

## Grocery wholesaler profitability

### Introduction

1. Wholesalers provide the primary link between convenience stores and product suppliers, including for both independent non-affiliated convenience stores and independent convenience stores that are affiliated to a symbol group (eg Spar or Londis). These stores, in turn, provide significant volume and revenue for wholesalers. The viability of independent convenience stores and wholesalers are thus fundamentally linked. Both the ACS and the FWD argued that the viability of the grocery wholesale sector was threatened by the exercise of buyer power by the largest grocery retailers (eg Asda, Morrisons, Sainsbury's and Tesco), and a reduction in the number of convenience stores served by grocery wholesalers.
2. The problem foreseen by the ACS and the FWD is that as the number of convenience stores served by grocery wholesalers declines, the average costs of supplying these stores increases. This, in turn, may force wholesalers to increase their prices to the extent that a significant number of these convenience stores are unable to operate profitably and therefore close. Accordingly, a tipping point might be reached beyond which, as a result of the closure of a certain number of convenience stores, the grocery wholesale sector is no longer economically viable. Without a wholesale sector the remaining convenience stores do not have a functioning supply chain.

## Structure of the grocery wholesale industry

3. Turnover among grocery wholesalers supplying convenience stores was £17.5 billion in 2006.<sup>1</sup> The 15 largest wholesalers (see Table 1) account for around 76 per cent of this revenue.<sup>2</sup> Grocery wholesaling is primarily undertaken on a 'cash-and-carry' or 'delivered' basis. Cash-and-carry wholesalers tend to serve independent non-affiliated convenience stores, while delivered wholesalers serve symbol group convenience stores.
4. The two largest grocery wholesalers in the UK, Palmer & Harvey (delivered) and Booker (cash and carry), account for 50 per cent of all grocery wholesale revenues and individually over 50 per cent of revenues in their respective sectors. In terms of volume, we estimate that the supply of groceries from wholesalers accounts for between 15 and 20 per cent of total UK grocery supply.<sup>3</sup>

TABLE 1 Wholesale companies in the UK grocery market

<i>Company</i>	<i>Principle mode of operation</i>	<i>Estimated turnover from wholesaling</i>	<i>Symbol group</i>	<i>Buying group</i>
P & H McLane	Delivered	3,533	Mace, Mace Express, Your Shop, Super Shop	
Booker Ltd	Cash & carry	3,100	Premier	
Bestway Cash & Carry Ltd (incl Batleys)	Cash & carry	1,800	Best One, Best in	
Makro Self Service Wholesalers Ltd	Cash & carry	1,190		Today's Group
Costco Wholesale UK Ltd	Cash & carry	1,046		
A F Blakemore and Son Limited	Delivered	480	Spar	Spar, Landmark
Londis (Holdings) Ltd*	Delivered	527	Londis	Today's Group
James Hall And Company (Holdings) Ltd	Delivered	280	Spar	Spar
Dhamecha Foods Ltd	Cash & carry	299		Today's Group
Capper & Co Ltd	Delivered	220	Spar	Spar
C J Lang & Son Ltd	Delivered	200	Spar	Spar
Henderson Wholesale Ltd	Delivered	240	Spar	Spar
A G Parfett & Sons Ltd	Cash & carry	260		Landmark
J W Filshill Ltd	Delivered	147		Key Leckerland
Appleby Westward Group Plc	Delivered	150	Spar	Spar

Source: IGD.

\*Excludes Budgens and Musgrave turnover.

<sup>1</sup>IGD, *UK Grocery and Food Service Wholesaling*, March 2007.

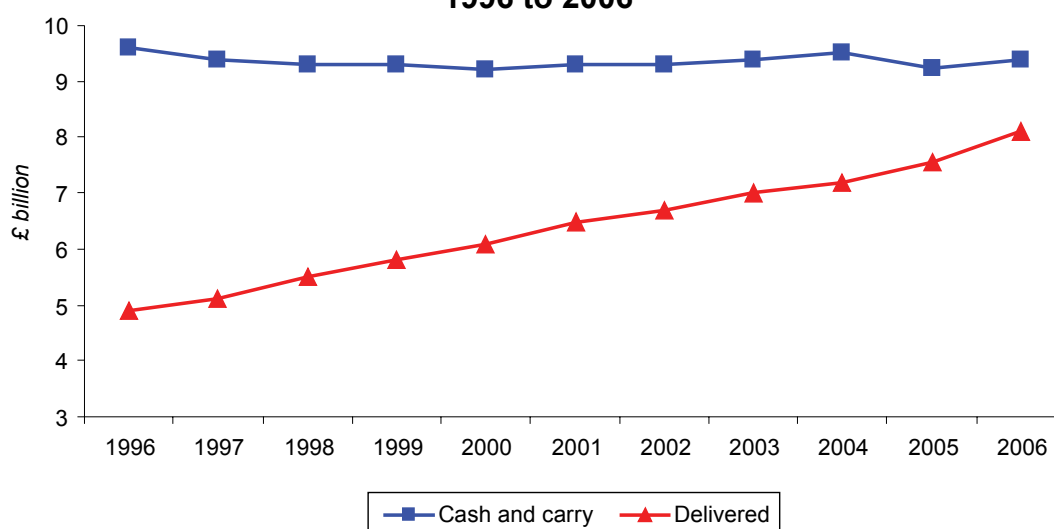
<sup>2</sup>There are around 400 wholesalers operating in the UK.

<sup>3</sup>Assuming average non-multiple retail gross margins of 20 per cent and total UK retail grocery sales of £101.7 billion.

5. Most wholesalers are affiliated to one or more of the buying groups operating within the sector. These buying groups are coalitions of one or more wholesalers set up to obtain more favourable terms from suppliers than each wholesaler could obtain on its own. That is, buying groups utilize the combined scale of their members, or affiliates, to obtain lower prices from suppliers. Of these, Nisa Today's, Spar and Landmark are the largest. In most cases, buying groups do not physically handle the products as they usually go directly from suppliers to members of the buying group.<sup>4</sup> Table 1 includes the buying groups associated with the largest wholesaling companies in the UK.
6. Of the £17.5 billion wholesaler revenue in 2006, approximately 46 per cent (£8.1 billion) was earned by delivered wholesalers. Cash-and-carry wholesalers earned 54 per cent of wholesaler revenue (£9.4 billion). Figure 1 shows that turnover in the cash-and-carry sector experienced a decline of 2 per cent over the period 1996 to 2006, whilst the delivered sector grew by 65 per cent.

FIGURE 1

**Grocery wholesalers, revenue, cash and carry versus delivered wholesalers, 1996 to 2006**



Source: IGD. UK Grocery and Food Service Wholesaling, March 2007.

<sup>4</sup>Usually buying group companies do not own significant warehousing assets. However, Nisa Today's told us that its principal activities involve the collection of annual retrospective discounts and advertising support from suppliers for onward distribution to members and the operation of a central distribution service for the supply of goods purchased for members.

7. The relative lack of revenue growth in cash-and-carry wholesaling compared with delivered wholesaling has been attributed to, among other factors, the decline in the number of independent non-affiliated convenience stores.<sup>5</sup> This decline has resulted in some cash-and-carry wholesalers developing their own symbol groups and a delivered service to protect their customer base.<sup>6</sup> For example, Booker has recruited almost 2,000 independent store owners to its 'Premier' fascia, which has helped it build a base of core customers worth about £800 million in annual revenue. This has led to some blurring between the cash-and-carry and delivered wholesaling segments, as cash-and-carry operators diversify into delivery services. Table 1 includes the symbol groups associated with the largest wholesaling companies in the UK.
  
8. There have been moves towards consolidation among wholesalers. In 2005, Bestway acquired Batley's Limited, and in 2006 there was a proposed merger between Nisa Today's (a buying group) and Costcutter (an operator of convenience stores), although this did not occur.<sup>7</sup> On 1 January 2007 Nisa Today's and Makro formed an alliance to combine their buying volume. Booker told us that these mergers were a sign that the sector was in decline and that operators were trying to maintain critical mass. However, Palmer & Harvey told us that further consolidation within the cash-and-carry sector was both likely and desirable as it would increase efficiency and improve the product offer of cash-and-carry operators.
  
9. The IGD has summarized the current position within the sector as:<sup>8</sup>
  - (a) The growth of sales within the delivered sector will ensure that sales to the independent and convenience retailing channel will overtake those of cash and carry in the near future.

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<sup>5</sup>From 2000 to 2006, the number of independent non-affiliated convenience store outlets fell from 35,500 to 25,893.

<sup>6</sup>A symbol group is a form of franchise in the retail sector; a wholesaler usually acting as the franchisor. The franchisor does not own or operate stores, but acts as a supplier to independent grocery retailers which trade under a common banner (symbol).

<sup>7</sup>Bestway also expressed an interest in the parties.

<sup>8</sup>IGD, *UK Grocery and Food Service Wholesaling*, March 2007, p46.

- (b) Delivered wholesalers have a better range of competencies with which to serve the key developing areas of independent and convenience retailing among the larger, fuller range stores.
- (c) With its better ability to service the smallest and more limited range stores more effectively, cash and carry retains a substantial and valuable (though pressured) customer base in to which delivered wholesalers find it harder to make inroads.

### **Financial performance of grocery wholesalers in 2006**

10. As set out in paragraph 3, turnover among grocery wholesalers supplying convenience stores was £17.5 billion in 2006. This represented an increase of 4.1 per cent on 2005, and 14 per cent on 2000.<sup>9</sup> As shown in Figure 1, the established trend of convergence of delivered and cash and carry continued in 2006, although at a more significant rate than in the recent past.
  
11. The significant increase in delivered sales in 2006 is attributed by IGD to:<sup>10</sup>
  - (a) the successful winning and extension of large-scale supply contracts within the multiple small store sector;
  - (b) the progressive development of the Budgens franchise business, in which company-owned stores have been converted to independent ownership, effectively switching their business into the wholesale sector;
  - (c) the successful implementation of higher levels of discipline among symbol group stores resulting in their switching a higher level of spend to their dedicated central sources of supply and away from the alternatives such as cash-and-carry wholesalers; and
  - (d) the rapid sales growth of chilled and fresh foods (increase of 10 per cent in 2006 from 2005) which is a bigger feature of the delivered wholesale sector.

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<sup>9</sup>IGD, *UK Grocery and Food Service Wholesaling*, March 2007, p18.

<sup>10</sup>Ibid, p20.

12. 2006 also saw an improved performance in the cash-and-carry sector arresting the 1.8 per cent decline in 2005. However, the growth of sales through the cash-and-carry wholesale sector continues to be restrained by its higher levels of dependence on independent non-affiliated convenience store sector. As discussed in paragraph 7, cash-and-carry wholesaling has been particularly affected by the increase in symbol group convenience stores. This relative recovery in cash-and-carry wholesaling seems related to the beginning of a successful turnaround of a sales decline by Booker, substantially the largest cash-and-carry operator.

***Performance trends based on the largest 15 grocery wholesalers***

13. Between 1995/96 and 2005/06, turnover for the 15 largest grocery wholesalers increased from £8.3 billion to £12.8 billion,<sup>11</sup> against total grocery wholesale industry turnover which increased from £14.5 billion to £17.5 billion. The 15 largest grocery wholesalers accounted for 57 per cent of total turnover in 1995/96, and by 2005/06 accounted for around 77 per cent of total turnover (see Figure 2).<sup>12</sup>

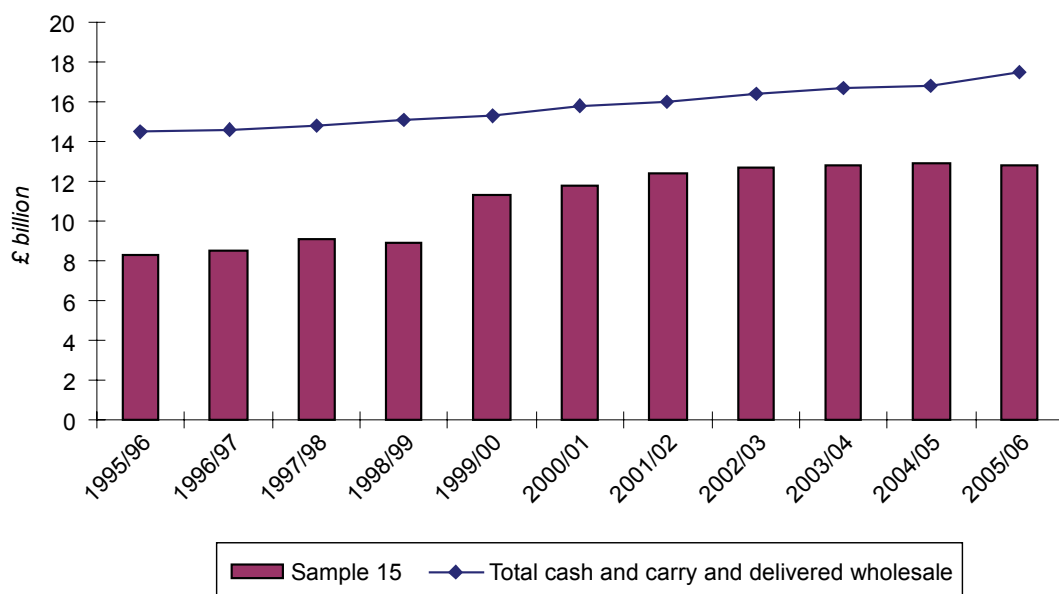
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<sup>11</sup>The profitability analysis assumes that all revenue and costs fall in the calendar year which the majority of a company's financial year is attributable to. For example, a company's accounts that are compiled for the year ended 31 March 2006 will be allocated to the 2005/06 calendar year. IGD figures are for the calendar year.

<sup>12</sup>Sales for the sample 15 are not available for 2006/07 as not all companies have reported results.

FIGURE 2

**Grocery wholesalers, revenue, 1994/95 to 2005/06**

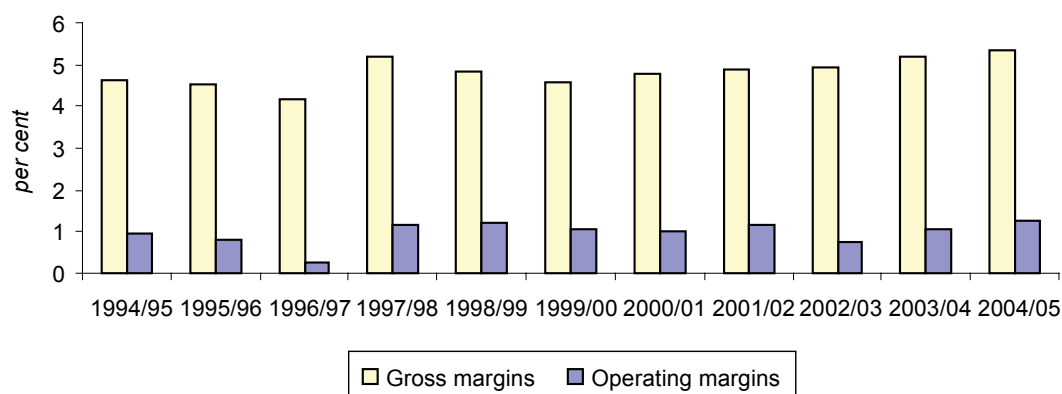


Source: IGD UK Grocery and Food Service Wholesaling March 2007, Companies House.

14. In the period 1995/96 to 2005/06 the 15 largest grocery wholesalers collectively achieved gross margins of between 4 and 5 per cent, and operating margins of around 1 per cent (see Figure 3).

FIGURE 3

**Fifteen largest grocery wholesalers, gross and operating margins, 1995/96 to 2005/06**



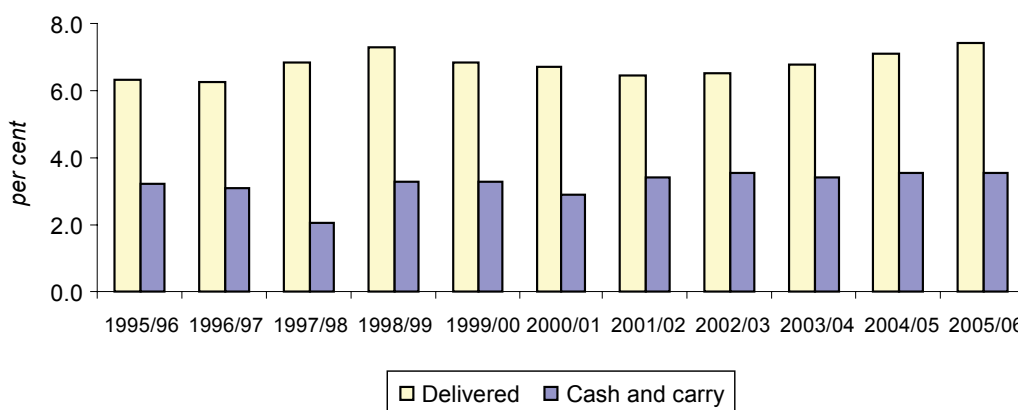
Source: Companies House data.

15. A comparison of gross margins between cash-and-carry and delivered wholesalers (see Figure 4) shows significant variance between the two sectors. The higher gross

margins in delivered wholesaling are accounted for by the provision of delivery and other support services. These services are incorporated in the price charged by delivered wholesalers which results in higher gross margins. At the operating level, after operating costs are deducted, margins are more comparable between delivered and cash-and-carry wholesaling (see Figure 5).

FIGURE 4

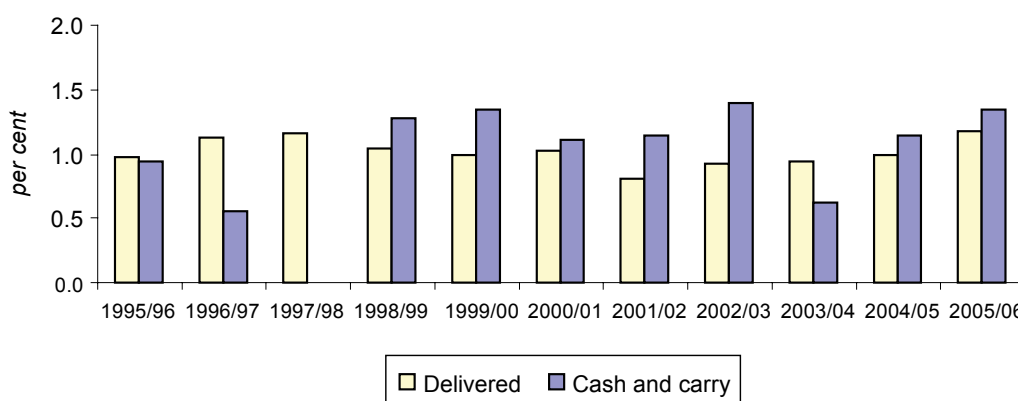
**Grocery wholesalers, gross margins, cash-and-carry versus delivered wholesalers, 1995/96 to 2005/06**



Source: Companies House data.

FIGURE 5

**Grocery wholesalers, operating margins, cash-and-carry versus delivered wholesalers, 1995/96 to 2005/06**

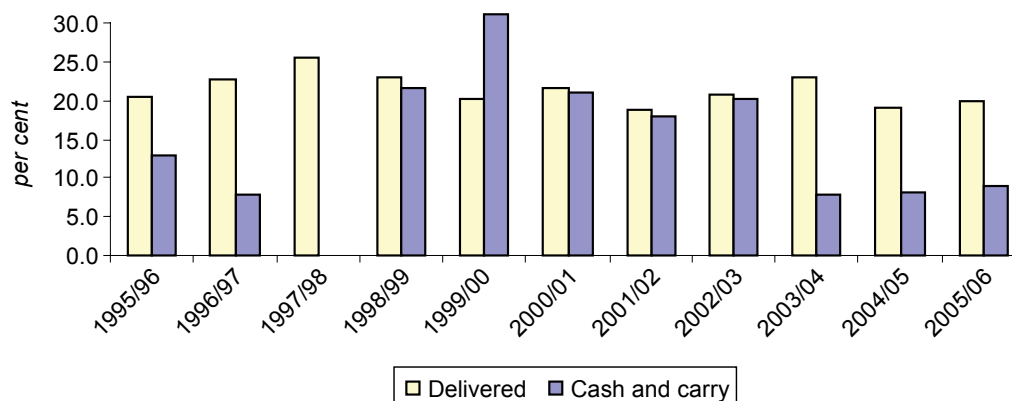


Source: Companies House data.

- The largest variances between the two sectors' operating margins were in 1996/97 and 1997/98 when two of the largest cash-and-carry wholesalers, Makro and Booker, experienced operating losses (see Figure 6).

FIGURE 6

**Grocery wholesalers, return on capital employed, cash-and-carry vs delivered wholesalers, 1995/96 to 2005/06**



Source: Companies House data.

17. Figure 7 shows the comparative return on capital employed (ROCE) for delivered wholesalers and cash-and-carry wholesalers: delivered have had steady returns while cash-and-carry have experienced declining returns since 2000/01. However, in 2005/06 cash-and-carry wholesalers still derived an average ROCE of more than 9 per cent compared with an average 8.5 per cent for grocery retailers in that year.<sup>13</sup> This indicates that returns may still have been at an acceptable level.<sup>14</sup>
18. While our analysis has focused on the 15 largest grocery wholesalers, the IGD has also noted that there are a significant number of smaller, regionally focused wholesalers, which continue to thrive, and attributes the resilience and success of these wholesalers to low-cost environments, and a strong culture of group trading. Group trading is where smaller operators combine to form buying groups to realize the scale and characteristics of the larger national competitors.<sup>15</sup> As a result, it does not appear that smaller wholesalers are intrinsically less profitable than the larger wholesalers discussed above.

<sup>13</sup>Calculation based on the average ROCE for six of the largest grocery retailers using Companies House data.

<sup>14</sup>Wholesalers usually have lower operating margins compared with retailers but comparable ROCEs. This is consistent with wholesalers having a higher asset turnover. Exceptional items have been excluded from the calculation of operating profits.

<sup>15</sup>IGD, *UK Grocery Wholesaling: A Strategic Guide*, p26, March 2006.

## Wholesaler vulnerability to declining trading volumes

19. We have considered the extent to which grocery wholesalers would be vulnerable to declining trading volumes that might be associated with the loss of a large number of convenience store customers. Some grocery wholesalers have told us that as a large proportion of their cost base is fixed, a decrease in sales volumes below a certain critical mass would mean that their businesses were no longer viable.
20. Of the largest cash-and-carry operators, Makro told us that a [redacted] per cent reduction in turnover would make its business unprofitable, while Bestway estimated this figure at [redacted] per cent (although it told us that this estimate was based on a very simplified calculation). Costco told us that, based on central costs remaining fixed, a drop in turnover of about [redacted] per cent would make its business unprofitable. However, it added that the business would become unviable at a much smaller decline in turnover as shareholders would demand an adequate return on investment.
21. Palmer & Harvey provided its own break-even analysis and calculated a decline in turnover of [redacted] per cent based on current volumes and fixed costs. However, it argued that this estimate was highly judgemental and, in the event of such a reduction in turnover, the business would be restructured to handle lower volumes.
22. We considered the likelihood of turnover declining by 20 to 40 per cent in the foreseeable future. The IGD, contrary to the arguments put to us by a number of wholesalers, predicted in its publication *UK Grocery Wholesaling: a strategic guide, 2006*, modest growth for the wholesale industry. It forecast that the grocery wholesale industry would grow to £18.4 billion by 2010, representing an annual growth of 1.6 per cent over the five-year period 2006 to 2010. Turnover, as shown above, actually increased to £17.5 billion in 2006, up 4.1 per cent on 2005, and only £0.9 billion less than the 2010 forecast figure.

23. The IGD in its 2006 report also forecast that the delivered sector would continue to fare better than the cash-and-carry sector. Delivered wholesale, which was expected to benefit from the anticipated ongoing growth of related symbol groups, was expected to grow to £8.9 billion in turnover by 2010. Cash and carry was expected to remain stable at about £9.5 billion.<sup>16</sup> The IGD reported turnover figures for 2006 were £8.1 billion for delivered and £9.4 billion for cash and carry.
24. The IGD cautioned that these forecasts were vulnerable to future acquisitions in the convenience sector by the grocery retail chains, which could potentially undermine the wholesaler's customer base. The scope for this to occur, however, seems limited given that a majority of convenience stores are now independently owned and, as a result, there are few large convenience store chains potentially available for purchase. However, even if the customer base for grocery wholesalers was to reduce, either through acquisitions by grocery retail chains or by market exit, we consider it unlikely that a tipping point will be reached where the grocery wholesale industry is no longer viable. A more likely scenario, in the event of a contraction of the customer base, is consolidation within the sector. This would be consistent with the ongoing trend towards industry consolidation that has been observed since 1994.
25. The FWD argued that a decline in the wholesaling industry might happen at a regional level, and that convenience stores in remote locations would be more likely to suffer from a lack of wholesaler choice. It provided data showing a decrease of 278 cash-and-carry outlets in the UK in the period 2000 to 2006, a decline of 40 per cent.<sup>17</sup> In particular, it highlighted four areas: the West Country and surrounds, mid/north and west Wales, East Anglia and surrounds and Southern Counties where there was more limited choice in cash-and-carry outlets than the rest of the UK.

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<sup>16</sup>The IGD made no equivalent forward forecast in the 2007 report: *UK Grocery and Food Service Wholesaling*, March 2007.

<sup>17</sup>FWD data based on 'Pro Wholesaler—Cash and Carry Big Book'.

These areas showed a significant number of locations where Booker was the only cash-and-carry operator. We do not, however, consider that a lack of wholesaler choice will necessarily result in a decline in the number of convenience stores in an area due to higher wholesale prices. Grocery wholesalers have a strong incentive to ensure that the convenience stores that they service, and which are competitively constrained by mid-sized and larger grocery stores, remain viable.