



McKINNA *et al*
Strategic Insight
Global Outlook

Senate Select Committee

Inquiry: Australia's Food Processing Sector

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1. Introduction

Australia's food processing sector is struggling to compete globally. There have been a series of very high-profile announcements of factory closures in regional Australia recently, resulting in the loss of a large number of jobs and triggering significant economic flow on effects in these local economies. Australian food companies are reporting heavily downgraded profits and in some cases, substantial losses. Companies that once consistently achieved high profits are now struggling to cover their cost of capital.

For economic reasons, multinational food companies operating in Australia are being forced to import products to market under their local brands, often from their own manufacturing facilities in other countries. CEOs of large food companies remain pessimistic about the Australian food manufacturing sector and predict that a further decline is inevitable. As such, they are reluctant to make further investment in their Australian operations. In recent years, this situation has been blamed on the strong \$AUD and the terms of trade driven by the mining boom, but there are other factors at play (which will be detailed in this submission).

I put forward this paper for consideration by the Senate Select Committee on the basis that, as a practicing consultant to the food industry, I have the advantage of a wide perspective across a number of Australia's leading food companies. The insights presented in this submission are based on a career spanning over 30 years as a consultant to the Australian food sector, advising both government and private enterprise clients alike. With a career background in government policy development as well as a client base that has included virtually every major agrifood producer in Australia, I



am well placed to observe the failures of the interface between government and industry that have contributed to this situation.

The other point I would make is that many food processing companies would be reluctant to express those views so frankly for fear of the commercial consequences.

Over the last thirty years, my consultancy McKINNA *et al* has worked extensively with the major food companies, conducting business analysis, market development and strategic troubleshooting projects. Over this time, we have identified a number of factors which collectively reduce the competitiveness of Australia's food industry.

This submission aims to identify and summarise those factors, as I observe them, that are impacting on the competitiveness of the Australian food processing industry and contributing to its decline. It does not drill down into any depth of detail as it is presumed that the Senate Select Committee has the resources to conduct the necessary further research.

I am available for further inquiry if required.

Dr David McKINNA
Principal
McKINNA *et al*



2. The structure of the Australian food processing sector

Overwhelmingly, the major food processing companies in Australia are now owned by multinationals.

Typically, these companies manage a portfolio of global brands supplied from a stable of processing plants strategically located to reduce shipping and manufacturing costs as well as minimise currency exposure and commercial risk. Production facilities are increasingly in low cost Asian countries. As such, the multinational marketers have no particular allegiance to Australia and make decisions about their sourcing and processing locations based on hard economics.

Historically, the Australian food processing sector was largely comprised of farmer-owned cooperatives. Most of the value-adding of farm produce (including fruit and vegetable canning and processing, dairy factories and abattoirs), took place in grower-owned businesses. Progressively, these farmer-owned cooperatives were forced to corporatize, because of their inability to raise capital for expansion (due to the limitations of the Cooperatives Act under which they operated, which prevented retaining profits and limited the ability to raise debt). Cooperatives had certain tax advantages, but with this came restrictions, such as the ability to retain earnings for future capital investment. There were also limitations on their ability to borrow because of the structure of their balance sheets, whereby the grower shareholdings were treated as a liability rather than an asset. This meant that they had low levels of collateral to borrow against.

As a consequence, most cooperatives were forced to open up their share registers to private investors and this made them targets for takeover bids from multinational companies because typically, their shares



were undervalued. In most cases, these takeovers were welcomed because the financial state of the cooperatives had deteriorated due to the restrictive trading platforms. Most would not have survived without an injection of outside capital. Aside from one or two notable exceptions (e.g. Murray Goulburn), these cooperatives are now wholly owned subsidiaries of multinational food companies.

Sitting below the large multinationals is a layer of SME food companies which are often family-owned businesses. In fact, in employment terms, the food sector is overwhelmingly comprised of SMEs. Many of these succeed through servicing niche markets, often taking their product to market through non-supermarket channels. Although less exposed to the global pressures of the mainstream food industry, many are struggling for the same reasons as outlined in this paper.

3. Factors affecting competitiveness

There are seven common themes that have been identified by the McKINNA *et al* consultancy team that influence Australia's food producers of all sizes and industry segments. The seven key factors undermining the global competitiveness of the Australian food processing sector are:

1. The supermarket oligopsony power.
2. The impact of supermarket private label programs.
3. Labour availability, cost and training.
4. The high cost of raw materials.
5. Transport and infrastructure cost and limitations.
6. Compliance costs.
7. Food labelling regulations.



These factors are discussed in further detail in the following pages.

3.1 Supermarket oligopsony power

Over the last ten years, there has been a shift in market power further along the supply chain, away from food processors and towards supermarkets. Various analysts estimate that Coles and Woolworths now control 70% of the packaged food market. This gives these two retailers tremendous oligopsony power which translates into dominant bargaining power over their suppliers. McKINNA *et al* research estimates that the various market shares of Australian food retailers are approximately:

Retailer:	Estimated market share:
Woolworths	40%
Coles	32%
Metcash	7%
Aldi	4%
Foodworks	2%
Spar	1%
Franklins	1%
Other	13%

Source: McKINNA *et al* estimates



Coles and Woolworths account for a very large part of the turnover of most large-scale food processors – up to 70% in some cases. For such companies, the loss of either the Coles or Woolworths business would dramatically undermine their profitability because of the decrease in the volume output throughput of their factories. The loss of both would have devastating consequences. Such a decline in volume would impact efficiency, economies of scale and overhead recovery enormously. Consequently, large Australian food businesses have little option but to yield to the pressure of the supermarkets to reduce prices and/or margins. This dynamic gives the supermarkets immense market power.

Multinational, fast food restaurant chains (e.g. McDonalds or KFC) also have considerable market power in Australia. In the case of frozen and shelf stable foods, they have the option to import from global suppliers. Local suppliers must match the price of the imported product or lose the business, again, with the same impact on profitability and overhead recovery.

Supermarkets have not only used their market power to reduce prices, but also to drive changes in the way food is produced in this country. Coles, for example, has introduced hormone growth promotant-free (HGP free) beef and plan to phase out cage laid eggs in its private label offering (which accounts for 70% of egg sales). Such moves will have a significant impact on both production costs and the profitability of these industries. Such change will lead to a fundamental restructuring of entire industries.



Recent government inquiries have found that the supermarket behaviors are not anti-competitive, in the sense that they do not disadvantage consumers. This is certainly true; competition on the selling side is intense and has contributed to a deflationary food environment. Consumers are benefitting greatly; in the short term at least. The issue of an imbalance of market power rests on the buying side - a situation that economists refer to as 'oligopsony power.'

Although there are large powerful supermarkets in most developed countries, to the best of my knowledge, nowhere else in the world is the market power so concentrated that two companies control 70%+ of the market.

3.2 The impact of supermarket private label programs

Apart from their immense buying power, supermarkets have another potent tool at their disposal - private label or 'house brand' products. Private label products are those sold under the supermarkets' own packaging and logo or with a brand exclusively owned or managed by them. Private label marketing has been evident for at least 30 years, but has only recently started to be embraced by Australian shoppers. Due to a history in Australia of inconsistent quality, poor packaging and a lack of marketing prowess, Australian shoppers were slow to adopt private label products. In the past few years, Australian retailers have revamped their private label offer to the point where increasingly, shoppers see these products as being as good as the proprietary brands but at a far cheaper price.

Private label now accounts for approximately 25% of all groceries sales in Australia and it is forecast to reach 30% within two years. In the UK, private label products account for up to 70% of sales in some chain stores. However, private label dramatically erodes the profitability of food processors on four fronts:



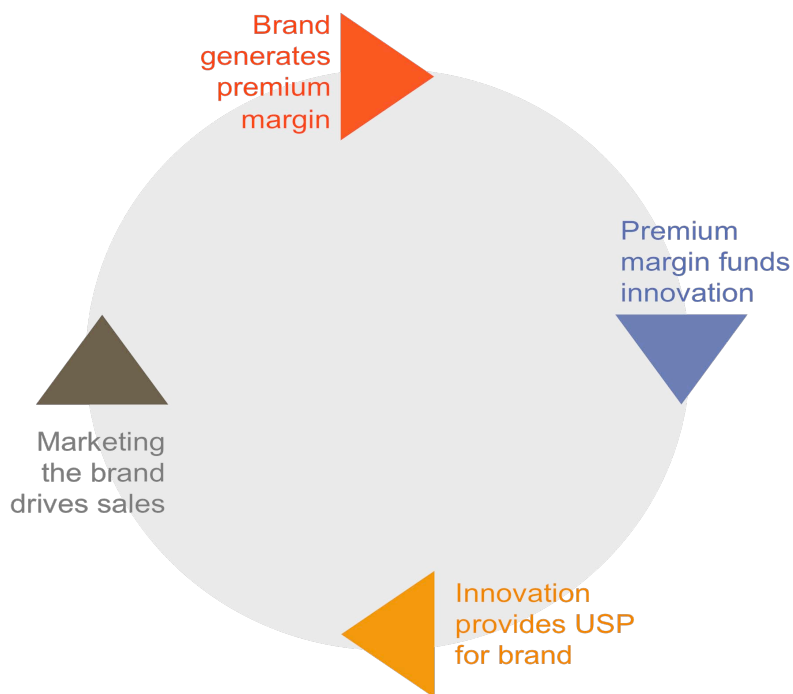
1. It takes market share from their own brands, which impacts on factory volume and therefore, overall costs.
2. Food companies have to shift their marketing spend from so-called above-the-line advertising (media advertising that directly promotes their brands) to below-the-line sales promotions (i.e. price discounting that tends to dilute their brand), in order to maintain their sales volumes. Without marketing support, proprietary brands are weakened which makes them vulnerable to substitution by private label products.
3. Private label brands devalue a food category because processors have to reduce prices and offer promotional discounts to defend their market share; therefore the price of that whole category reduces.
4. When processors pack the private label products for supermarkets as an adjunct to their own proprietary product, the profit margins are usually much less than they make on their own branded product.

Increasingly, private label product is being imported, largely due to the strong Australian dollar. This cuts local manufacturers out of the picture totally and forces them to compete against import prices on the shelf.

Strong proprietary brands are essential to fund innovation and investment as illustrated on the following chart:



The virtuous circle of brand development



USP = Unique Selling Proposition

Strong proprietary brands generate premium profits over and above those earned from manufacturing per se. A large part of this premium is typically reinvested into new product development and innovation to fund the next generation of products which are essential to refresh the brands. Private label takes away the ability to generate the profits required to fund innovation.

3.3 Labour availability, cost and training

Food processing remains highly labour intensive. Despite the advancements in new technologies such as robotics, most Australian food factories still have a high labour component reflected in their costs. A further issue is that many processors have peaks and troughs in their labour requirements as the raw material supply for food manufacturing can be highly seasonal. Fruit and vegetable crops in particular have a short harvest



window and usually have to be processed immediately. This situation leaves agrifood companies with two options:

1. Maintain their workforce in the off-season, despite low productivity;
2. Pay a premium for seasonal labour in the high season.

In both cases, labour for processing seasonal food products is usually higher than other types of manufacturing. Since the mining boom, sourcing unskilled and semi-skilled seasonal labour, particularly in regional Australia, has become a major issue for food companies.

Recent McKINNA *et al* research right across Australia indicated that recruiting, retaining and motivating staff was the number one issue for employers in the agrifood domain. Skills such as engineering, diesel mechanics, refrigeration technicians, food technologists and factory managers are especially difficult to source. Some agrifood producers have gone to the point of conducting all recruitment overseas, without even running advertisements in Australia, because of difficulty in finding key staff such as farm managers locally.

Australian labour, taxation and workplace laws, together with union influence, have made wages higher in Australia, compared to overseas countries where workplace conditions are less generous. Labour on-costs such as compulsory superannuation, occupational health and safety compliance, payroll tax and other requirements add substantially to the total labour costs.

The issues of penalty rates and job security requirements are especially onerous for industries where there is a seasonal supply situation. The tightening up of visa laws (particularly 457 and 417), have also made it more



difficult for producers to recruit contract migrant labour for seasonal needs.

The other dissonance in the food processing sector comes from the lack of engagement between industry and educators. Businesses often complain that universities and TAFE colleges are not producing the skill types and levels required, because they are not well connected with industry. The pathways for students between training and job outcomes can be rather *ad hoc*.

3.4 The high cost of raw materials.

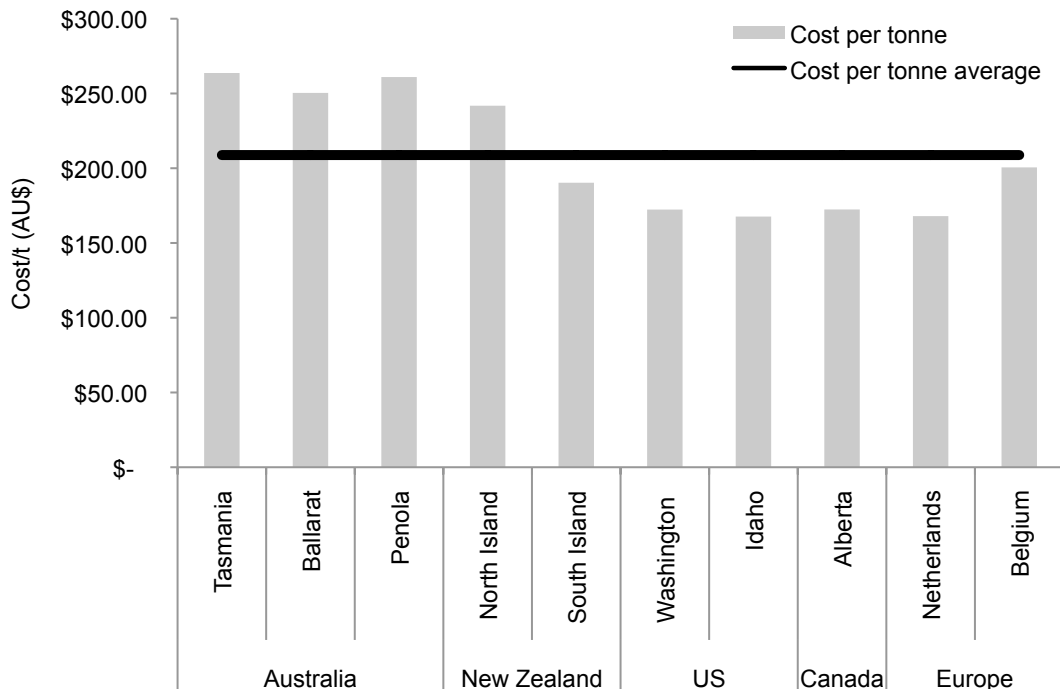
Although this issue varies considerably from category to category, in some cases, Australia's lack of price competitiveness is due to the high cost of locally produced raw materials. In the vegetable sector in particular, major Australian processors have moved their processing operations to New Zealand or Asia in recent years because of this. Alternatively, some now rely on frozen or semi-processed imported inputs.

The following is a case study of a project that McKINNA *et al* conducted on behalf of McCain Foods Australia, which benchmarked the cost of raw potatoes for use in French fries production across ten regions around the world. This information has been provided with the permission of McCain Foods Australia Limited.

The following tables show a comparison of the cost of raw potatoes at the factory-delivered price in ten regions around the world. The first table illustrates the cost per tonne at a \$USD exchange rate of 74c and the second, cost per hectare at 99c to the Australian dollar.



**Table 1: Costs per tonne in \$AUD to produce processing potatoes.
Calculated in \$AUD at \$USD 0.74 exchange rate.**

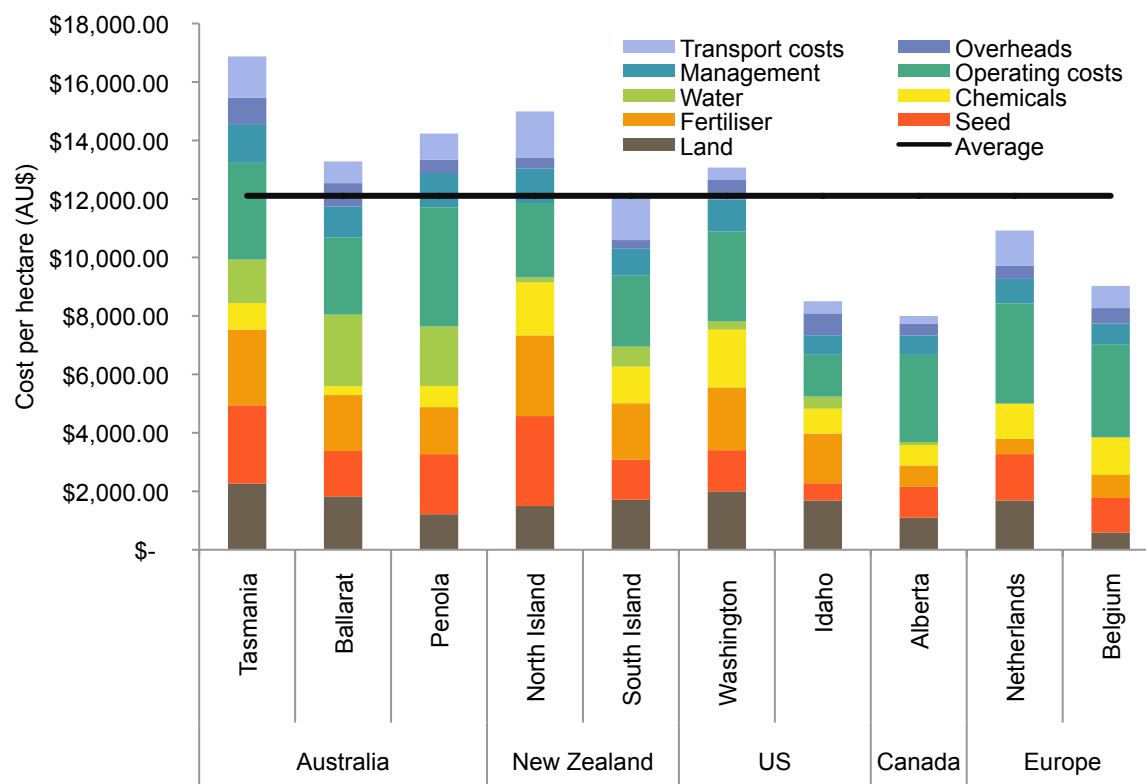


Provided with permission from McCain Foods Australia.

The above graph indicates that even under a reasonably favourable exchange rate, Australia is globally uncompetitive by a large margin.



Table 2: Comparison of production costs per hectare for processing potatoes. Calculated in \$AUD at exchange rate of USD \$0.99.



Provided with permission from McCain Foods Australia.

The cost to produce raw processing potatoes in Australia is around double that of North America for an identical item on a per hectare basis. Although the costs of inputs e.g. fuel, labour, etc., are significantly higher in Australia, a bigger issue is yield and productivity. Cost of water, including pumping and irrigation is also significantly higher in Australia. Typically, farms in Australia pump with diesel power because of the cost or lack of availability of electricity. This situation will only get worse with the carbon tax and because of the privatisation of power supply.



Although Australian farmers claim that they are the most efficient and adaptive in the world, this study shows that this is not always the case. A major factor contributing to the higher raw material cost is to do with farming practices. Historically, state departments of agriculture invested heavily in research, development and extension services which gave Australian farmers a leadership advantage with farming practices. However, over the last decade, almost all states have pulled right back from this and have left R,D&E to the private sector or industry associations. Unfortunately, the private sector has not filled the gap left by the departments of agriculture.

3.5 The transport cost and infrastructure limitations.

Another key contributor to Australia's lack of competitiveness in food manufacturing is the high transport costs and the weaknesses in Australia's transport infrastructure. The vast majority of food, both unprocessed raw food, processed food and inputs into processing, are transported by road. Over the past decade, since the state governments have privatized the rail systems, there has been a lack of investment in rail, both in track infrastructure as well as in rolling stock. As a result, the rail system is now unreliable and has limitations with respect to speed and weight.

Food companies, therefore, move almost all their product by road. Rail is only competitive for heavy loads over long distances (which really only applies to bulk grains).

Road freight costs are set to increase for the following reasons:

1. *The removal of the fuel rebate, which is due in 2013 under carbon tax legislation (which at the time of writing was going through the House of Representatives).*
2. *The high capital cost of trucking equipment.*



3. *Difficulty in getting drivers and restriction on driving times.*
4. *Road restrictions or weight limits for B-doubles and the inability to use B-triples and road trains.*
5. *The congestion on the road system*
6. *The high cost of insurance.*
7. *Restrictive licensing and regulation differences across state boundaries.*

The situation is such that a food processor that exports from inland NSW to key markets around the world, cannot fully load 40-foot freezer containers because of road weight limits. Effectively this means that the business is paying for the full cost of a container with a 35 tonne capacity and yet only being allowed to load this to somewhere around half this level, effectively doubling the freight cost per tonne.

3.6 Compliance costs.

Another significant factor for processors is the cost of compliance to meet the various federal, state and local regulations, together with the food standards of the major supermarkets. Businesses complain that they have to carry additional staff just to deal with the large amount of paperwork required with respect to compliance. The lack of uniform regulation across the state boundaries means that companies operating in different states have to meet different compliance requirements, leading to duplication of effort. A food business must comply with a labyrinth of federal, state and local government compliance requirements.



3.7 Food labelling

Many in the agrifood sector believe that the looseness and ambiguity in Australia's food labelling laws is another factor in our diminished competitiveness. Food companies are divided on the issue. Some people argue that if Australian consumers had their choice of buying Australian and if this was clearly indicated, that it would be a major benefit to Australian producers. The view is that a high percentage of Australians are loyal to 'Australian made' goods but that the packaging does not guide them accurately.

The issue is that in many cases, the food is not clearly labeled from the place of origin and consumers are unknowingly being duped. For example, a food product can have a high overseas content and still be labeled as 'Product of Australia.' A recent project by this consultancy revealed an extreme example of this - a seafood product was being caught in the Atlantic Ocean, frozen at sea on a Korean vessel, landed in China for first stage processing, imported into New Zealand, repacked as product of New Zealand and then shipped to Australia to be thawed, reprocessed and crumbed here. This product was sold in Australia as 'Product of Australia', competing against Australian-caught fish from the local fishery on an equal basis. Other examples of this situation are often quoted in the media.

Not all food companies will agree on the issue of food labelling. Some have trialed promoting 'Australian made' campaigns and have found these to be a dismal failure. The vast majority of consumers, in fact, purchase on the basis of price and taste factors. In reality, the level of loyalty to 'Australian made' product is low.

In a trading environment where more food than ever is being shipped around the world, the practicality of being forced to comply with strict country of origin laws is problematic for many producers who source inputs globally. For example, a food company may have a crop



failure due to seasonal factors and be forced to import inputs to maintain the listing of their product on the supermarket shelves, i.e. in a mixed frozen vegetable pack, it may be necessary for a food company to import broccoli because there was none available locally. Even though all the other product in the pack is Australian and the product is packed in Australia, strictly speaking the 'Grown in Australia' label cannot be applied. This puts the company at expense of developing new packaging material, creating new barcodes and product codes, segregating the product in its value chain and supply chains, etc. Tighter, multinational labeling laws would make it harder and more costly for this company to sell imported product under its brands but at the same time, it could jeopardize sales of local product.

The recent release of the draft code on nutritional labeling has been met with dismay by the food industry. It has been seen by many to be just another hurdle that they must deal with. Nutritional labeling is necessarily complex and even the health professionals cannot agree. Food companies are struggling to see the logic of a system which rates some categories of fruit negatively with a red traffic light because of their high sugar content (derived of naturally occurring fructose).

Nutritional labeling is necessarily complex and conflicting. It is unrealistic to expect to be able to develop a scheme which can give consumers an accurate picture on a food pack. The focus needs to be on consumer education so that they can make informed choices around the needs of each family member.



4. Prognosis

For reasons that have been explained above, it is difficult to be optimistic about the future of Australia's food manufacturing sector. Most economists predict that the \$AUD will stay at near or above parity with the \$USD for as long as the mining industry continues to boom - predicted to be as long as the next five to ten years. By then, much of Australia's food processing will have moved off-shore.

Food companies argue that the \$AUD would have to be somewhere around US\$0.75 to be competitive globally and this seems a long way off at this point in time. But even if the \$AUD does fall, for reasons demonstrated earlier, this doesn't necessarily mean that Australia will automatically become globally competitive.

With low profitability and a prevailing sense of pessimism in local food manufacturing, it is not surprising that multinational food companies are uncomfortable about investing in manufacturing assets in Australia. As they make decisions about production expansion to service the growing markets of India and China, offshore investment is obviously more attractive. This situation comes at a great cost to regional Australia in particular. The loss of jobs in towns like Girgarre has major flow on effects in the local community. Commonly, it is the food processor that is the major employer in a particular region and the closure of just one plant can have a major impact not just on jobs, but also on the social health and optimism of the overall community.

It is likely that in the future, Australia's food processing industry will be confined to first stage value-adding of those commodities in which we have a competitive advantage in growing. We can be competitive in large-scale agrifood production that requires minimal labour, including bulk grains, sugar, beef, lamb and milk. These



commodities will then go overseas for further downstream processing. It is significant that overseas investors, including sovereign wealth funds, are investing in this class of asset in Australia because they see it has a future. The sovereign wealth funds are particularly interested for food security reasons.

However, for food products where there is a high labour content or the cost of raw or materials is high, Australia is not competitive and these industries will gradually die. High labour, fresh food products will only remain viable because it is not practical to ship them cost effectively, e.g. washed lettuce mix.

5. Policy frameworks

Presumably the purpose of the Senate inquiry is to develop policy frameworks that will provide the foundations for Australia's future competitiveness, food security and to foster investment in the Australian food industry. Without attempting to be prescriptive, in a broad sense, it is my view that the policies should be built around:

1. Incentives for investment in innovation and efficiency such as accelerated depreciation and grants.
2. Labour reforms which provide more flexibility for the 24-hour, seasonal nature of the work.
3. Improving education, training and industry engagement in this.
4. Investment in road and rail infrastructure.
5. A commitment by government to re-invest in improving the productivity of Australian farms.
6. Raising awareness of Australian farmers in how global supply chains work and adapting their



business model to the most appropriate supply chain.

7. National uniformity and streamlining of compliance requirements.
8. A sensible approach to food labeling,
9. A focus on consumer education with respect to diet and nutrition rather than prescriptive nutritional labeling.

The issue of the high Australian dollar is a difficult one. The move back to a protectionist market would be a totally counterproductive step.

Consideration could also be given to additional tax concessions for businesses operating in regional Australia, where most of the food processing industry is located. This may encourage investment.



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Dr David McKinna
DDA, BEc (Hons), MEc, PhD

Career Summary

Dr David McKinna has spent the best part of his career as the principal of strategy consultancy McKINNA *et al*, which he founded in 1983.

McKINNA *et al* has a long history of strategy and marketing consulting in sectors as diverse as food and beverage, fast moving consumer goods (FMCG), agribusiness, banking, education, retail, home improvement, packaging and public governance. The consultancy has long-term relationships with a blue chip client base and is known for solving strategic challenges that others have refused to take on.

McKINNA *et al* has a global project history spanning Asia, North America, Europe and India and advises an international client base comprising market-leading brands.

David McKinna is frequently quoted in the media for his business insights and is known as a leading opinion maker in the agrifood domain.



Previous Roles

1970 – 1980	Ministerial Advisor Department of Agriculture, Victoria
1980s	Economics and Business Lecturer Monash University
1980 – 1983	Marketing Director Victorian Egg Marketing Board (now Farm Pride)
1980s	Acting Strategy Director Meat and Livestock Australia
1990s	Chairman Monash University Agribusiness Advisory Board

Career Achievements

- Contributor to some of the most successful and award winning strategic marketing solutions in Australia such as MLA's turnaround strategy for red meat consumption; Woolworths 'The Fresh Food People' program; and the award-winning 'Big M' milk strategy for Australian Milk Marketing.
- Delivered major global market development projects for Australia's key food products including meat, fruit & vegetables, eggs, seafood, dairy and wine in Asia, Europe, North America and the Middle East.
- Author of highly influential government advisory reports on the food and beverage and agribusiness sectors.
- A successful history in the home improvement sector consulting to leading brands such as Boral, Dulux, Yates, Mitre10 and Black and Decker.



- Successful crisis management for BankSA which averted the potential collapse of the bank in the 1990s.
- A founding father of the David Syme Business School (now Monash) and the Agribusiness program at Monash University.
- Considerable media and public speaking exposure often on sensitive and highly political issues.
- Expert witness in precedent setting legal cases in Australia and Europe, largely in the food and beverage domain.

Qualifications & Professional Associations

PhD Business Marketing - *Cornell University (USA)*

Master of Economics - *Monash University*

Bachelor of Economics (First Class Honours) - *Monash University*

Diploma of Agricultural Science - *Dookie College*

QPMR - Australian Market & Social Research Society

AFAMI CPM - Australian Marketing Institute



Directorships

1983-2010	McKINNA <i>et al</i>
1990s	Surf Life Saving Australia
1990s	Monash University Agribusiness Advisory Board (<i>Chairman</i>)
1986-88	Victorian Egg Marketing Board (<i>Now Farm Pride</i>)
1986-88	Good Foods Limited
1984-87	Australian Apple & Pear Corp (<i>now Horticulture Australia Ltd</i>)
2009	Timbercorp (<i>Appointed to engineer turnaround strategy thwarted by GFC</i>)

A sample of McKINNA *et al* food processing clients

Berri
Sunbeam
Simplot
McCain Foods
Heinz Watties
Golden Circle
SPC Ardmona
Colonial Farm
Sun White Rice
General Mills

