POLICY BRIEF: Barriers to entry in supermarkets

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Introduction

Modern retail formats and supermarkets, in particular, play an increasingly important role for consumers and suppliers alike in developing countries. Competition between supermarkets impacts on the pricing, quality, access, and choice of products and services to consumers. The conduct of supermarkets also has a crucial impact on suppliers as their main route to market. Competition in supermarkets therefore matters for its own sake and because of the far-reaching implications for the economy.

In this context, a recent CCRED study examined barriers to entry and growth in supermarkets in South Africa.[1] The study assessed the experiences of entrants, Fruit and Veg City (FVC) and Choppies, and considered the position of independent retailers working with buying groups. This brief draws together the main findings and considers policy implications.

Barriers to entry and how they can be overcome are particularly relevant in the South African context where there are significant challenges to opening up the economy to wider participation of historically disadvantaged individuals.

The formal South African supermarket industry is concentrated, with large supermarket chains - Shoprite, Pick n Pay, SPAR and Woolworths - dominating grocery retail markets. Nonetheless, Fruit and Veg City (FVC) has managed to make substantial inroads into the industry with an initial focus on fresh fruit and vegetables. A new player, Botswana-owned Choppies, has also recently entered South Africa and is growing strongly with a focus on low-income consumers.

The research assessed the experience of FVC, in particular, and considered whether it provides a role-model for others or whether it is the exception that proves the rule of high levels of concentration and the inability of smaller firms to be competitive. The study also identified issues faced by independent retailers

Key barriers to entry

The main structural barriers to entry in this sector are a function of the inherent characteristics of supermarket chains. Some of the biggest barriers are the substantial investments required in distribution centres and logistics networks as part of the supply chain of supermarkets, as well as scale and scope economies in having multiple stores. Investments in distribution centres by the largest supermarkets Shoprite and Pick n Pay have been significant and give an indication of the orders of magnitude involved. Shoprite invests annually in distribution centres, related equipment and vehicles. It invested around R400mill in 2014 and over R650mill in 2015 (an increase of 63%). In 2015, this was around 14%

[1] The research was funded by the National Treasury. The research is reported in CCRED Working Paper 2015/9, www.competition.org.za

of total capital expenditure. Pick n Pay invested R628 million in 2010 in one of its largest distribution centres in Longmeadow, as well as another similar investment in its Philippi distribution centre in 2012.

FVC overcame this barrier, *inter alia*, by focusing initially only in a niche area - fresh produce - and procuring daily directly from local municipal fresh produce markets. In addition to efficient management and lean operations, this assisted significantly in cutting costs. This also provided a source of demand for smaller farmers not able to deal directly with the large supermarket chains. It is important to note that while FVC appears to be a recent entrant, it began operations in 1993 and took close to a decade to gain traction. It, and other similar businesses, may have had a much greater effect, had barriers been lessened. As FVC built a footprint they could support investments in distribution centres and logistics networks.

On the back of strong growth in Botswana, South Africa and Zimbabwe, Choppies has also invested in two distribution centres in Rustenburg and seven more in Botswana and Zimbabwe, as well as owning a large fleet of trucks. Choppies thus was able to leverage off its business in neighbouring countries.

The growth of independent retailers (ranging from township spaza shops to modernized superettes and supermarkets) is a surprising finding from the study. It points to the relevance of retailers who know their local markets and can be responsive to needs of their consumers. This is an aspect which is sometimes ignored in the black industrialists debate. At issue is whether independent retailers can grow from a local base or the obstacles block this.

Spurred by income from social grants, independent retailers are an important alternative to national chain supermarkets for consumers, particularly low-income consumers in urban and township areas in South Africa. Bulk buying groups have reduced certain barriers to entry faced by independent retailers that procure through these intermediaries. Independent retailers are able to charge lower prices given their low overhead costs and lean margin operations. They are often flexible enough to meet the customised needs of their consumers, and regularly restock a limited range of fast-moving products.

However, the lack of access to distribution centres and logistics networks still places independent retailers and new entrants at a considerable competitive disadvantage. Suppliers often provide additional discounts for sales to distribution centres even for the same volumes of product. These include distribution, warehouse and pallet discounts, which could amount to up to 10% off the price of products. Investments in distribution centres therefore can contribute to levelling the playing fields with respect to sourcing for smaller players who have access to them.

Advertising costs are also a significant barrier to expansion for supermarkets and independent retailers. Independent retailers have found ways of partially overcoming this through the buying groups they are affiliated with. These groups undertake advertising and promotions, including through the use of knock-and-drop advertising and direct marketing on behalf of independent retailers.

Other major barriers for small players include lack of business management skills, retail capabilities and access to finance. The FVC case study provides useful lessons on how cost advantages and growth can be attained through efficient management and procurement methods. From its initial niche in fresh fruits and vegetables, its flexible business model allowed for growth and diversification into other formats and markets, including profitable export markets. Running low margin distribution centres and effective waste management interventions has further facilitated its growth.

Procuring directly from municipal markets and keen cost management efforts has allowed FVC to charge lower prices for fresh fruits and vegetables to customers than the incumbent supermarkets (estimates are that price are lower by 20 - 25%). It highlights the significant benefits that greater competition can bring for consumers and the importance of opening up the playing field to new entrants, with different business models and efficient management. It also points to the role for fresh produce municipal markets, open to all.

Choppies has also managed to penetrate low income markets on the back of a successful business model that focuses on relatively cheap products (with a strong focus on its own-label brands), long shopping hours and convenient locations. Choppies grew from a single store in Zeerust in 2008 to 31 stores in 2015 in South Africa, with ambitions to open 19 more stores by 2016. Their success has further been credited to owning a large transport fleet.

Similarly, buying groups are playing a crucial role in equipping independent retailers with management skills, advertising and retail capabilities by providing training at little or no cost to the retailer.

The most prevalent strategic barrier to entry identified in the research is the practice of long term exclusive lease agreements entered into by incumbent supermarkets and property developers in shopping malls or retail centres. These stipulate, on the insistence of the anchor tenant (the supermarket), that no rival supermarket can operate in the same mall. The exclusivity requirements often span decades, creating a barrier to entry or expansion for rival supermarkets in that centre. Other new entrants and specialist retailers (such as butcheries and bakeries) particularly in shopping centres in rural areas are also negatively affected by such leases.

Until recently, most Choppies stores have been located along taxi/transport routes in mining towns in North West province. However, the group has started opening stores in shopping malls. Independent supermarkets are also often not located in malls. These retailers are typically small businesses, with free standing stores targeting low income customers in peri-urban, township, industrial and central business district areas of cities. Access to prime retail space is important to allow these new entrants to grow and become effective competitors to the incumbent supermarkets.

The exclusive leases have been the subject of Competition Commission investigations and a current market inquiry. A key question is whether existing competition between the major chains means that niche retailers and small entrants are insignificant in competition terms. In this regard, the *substantial* lessening or prevention of competition test for investigations is a higher hurdle than the prevention, restriction or distortion test for market inquiries.

Policy recommendations

The development of FVC, independents and Choppies demonstrates the competitive value of a diversity of retail business models – for consumers and for suppliers. The South African retail space, however, remains dominated by the major chains. The study suggests paying attention to keeping the retail space open to entrants.

There are a number of discrete areas in which policy makers can intervene to address some of these barriers to entry:

- Facilitate legally enforceable undertakings by incumbent supermarkets to either not enter into leases with exclusivity clauses, or mandate the reduction of the duration and scope of the clauses in instances where such leases have already been entered into. The market inquiry currently being undertaken by the Competition Commission would be expected to make concrete recommendations and proactively address the challenge of measures to foster greater competition. The test under market inquiries is one of distorting, lessening or preventing competition, and not the substantial lessening standard of anti-competitive conduct cases.

  In other countries, measures have been largely been put in place under the competition regime. In the UK, the Competition Commission made an order to phase out exclusivity clauses in its Groceries Market Investigation Order of 2010 following recommendations for an investigation from the former Office of Fair Trading. In Australia, following the inquiry by the ACCC, the major supermarket chains, a wholesaler and other retailers *voluntarily* provided court-enforceable undertakings which phased out exclusive lease provisions over a number of years.

- Encompass open and flexible retail space in urban planning to ensure a mix of formats and address exclusivity through planning policies. In other countries, such as Australia and the UK, urban development has played a key role in opening up markets in retail to wider participation and ensuring competition to incumbents. This requires municipalities to play a role in opening up markets, possibly under guidance from national government and the competition authorities.

- The contribution of fresh produce markets in providing market opportunities to both farmers and retailers needs to be fully appreciated. They are an alternative to the private distribution arrangements of the national chains who would otherwise have even greater power as the route to consumers for farmers, and able to extract rents from the exercise of this power. Indeed, the example of FVC and the potential for further expansion of independent retailers indicates that support should be provided to fresh produce markets to expand their position, recognising the spin-off economic benefits. In simple terms, rivalry from FVC has meant significantly lower prices to consumers and a greater range of options for suppliers.

- Provide support to new entrants and independent retailers through facilitating access to distribution centres and logistics networks. For instance, Pick n Pay in an initiative with Gauteng Department of Economic Development, recently announced that it would open up its distribution channels to township spaza shops, giving them access to stock at competitive pricing.

- The playing field for smaller players and new entrants can be somewhat levelled by mandating or facilitating voluntary codes of conduct between producers, wholesalers and retailers. From the perspective of small and medium suppliers, such codes of conduct serve to protect them against possible abuse of market power of large supermarkets. This is similar to what has been done in the UK, through the UK's Groceries Supply Code of Practice which stipulates that retailers are required to comply with The Groceries Market Investigation Order of the former Office of Fair Trading. This Code is enforced in the UK by an independent Groceries Code Adjudicator, set up specifically to oversee the relationship between supermarkets and their suppliers and housed within the former OFT.

In Ireland, there are plans to institute a mandatory Code of Conduct in the grocery sector, to be overseen by the Department of Enterprise, Trade and Employment. In Spain, a new act focusing on measures to improve the functioning of the food chain was promulgated in 2013 which uses a mixed model of regulation and self-regulation (through voluntary codes of conduct) to govern commercial relations between the agents in the food chain. In South Africa, such codes could be administered through the Economic Development Department through the appointment of a similar independent adjudicating body.

- As means of supporting local small and medium sized suppliers, supermarkets can be required to invest in formal supplier development programmes. While *ad hoc* programmes arising from competition case settlements and conditions, such as the Massmart Supplier Development Fund (developed from the Walmart/Massmart merger) and the Agro-Processing Competitiveness Fund (set up from the Pioneer cartel settlement) in conjunction with the IDC have yielded some positive results, such programmes need to be part of regular, long-term operations of supermarkets in order to have a wider and more sustainable impact and not merely treated as a form or corporate social responsibility. Such programmes can continue to be administered by the IDC.

- Provide financial assistance to new entrants, small suppliers and independent retailers given that cash flow issues and access to finance from commercial banks are major hindrances. While it may be argued that there is significant government funding available for small businesses, lack of awareness of such programmes as well as the red tape and bureaucracy involved in accessing these funds limits their potential. Further, providing funding without upskilling capabilities is not in itself sufficient to attain sustainable inclusive outcomes.

- Government can provide training subsidies to new entrants and buying groups that assist independent retailers to build retail capabilities in advertising, marketing, cash flow management, inventory and waste management etc.

These measures are material and include some quick wins. The tangible value is evident in the impact that has been seen from greater rivalry, the point is it need to be more extensive. The time taken for FVC to reach critical mass points to the magnitude of the barriers to small rivals and the value of concrete steps to reduce them at each point.