Vertical integration in grocery retailing

A perspective on strategy versus opportunism
Contacts

Vienna
Harald Dutzler
Partner
PwC Strategy& Austria
+43-664-515-2904
harald.dutzler@strategyand.at.pwc.com

Johannes Greller
Manager
PwC Strategy& Austria
+43-664-515-2916
johannes.greller@strategyand.at.pwc.com

Munich
Dr. Peter Hochrainer
Principal
PwC Strategy& Germany
+49-172-233-7765
peter.hochrainer@strategyand.de.pwc.com

About the authors

Harald Dutzler is a leading practitioner for Strategy&, PwC’s strategy consulting business. He is a partner with PwC Strategy& Austria, based in Vienna, focusing on cost transformation and organizational development as well as supply chain management in the fashion and sports retail industry.

Dr. Peter Hochrainer is a principal with PwC Strategy& Germany, where he is part of Strategy&’s retail and consumer practice. Based in Munich, he has extensive experience in large-scale Fit for Growth* programs with specialization in strategic procurement, supply chain management, production, and production networks.

Johannes Greller is a manager with PwC Strategy& Austria, where he is part of Strategy&’s retail and consumer practice. Based in Vienna, he has significant experience in holistic value chain transformations for FMCG companies and retailers. He specializes in large-scale Fit for Growth* programs with focus on category management, supply chain management and organization transformation.

*Fit for Growth is a registered service mark of PwC Strategy& Inc. in the United States.
INTRODUCTION

Vertical integration is accelerating in the grocery industry. The number of M&A deals involving European grocers buying suppliers has risen dramatically, up 133 percent between 2016 (six deals) and 2017 (14), and it continues to climb. Vertical integration is not a new concept for grocery retailers; at some organizations, the approach dates back to the 1950s, and most grocers have some kind of private-label business in place, typically involving third-party manufacturing. But until recently, most companies have limited their efforts to a few product categories or a few steps along the value chain, with little strategic coherence. This is in stark contrast to other industries, in which innovative companies have completely disrupted traditional players by integrating along the entire value chain: sourcing their own materials, developing private-label offerings that can compete with national brands, and getting those into the homes of consumers through new last-mile solutions.

The recent push among grocery retailers to vertically integrate stems from three main causes. As the market evolves, grocers need to:

• Control costs along the entire supply chain (rather than just claiming a slice of profits through private-label products)
• Increase transparency across the entire supply chain
• Holistically manage and produce key product categories

To succeed, management teams will need to move beyond short-term, opportunistic decision making and instead develop a comprehensive strategy for vertical integration within key products. Moreover, they need to build up the capabilities to execute that strategy and understand the implications it will have on their business model.

“In the past vertical integration in grocery retailing often was born out of necessity.”
A lesson from other industries

Grocers are not alone. Other industries have had to respond to technology-driven disruptions that eliminated retailers’ role as the main gatekeeper to customers. However, forward-looking companies in some of those industries have shown what is possible through vertical integration. Consider Inditex, the parent company of the fashion brand Zara. Through innovative sourcing, a smarter distribution model, and a heavy reliance on data to inform design choices and inventory, Zara has disrupted the retail apparel category. Clothing lines used to be planned out several seasons in advance, but Zara devised a way to get clothes from the design table onto store shelves in as little as two weeks.

Ikea is another well-known example. The company goes as far upstream as possible in the supply chain — including owning its own forests that provide the company’s lumber — and develops highly standardized components and finished goods, with a clear brand positioning in the market. Both Zara and Ikea sell only their own products in their stores, and both have taken significant market share from established players, making those competitors seem slow-footed and unresponsive to the market.

Vertical integration is the logical consequence of the decision for a private label portfolio.”

In grocery, there is a similar opportunity in vertical integration. Many companies have private-label businesses for a few product categories or along certain segments of the value chain (see Exhibit 1). For example, one German discount grocer uses contract manufacturers to sell its own branded detergents, health and beauty products, and stationery, differentiating those products through proprietary formulations and recipes. It also leases fields to grow its own fruits and vegetables. Similarly, a Swiss grocer operates production facilities that manufacture private-label products in categories ranging from dry goods, such as rice and coffee, to fresh goods (meat, fish, dairy, cheese, and bread).
EXHIBIT 1
Grocery value chain developments

<table>
<thead>
<tr>
<th>Origination</th>
<th>Production</th>
<th>Procurement</th>
<th>Logistics</th>
<th>Store</th>
<th>Last mile delivery</th>
<th>Consumer</th>
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**Forward integration of brand players**
- Brand equity for customer access
- B2C channels with stores and eCommerce

**Private label — purchasing**
- Building own brands
- Access to profit pool (brand mark-up)

**Backward integration — manufacturing and origination**
- Controlling total cost base

**New value-add — logistics and technology**
- For stores and last-mile

Source: PwC Strategy& analysis

In the past, this kind of limited approach was viable. Companies could launch small, targeted measures in a few categories where they saw an opportunity to capture part of an existing profit pool. Today, however, the market is shifting, and there are three reasons to think more strategically and comprehensively about vertical integration:

1. **Total cost control.** Grocery retailers face growing pressure to control costs more effectively, particularly as online grocers (which have an inherent cost advantage) begin to take share in dry-goods categories. Integration is one clear means of managing costs, because it can reduce the number of intermediaries along the supply chain (and their corresponding margins), eliminate brand-related markups, and decrease the process complexity of carrying multiple brands in a category.

“Economies of scale are an essential factor in the decision to vertically integrate — too low volumes make it fast unprofitable.”
2. **Transparency for customers.** The second factor is a need to increase transparency throughout the supply chain, from origin to end customer. As supply chains become more global and complex, grocers need to ensure a secure supply of products (including raw materials) and product quality and safety to avoid labor-related reputational risks in categories such as fruit and vegetables. Vertical integration creates this transparency and control, so that grocers have up-to-date, end-to-end supply chain information and customers are reassured that they know where their food is coming from. (New technologies such as blockchain are one means of creating this transparency. Blockchain allows specific product attributes to be verifiably documented online, so that grocers can confirm those attributes for customers.)

3. **Category ownership.** Third, vertical integration can help a grocer own a specific category, translating customer insights and preferences directly into new product and service innovations that can create value. This is an area where grocers have a distinct advantage over consumer packaged goods (CPG) manufacturers, which typically have had little information about their end customers. Online commerce has closed that gap somewhat — and created opportunities for some manufacturers to start selling directly to their customers. But for most sales in most categories, grocers still serve as gatekeepers to customer interactions, allowing them to gather insights and identify pain points and then develop innovative new offerings to solve those problems.

Notably, these three drivers affect fresh goods and dry goods differently. For fresh products, all three apply. Grocers that vertically integrate in these categories can optimize costs, increase transparency across the supply chain, ensure inventory availability, and become dominant in specific categories.

For dry goods, supply chain transparency is less important (because those supply chains tend to be more stable), but the cost advantages are relevant, and category ownership can help grocers defend against the threat of CPG companies selling directly to their customers through online channels (see Exhibit 2).
EXHIBIT 2
Drivers of vertical integration in different categories

<table>
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<tr>
<th>Drivers</th>
<th>Categories</th>
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<tbody>
<tr>
<td></td>
<td>Fresh</td>
<td>Dry goods</td>
<td></td>
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<tr>
<td></td>
<td>Fruit and vegetables</td>
<td>Food</td>
<td></td>
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<td></td>
<td>Bread and bakery</td>
<td>Beverages</td>
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<tr>
<td></td>
<td>Meat and sausages</td>
<td>Non-food</td>
<td></td>
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<tr>
<td></td>
<td>Dairy</td>
<td>Personal care</td>
<td></td>
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<tr>
<td></td>
<td>Convenience (incl. trend foods and organic products)</td>
<td>Beauty care</td>
<td></td>
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<tr>
<td>Total cost control</td>
<td>• Total cost optimization</td>
<td>• Total cost optimization</td>
<td></td>
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<tr>
<td>Supply chain transparency</td>
<td>• Availability in supply chain</td>
<td>• Defense against branded disintermediation</td>
<td></td>
</tr>
<tr>
<td>Category ownership</td>
<td>• Competence in food</td>
<td>• New value add</td>
<td></td>
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<td></td>
<td>Source: PwC Strategy&amp; analysis</td>
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Operating model implications

Vertical integration is not easy for grocery retailers. They are not natural manufacturers, and success requires assessing different operating model considerations (see Exhibit 3).

EXHIBIT 3
Total cost control and brand value

Cost control on:
- Logistics
- Intermediary steps
- Conversion costs
- Raw materials

<table>
<thead>
<tr>
<th>Product cost</th>
<th>Manufacturer margin</th>
<th>Private label contract manufacturing</th>
<th>Brand markup</th>
<th>Brand purchase price</th>
<th>Retailer margin</th>
<th>Sales price</th>
</tr>
</thead>
<tbody>
<tr>
<td>Private label contract manufacturing</td>
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</table>

Historically: Controlling profit pools
Nowadays: Controlling total costs

Source: PwC Strategy& analysis
Specifically, grocers must strike the right balance between owning assets — such as production facilities and logistics infrastructure — and employing another approach that lets them control assets without owning them. Similarly, they will need to build up production capabilities in key areas, which requires identifying and sharing best practices and capturing synergies across categories. Within each category, grocers must determine how controlling production will generate an advantage — for example, in costs alone, volume, depth of assortment, or flexibility. Finally, they must align their private-label offering with their overall category assortment strategy in a way that preserves relationships with CPG manufacturers while still retaining the advantages of integration.

These considerations are separate from the already-tough business of grocery retail. Accordingly, grocers should consider breaking integrated activities and assets into a separate unit within the organization. That unit should be aligned with the overall private-label business but should retain enough autonomy to build up the capabilities it needs to make fast decisions.

“Until recently the typical approach to vertical integration was rather opportunistic than strategic.”
Conclusion

The grocery industry is changing, and grocers must change too. Vertical integration is a key means for grocery retailers to adapt to this new environment and defend themselves against disruptive new entrants from outside the industry.

Key takeaways

• Technology-enabled disruptions in other industries, such as fashion, have already diminished those retailers’ role as the main gatekeeper to end customers. The same could happen to grocers, which means holistic vertical integration strategies are becoming a key capability.

• Vertical integration used to be a way for grocers to claim part of the profit pools of manufacturers. Today, it’s also a way to control costs across the end-to-end value chain.

• End customers increasingly want transparency regarding the source of their groceries, and vertical integration can help grocers create that transparency.

• As traditional manufacturers begin selling directly to consumers, vertical integration helps grocers dominate key product categories and thus capture customer insights that can inform future product development and innovation.
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