reflect different growth rates at a state level*



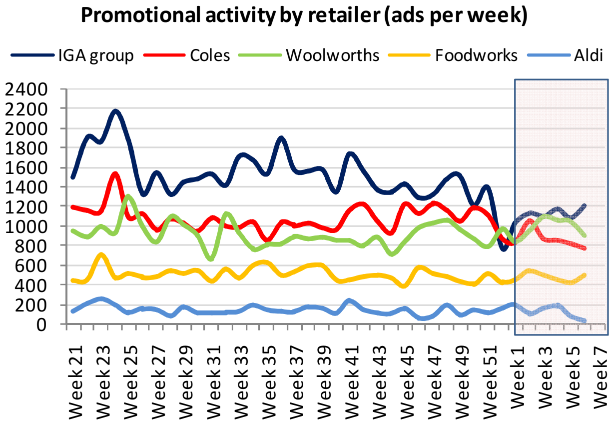
Hot 10 topics in food – Our take on the top issues in 2011 that will shape the food retail market are:

1. ***Bridging the gap*** – who will win as the big two grocers want to close the gap on each other – Woolworths would claw back sales, Coles wants better margins. (see below)
2. ***Passing on food inflation*** – when and by how much will rising costs reach the consumer? (see below)
3. ***Luring shoppers back to "premium"*** – several premium categories are holding value and volume, but how will this spread as consumer confidence lifts?
4. ***Giving meaning to green*** – has the household lost interest after confused government pledges, and how long will this indifference last?
5. ***Building ethical value*** – ethical marketing platforms expanded but at lower prices in 2011. Can producers capture more value as consumers take more interest in where things come from?
6. ***Making convenience competitive*** – can there be sustainable growth in branded "snack foods" and strengthening of the convenience channel to win back a higher share of meals?
7. ***Buying local*** – retailers are trying to massage their offers towards local appeal to personalise the offer
8. ***Doing what I say*** – with closer interest being paid to changing consumer preferences, actions in the shopping aisles matter most. Tracking reality v preferences will be an important business tool.
9. ***Is there an App for that?*** - multi-channels for communicating and marketing with consumers will be the key to win over tech-savvy consumers
10. ***Artisan foods*** – with a spur in high quality home cooking inspired by many TV shows, products pitched at artisan values may win consumer favour

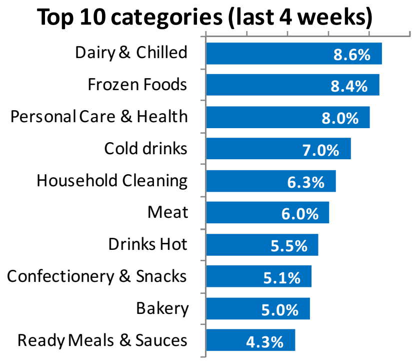
freshlogic

Retailer promotional activity in early 2011 –

Freshlogic's tracking of retailer printed promotional activity through our Adwatch service showed that overall promotional activity since the start of 2011 has been less-intensive than in the latter part of 2010 as the focus has shifted to stronger discounting of staple lines. As the major two grocers ramp up their battle on "price", there's been a general backing off in the number of lines specialled by the independents under the IGA banner.



- *Deeper analysis of the data from Adwatch shows the category focus being applied by each of the retailers, and how the change in intensity of promotions affects discount levels*
- *This can help brand managers understand what is showing up in scan sales data as to the effect of promotional activity on volumes and average unit sales.*



Consumer media landscape changing quickly – SME's in food

now have a new set of media options at their disposal. Australian corporate spending on online ads shot up 21% to $2.27 billion during calendar 2010, including a 19% increase in the "search ad" category to $1.13 billion. The expansion of the use of on-line placements somewhat levels the playing field for SME'S and potentially dilutes the big budget advantages of major brand owners. While this trend can enable increased demand stimulation, the challenge is aligning this with the capture of retail shelf space.

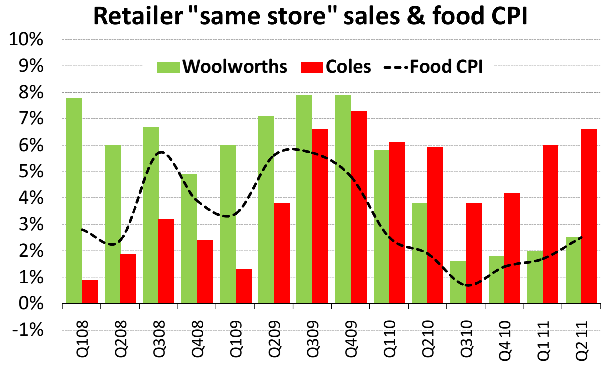
This opens up scope for tailoring the pitch....technology is a key enabler here, while media marketers will resist this push as they can see potential for lower media spending as tailoring becomes more effective. This has led to some creative spin on the effectiveness of print media as these media channels continue to decline.

- *The emerging trend needs to be fully understood to be effectively harnessed by food companies, or media marketers will take their money for dubious "click through" claims*

What's making news

Stage set for a keen grocery battle in 2011 –

Published 2nd quarter sales results from major grocery retailers shows we are well into in a period of Coles' ascendancy – at least in terms of underlying sales growth. Coles is clearly gaining share of the volume of grocery sales in these numbers. Coles' same-store sales were more than 3 times that of its larger rival in the September quarter, but the gap closed slightly in December. Woolworths also suffered from a low impact of its new stores which has been a worrying trend for the past year. There is added pressure from a resurgent Coles with the continuing roll-out of Aldi stores.



While the battle for the perception as cheapest in the eyes of the consumer is leaning towards Coles, there remains a wide gap in profitability though which should have some worrying about the possible depth of a price war given the higher available margins of Woolworths. Woolworths food & liquor EBIT margin rose to 7.48% in the December half year (a gain of 0.32%), while Coles improved half a % to 4.09% in the same period.

- *This situation will undoubtedly increase the competitive tension between the big players. The key interest is whether and how Woolworths will respond, and what categories may targeted for specific attention. Buckle up!*

Milk wars: storm in a teacup or a game-changer? – the latest round in the slugfest between Coles and

Woolworths has bitten hard for the dairy industry, if you believe the noise which has followed Coles' slashing of private label lines, which others followed and in the case of Aldi, bettered. The impact on milk isn't nearly as bad as the 'industry destruction" impacts that the national farmers lobby ADF has been protesting, although the effects will be hardest in the

Queensland and NSW markets, where most of milk production is geared for packaged milk use. There are stark differences in supply chain margins in different parts of the industry. Queensland's cost of milk at the farmgate is much higher than Victoria (which punches out two-thirds of our milk), as well as having a much lower average retail price with more intense brand competition. The margins to processors in Queensland across the category may be as much as 15c/litre *lower* than in Victoria.

With the scope for a significant shift in volumes from branded product in supermarkets and in the route trade (servicing convenience stores and cafes), the effect of the deep discounting on private label lines will hurt the northern fresh milk supply chain. WA farmers won a reprieve from Coles on the treatment in their region – it will be interesting to see what comes of this issue as a Senate Economic Review starts to take submissions on the effect of the price war.

- *The effects of the discount campaigns on volumes within grocery (taking volume from brands and non-grocery outlets) will be a potent influence of changes in the food retail landscape in 2011.*

Food inflation warming up, but will it surge? – Both major grocery retailers reported food and liquor inflation at or below zero in the last quarter of 2010, after several quarters in this territory. Pressure is building through globally-traded commodity supply chains and has certainly reached our shores, as the summary on the right illustrates.

The world has talked itself into a food-supply crisis, quickly shaking off lower prices that came in the aftershocks of the GFC. For both major grocery players, the ability to achieve some growth in sales and margins from price rises will be critical in the next year, just as it will be for suppliers that see higher costs coming through the chain.

- *The challenge for grocers is overcoming their fear of the price-sensitive shopper, who they have nurtured well to stay hooked on cheaper food in the past 2 years.*

Pressure in the pipeline?

Milk	**Weaker** – the retail price war has seen off price inflation for now, which will ripple back to farmgate.
Cheese	Spot prices **about 20% up** on this time last year, but prices steady over 2010.
Butter	Spot prices very strong, **up 20-25%** over 6 months global supply is short.
Veg oils	More demand from biodiesel and limits on supply have pulled oils up about **50% higher** than a year ago.
Beef	**Cattle prices up 5-10% in 6 months**, on complex effects of weather, currency and export demand, but retailer discounting is limiting price rises
Feed grain	**Up about 15-25%** (it varies by grain and location) on prices in July 2010. Export demand is leading prices up.
Milling wheat	**Up about 10-15%** on prices of 6 months ago, but that's a gain of almost 50% in a year
Energy utilities	Cost inflation running **higher than 12% per annum**

The consumer

Portion sizes in focus – New research has revealed that Australian consumers prefer to control their diet through reduced portion sizes rather than adopt specific diet plans. The proportion of Australians who regularly make an effort to eat and drink smaller portions has increased to 46% in 2010 compared to 29% in 2009, a trend that is likely to gather momentum in 2011. Australian consumers are also more concerned about the inclusion of a wide range of foods in their diets rather than restriction or "forbidden" foods. Portion control is perceived by consumers as a more flexible approach to disciplined eating, allowing them to choose from a wide variety of foods while managing portion sizes.

- *New patterns in consumption are the key to understanding how grocery products- including fresh food portions - can be tailored to meet changing demands.*
- *Encouraging smaller portions typically generate price premiums, but as a downside require more frequent shopping trips. The upside for packaging providers is also potentially significant.*

Households caring less about "green" – an interesting indicator of how households have lost interest in the green agenda comes from electricity retailers. Energy specialist Switchwise reported that 138,000 households have walked away from state-based Green Energy plans of the electricity retailers in the past month. With energy prices rising at more than 15% per annum are no doubt a pressure point for many, there was a 33% fall in the volume of green energy bought by households in 2010, and a fall in the number joining plans.

- *Rising power costs, coupled with a confused outlook for Australia's emissions reduction approach, has sapped household commitment to personal green agendas.*

Global retail

Big retailers localising their appeal - the trend for big retailers is to move away from the copy and paste approach for store formats and product offerings. Localising the appeal through multiple formats, tailored ranges and differentiation of image will expand. The recession in the US and Europe has kept strategists in major grocery retailers very busy, and now the roll-out of new directions is taking shape.

Wal-Mart will diversify its US offer focus on smaller stores, after announcing a rare dip in US 4th quarter 2010 sales with plans to target urban markets and smaller towns, in a move to a "three-format portfolio" in the US. While it promises to go after an "everyday price leadership" plan, it also plans to open 30-40 small and medium format stores in FY 2012, with food-oriented Neighborhood Markets making up most of the medium-format stores, while the company will pilot some small stores.

Carrefour tries to kick-start a tired old format at home, by refreshing its core hypermarket business in France where it has the slowest sales growth rates. Meanwhile it is dabbling with new eco-friendly outlets - with efficient frozen cabinets, optimised lighting, and use of less polluting gas for its air conditioning and heating. It is pushing out Express outlets in other parts of Europe. The group is trying to quit its Asian business outside China, and will put more into improving business in Brazil.

In UK, the future is convenience – The fact that major UK retailers account for just 4,000 of the 48,000 stores operating in the fast-growing convenience sector, the leading players are racing to build a presence in this channel. The UK convenience channel increased in value by 6.3% in the last year and now accounts for about 21% of the total UK grocery market, growing faster than the overall market.

Fruit Logistica 2011

We attended the annual Fruit Logistica trade show in Berlin in early February.

Here are some of the major take-outs from what we saw:

- A common theme of smaller portion sizes including many products in singles.
- A wider array of product forms, with some food service "*plate ready*" options being introduced as retail products.
- Expansion of the "managed variety approach" across fruits and some vegetables, involving full supply chain involvement from variety owners.
- More "supply chain partners" seeking to do much more than move boxes - offers include IT systems, packaging solutions, new product support and inventory management.
- Sustainability evolving well past being a standalone issues into the fabric of everyday business and earning acknowledgement in the essence of many tier 1 corporate brands.
- The equipment to process fruit & vegetables has improved further to service and expand the demand for "fresh meal ready & waste free" products.

Further details on these matters are available here on our website.

All major chains are chasing solutions. Tesco's Express and One Stop formats now account for 66% of the retailer's total UK store estate, while Waitrose has begun testing a new banner called "Little Waitrose" and has announced that it will be opening some 28 convenience stores this year, more than trebling its current 13-strong convenience store estate. Convenience channel growth is partly led by changing consumer lifestyles, including more top-up shopping and the rise in single occupancy households, driving convenience shopping, meal-solutions and food-to-go.

Mainstream retailers are being forced to meet and exploit the traffic flows and the demand caused by unplanned daily shopping trips, time-saving pressures and the needs of smaller households .

Premium UK chain keen on NZ dairy welfare mark – Premium British grocer Waitrose has reportedly shown considerable interest in a New Zealand vet's quality mark that guarantees milk has come from "well-treated cows" on environmentally friendly farms. Researchers developed the *Caring Dairying* scheme because several widely reported stories were not acceptable to international consumers, including early induction of cows to bring milking forward, the sending of malnourished cows to the meat works and prosecutions of dairy farmers for the mismanagement of effluent. The scheme is supported by Pfizer Animal Health, and follows a new Animal Welfare Code for Dairy Cattle. Farmers will be audited to achieve certified status to show they follow "*good farming practice*".

The interest in the story behind the product takes on greater clout with the extension into welfare-based issues.

Tesco extends ethnic food range – UK retailer Tesco has launched seven different ethnic ranges in the UK, adding Turkish, Sri Lankan, Latin, Philippino, African and South African ranges to its offer, in response to demand for ethnic food. Over the past 12 months, Tesco has doubled the size of its world food range to 3,000 products in response to growing consumer demand, which has led to a 35% increase in sales. Tesco state they are responding to a natural curiosity from shoppers to try other cuisines, especially with different looking sauces, condiments, vegetables, tinned products and sweets and hence, Tesco has also supported these products with educational material including tips on how to prepare various products on the shelves.

A move by this retailer to cater for the ethnic diversity in some store catchments and also at the same time, to keep food shopping interesting for all shoppers.

US Safeway simplifies the nutrition message - Safeway Inc has announced a new SimpleNutrition program, an in-store shelf tag system that makes it easier for shoppers to find better nutrition choices among foods and beverages. SimpleNutrition makes it easy to find nutritionally better items in store with green shelf tags that highlight up to two of 22 different nutrition and ingredient benefits, such as: *Gluten Free, Organic, Sodium Smart,* or *Made with Whole Grains*.

Big US retailers set up online here – Big US retailers who are struggling in domestic market are setting up online in Australia in a bid for business growth and expansion outside the US. Recently, the giant US stationary chain Staples who sells PC and IT products launched an Australian website and they are to be followed by Amazon and Best Buys in 2011, according to US retail specialists. These retailers are enjoying patronage from Australian internet shoppers, attracted by the value advantages of a stronger $AUD.

This action by the US retailers has compounded the current sales challenges of the local retailers. It also signals the pace of commercial change that internet retailing can drive. It seems likely that these events have drawn some new consumers into internet shopping and subject to a positive experience, they then use for other retail purchases.

This level of activity by foreign retailers will prompt competitive responses from local retailers and lift the overall profile of internet shopping.

Other things of interest...

Danes lodge "fat tax" plans with EU – Denmark has officially notified its planned fat tax to the European Commission. The levy is expected to net the Danish treasury over €200 million per annum. The tax, expected to take effect on July 1, will be Dkr16 (€2.15) per kilogram of saturated fat in food produced in Denmark, with a similar tax will be imposed on fat used in imported foods. Denmark plans the tax to apply to seven categories of foods - meat; dairy products; animal fats; edible oils and fats; margarine; spreadable blended spreads; and other food which is close to the first six and is considered a substitute. The Danish Dairy Board said that it would lead to a 30% increase in the shop price of a 250g pack of butter.

Discounts to devalue eating out trade – Charging the full price for a meal out will become more difficult for restaurant and pub operators as diners become increasingly accustomed to discounts through the widespread availability of money-off vouchers, according to UK market analyst Horizons. Discount deals in pubs and restaurants have played an important role in keeping consumers eating out over the past 18 months, with 16% of diners using vouchers. Horizons' research shows that of the 16% who use vouchers most prefer "2 for 1" deals. Pizza Express, McDonald's and Tesco are among the most common places to redeem them.

Foodservice channels have been serving up offers and incentives to revive consumers' appetites. However, it will take some time to wean consumers off continual discounting.

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Freshlogic is a specialised consulting and analysis business with a strong focus on the food industry. We deliver a range of services to industry and corporate clients, which aim to interpret market and supply chain conditions, or address challenges faced in food supply chains associated with changes in the preferences of consumers, the expectations of the community, international trade and economic settings.

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