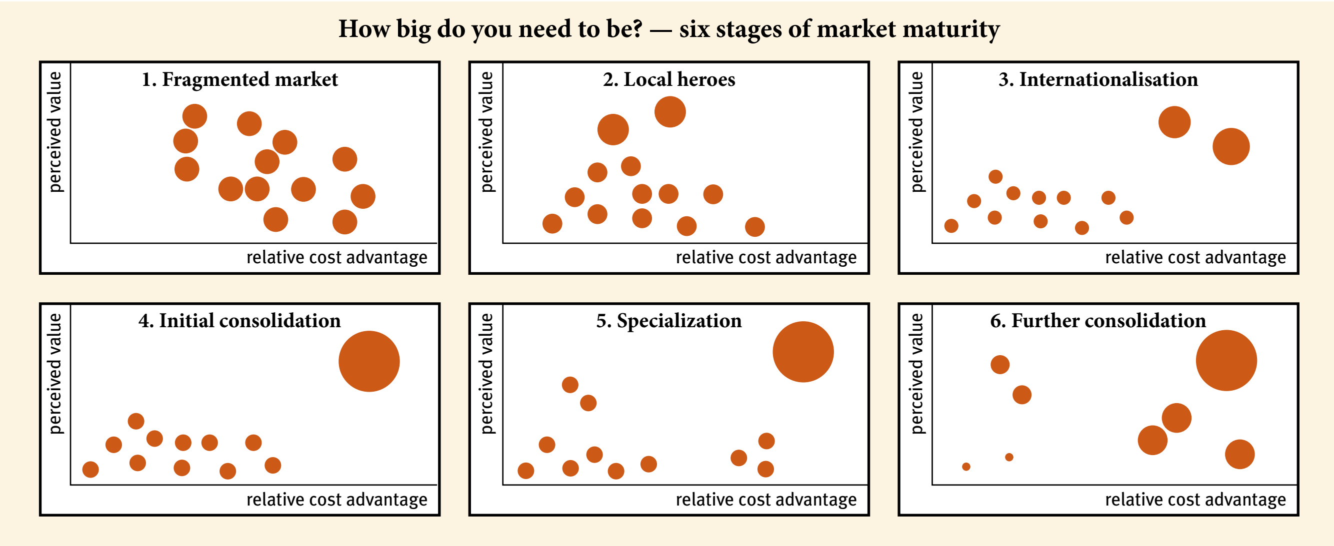
Size is what matters

AT THE AIBI CONGRESS IN LATE MAY 2013 MARC KENNIS, SENIOR ANALYST AT RABOBANK FOOD & AGRI RESEARCH, UTRECHT, THE NETHERLANDS, TALKED ABOUT THE FUTURE OF THE FROZEN BAKED GOODS INDUSTRY IN EUROPE, WHICH IS A PARTICULARLY INTERESTING LECTURE TOPIC BECAUSE IT SHOWS HOW BANKERS ASSESS THIS SECTOR OF THE INDUSTRY



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According to Kennis, bread and bread rolls still account for the majority of frozen bake-off products, although according to market studies by GIRA in Ferney-Voltaire, France, and the Rabobank, patisserie and savory filled dough pieces currently achieve the largest growth rates of around 5 % and around 6.5 % respectively. According to these studies, bread is slightly above the 4 % mark. France and Germany are by far the biggest markets (together around 1,500 t annually), but according to the study commissioned by the Rabobank, the biggest growth rates are currently being achieved in Great Britain and Italy. According to Kennis, the modern food retail (super- and hypermarkets) is the biggest sales channel with 47 %, but catering, food service, convenience stores etc. are growing considerably faster at 4.9–5.8 % annually. According to the studies, sales in the artisan sector are growing at 5 % annually, i.e. stronger than the retail, which achieves growth of only 3.5 %.

Frozen dough pieces are especially suitable for the retail, food service and convenience stores because they provide great flexibility in an attractive market, require little specialist knowledge and leave little waste (remainder stock). Social and macroeconomic trends also favor this market. All this taken together requires more offerings and innovations in several respects: simplification in handling and packaging, in shelf life to avoid waste, in relation to raw materials to avoid rising raw materials costs, and finally in flavor, appearance and texture to satisfy consumer demands.

Kennis believes the market is divided into cheap and luxury products, because firstly consumers want both, and secondly the economic crisis has divided society into the haves and the have-nots. The middle segment loses in any case.

There are five challenges clearly demonstrating that size is what counts:

1) Retail groups are becoming ever larger and more powerful, and can be increasingly seen as a chokepoint in that they pass on raw materials increases to end consumers.
2) The money that needs to be spent to generate one additional Euro of sales is called the capital intensity. According to Rabobank studies, the average capital intensity in the frozen bakery industry has been growing for years, and is currently already above EUR 0.50. Capital intensity is logically an important factor with an influence on operating margins and thus on the reported EBIT (Earnings Before Interest and Taxes).
3) As a rule, bigger companies find it easier when buying raw materials to develop purchasing power and to negotiate better terms of contract to ensure that the gap between the term of contract as a supplier and the term of contract as a purchaser does not become too large.
4) Product innovation costs money. Development expenditure among major suppliers is currently between 0.25 and 0.5 %. As a rule, small businesses find it difficult to keep pace even with these low expenditures.

5) Achieving positive relations with major clients such as the retail needs flexibility, good account management, customer-specific innovations and the ability to cooperate in category management. That all costs more money and personnel than small companies can afford.

How big is big enough?

There are six stages of market saturation, ranging from many small suppliers from which champions emerge, to an advanced stage of market consolidation with a few small specialists around the edges, finally ending in extensive consolidation with one large market player, a few medium-sized ones and even fewer small market participants. Kennis estimates that the market for frozen baked goods is in the last but one stage of specialization and consolidation. To reach the concentration index of the retail (calculated as the Herfindahl Index), the three biggest frozen baked goods manufacturers must each increase their sales by EUR 130–170m, which would correspond to approx. 14–23 %. Those in positions 4 to 8 would need to achieve growth rates as high as 22–50 %, which would probably be much more difficult since it implies annual sales of EUR 400–500m.

The industry currently spends between 0.25 and 0.5 % on research and development. For the biggest this amounts to EUR 3.5–6.5m annually. That is a gigantic capability compared to smaller businesses. If the next smallest wanted to spend only half as much (EUR 1.75m) they would need a volume of EUR 350m even if they wanted to invest 0.5 % of their turnover.

A key account manager is more worthwhile for big businesses than for small ones. He/she costs around EUR 100,000 per year. The maximum allowable costs should amount to 1 % of the EBIT margin per customer. I.e. the customer of this key account manager must represent sales of at least EUR 10m. If one wishes to avoid becoming over-dependent, care should be taken to ensure that no single customer contributes more than 5 % of sales. Under these conditions, the minimum turnover size to justify employing such key account managers is EUR 200m.

Market development as a yardstick, exemplified by the case of CSM NV, Diemen, the Netherlands

CSM has commenced the sale of its bakery division, which also includes frozen baked goods sales of around EUR 830m, because among other things it was impossible to raise sufficient capital to expand the business. According to Kennis, if someone of this order of magnitude already regards themselves as too small, it is an indication that the market demands size. In view of this observation, the judgment is: sales of EUR 200m are a minimum, more is better, and many of those currently participating in the market will probably be unable to reach this size through their own resources, with the result that purchased acquisitions will be necessary. For all those who cannot or don't want to grow through acquisitions by purchase, Kennis has developed alternative corporate strategies based on the so-called Porter Model for competitive advantages:

1) Strive for cost leadership in a few differentiated product fields
2) Focus on innovations and the development of high-end products for a better EBIT
3) Build up top-quality customer relations with the aim of increasing the EBIT

All three actions should be aimed at the decisive target, namely improving the ROCE (Return on Capital Employed). ROCE is regarded as a measure of total capital profitability, and as a rule it is calculated as the ratio of EBIT to the capital employed. Some definitions also use the after-tax profit for this calculation. The capital employed is the long-term available equity capital, loans, bank credits and pension reserves. +++

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