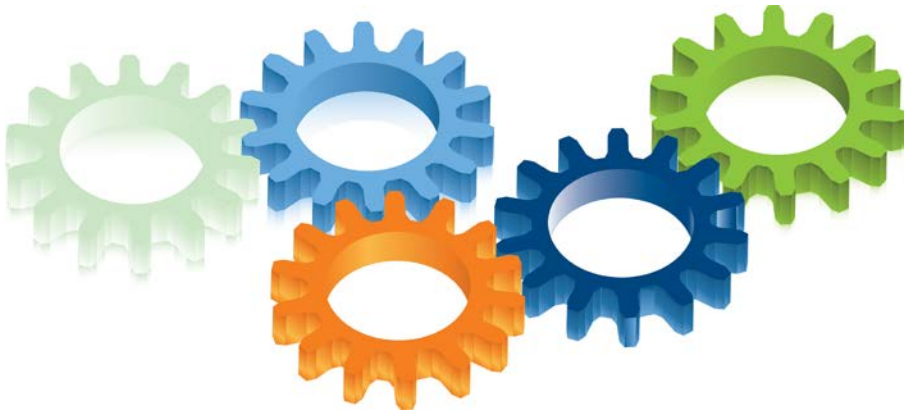

Australian Food and Grocery Council

COMPETITIVENESS & SUSTAINABLE GROWTH

JUNE 2014

CHALLENGES FOR THE AUSTRALIAN FOOD AND GROCERY INDUSTRY

AFGC one voice - adding value

KPMG cutting through complexity

Inherent Limitations

This Report has been prepared as outlined in "Section 2.1: Objectives" of this Report and in accordance with "Appendix 6.3: Scope and Methodology" of this Report. This Report has been prepared at the request of the Australian Food Grocery Council (AFGC) pursuant to the terms of KPMG's engagement letter executed 20 January 2014. The services provided in connection with this engagement comprise an advisory engagement, which is not subject to assurance or other standards issued by the Australian Auditing and Assurance Standards Board and, consequently no opinions or conclusions intended to convey assurance have been expressed. This Report has been prepared for general guidance on matters of interest only, and does not constitute professional advice. You should not act upon the information contained in this Report without obtaining specific professional advice. No representation or warranty (express or implied) is given as to the accuracy or completeness of the information contained in this Report, and, to the extent permitted by law, KPMG, its members, employees and agents, and the AFGC accept no liability, and disclaim all responsibility, for the consequences of you or anyone else acting, or refraining to act, in reliance on the information contained in this publication or for any decision based on it. Any estimates or projections of future economic performance are impacted by numerous factors that may influence the various components of the estimates or projections, and are inherently indeterminable whether considered in isolation or in conflux. KPMG and the AFGC exercise reasonable care when making forecasts or predictions, however factors in the process such as market behaviour, are inherently uncertain. As such, future events may not unfold as expected and actual results achieved for the forecast periods covered will vary from the information presented. Any estimates or projections will only take into account information available to KPMG and AFGC up to the date of the deliverable and so findings may be affected by new information. Accordingly, we do not warrant or guarantee that any outcome presented in this report will be achieved. Further, events may have occurred since we prepared this Report which may impact on it and its findings. KPMG and the AFGC have indicated within this Report the sources of the information provided. We have not sought to independently verify those sources unless otherwise noted within this Report. KPMG and the AFGC are under no obligation in any circumstance to update this Report, in either oral or written form, for events occurring after the Report has been issued in final form. The findings in this Report have been formed on the above basis.

Third Party Reliance

This Report is solely for the purpose set out in "Section 2.1: Objectives" of this Report and for the AFGC's information and is not to be used for any other purpose. KPMG, any member or employee of KPMG nor the AFGC undertakes responsibility arising in any way from reliance placed by third parties on this Report. Any reliance placed is that party's sole responsibility. Third parties who access this Report are not a party to KPMG's engagement with AFGC and, accordingly, may not place reliance on this Report. KPMG and AFGC shall not be liable for any losses, claims, expenses, actions, demands, damages, liabilities or any other proceedings arising out of any reliance by a third party on this Report.

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1 Executive Summary

This report provides a fact-based overview of the financial performance of the Australian food and grocery industry[1], which represented 27.5 per cent of the Australian manufacturing industry, or $111.2 billion in turnover, and employed close to 300,000 people in FY12.

The report is divided into three parts. The first is a high level overview of the key drivers for the industry. The second provides an analysis of the data provided by 17 AFGC member organisations (the participants), which represent approximately 16 per cent of the food and grocery manufacturing industry turnover and 25 per cent of AFGC members turnover. The analysis provides insight into the financial performance, channel dynamics and the key drivers of profitability, and it also describes trends by size of market participant. The third looks at two specific themes: the relative profitability and efficiency of the participating group to international comparators, and Australia's export and international trade position.

It is important to note that this 2014 Report is not directly comparable to the 2013 Report as the participant group is not the same for 2014. Accordingly, historical data reflects updated results from all the participants for all four years reported.

Industry developments:

The Australian economy has been relatively resilient over the past few years since the last global financial crisis (GFC), however the value added manufacturing sector did not fare as well as it declined by 6.2 per cent between FY08 and FY13.

Despite somewhat subdued consumer confidence, the retail sector and in particular the supermarket sector continued to grow at 3.3 per cent Compounded Annual Growth Rate (CAGR) between FY08 and FY13[2]. At the same time, the food and grocery manufacturing industry declined by 0.1 per cent between FY08 and FY12[3]. In part, the disparity between the retailers and manufacturers has been driven by cost pressures through the production processes which were further exacerbated by retailers' pressure on the suppliers to discount, resulting in increasing trade spend. Furthermore, the Australian food and grocery manufacturers face increased competitive pressure from imports and are affected by the strong Australian dollar (AUD).

Over the past decade, there had been no real growth in the level of total annual investment in the industry. Given the current state of the industry, this may pose a real threat to the sustainability of the Australian manufacturers and their ability to successfully compete and grow in both the local and global markets.

Key findings from this study:

The profitability of the participants over the last four years fell with gross margins reducing from 41.0 per cent in FY10 to 38.5 per cent in FY13, and earnings before interest and tax (EBIT) reducing from 12.3 per cent in FY10 to 9.3 per cent in FY13 as a percentage of net sales.

Profitability was significantly impacted by gross sales levels contracting by 4.0 per cent in FY12 and have yet to recover in FY13. Despite a continued growth in trade spend by a 4.0 per cent CAGR from FY10 to FY13, it did not drive overall volume

[1] The industry definition used in the State of the Industry report 2013 includes Food & Beverage manufacturing, Grocery Manufacturing and Fresh Produce Production. Figures in this section are based on this source and are in line with this definition

[2] Australian Bureau of Statistics, catalogue number 8501.0

[3] The food and grocery industry data is based on information from Australian Bureau of Statistics which is not available for FY13

nor gross sales increases. As a result, net sales eroded by 2.8 per cent over the same period.

Overall, trade spend was the key driver for the declining gross and EBIT margins. Cost reductions in total operating costs and in some categories of cost of goods sold were not sufficient to sustain profitability levels.

The tier-2 participants in the study, who tended to have a lower exposure to the large supermarket retailers and deep discounting activity, continued to grow their gross and net sales. Overall tier-2 players experienced a mean EBIT 1.5 percent higher than the major players.

In FY13 capital expenditure and R&D increased and a growing share directed to growth related initiatives rather than past years' focus on cost reduction.

Key themes:

- *Pressure on profitability and efficiency compared to global comparators*

The performance of the participants was analysed against the performance of a sample set of international comparator organisations. The analysis found that in FY13, the participants' EBIT margin levels were 7.0 per cent lower compared to the international group.

In terms of efficiency, in FY13 the international peers experience a higher working capital turnover as well as a superior Return on Capital Employed (ROCE). Recent improvement in the participants ROCE may not be sustainable as it appears much of this is derived from write-down of non tangible assets and greater utilisation of existing assets rather than investment in new assets, whether directly or via acquisitions.

In part, the international comparator groups' ability to outperform our local market is due to Australia's high cost structure, which continues to increase year by year. According to KPMG's Competitive Alternatives Study 2014, the cost of doing business in the Australian agri-food manufacturing sector was higher than all comparable mature countries from North America, Europe, and Asia Pacific that were part of the study. Key drivers included the relatively high cost of transportation, utilities, labour and rent, the strong AUD and the increasing regulatory burden compared to other regions in the study. In addition, the relatively small Australian domestic market provides limited opportunities for food and grocery manufacturers to generate scale efficiencies compared to other regions.

- *Need to improve Australia's export and international trade position*

With a relatively small domestic market, Australia's export of food and grocery products has been increasing in recent years. However, in the past decade Australia has been consistently losing market share and its position as key exporter of processed food in many of its key foreign destinations, including China, Japan, Indonesia and Malaysia. The high value of the Australian dollar, the low levels of investment in the industry, the productivity issues and the high cost environment, impede Australia's ability to compete in the international market.

Overall, the major trends indicate a deterioration of the attractiveness of Australia as a base for value added manufacturing of food and grocery products. However, with significant global demand and the recent depreciation of the Australian dollar, there is a significant potential for growing the export channel. The critical imperative is for cooperation between government and industry to better position Australia to capitalise on these growth opportunities.

2 Overview

2.1 Objectives

KPMG was engaged by the AFGC to assist to deliver a fact-based study on the performance of the food and grocery industry in Australia and to better understand the current health of the industry and identify barriers to growth.

2.2 Sample size and participant selection

For the purpose of this study, participation was sought from the AFGC member base where all members were encouraged to participate.

Table 3.1: Resulting sample size and representation of the food and grocery industry based on revenue

	Count	% AFGC	% industry
Total	17	25%	16%

Note: Total revenues of Australian Food and Grocery Council members and the industry is based on the revenues as registered in publicly available sources and may therefore vary from sales levels as defined in this study
Source: KPMG analysis, Australian Food and Grocery Council

This study is based on a sample of 17 participating companies representing approximately 25 per cent of AFGC members in terms of size and 16 per cent of the food and grocery industry (excluding Fresh) as defined in the *State of the Industry report 2013*. To protect the confidentiality of the participants, the names of the participants are not disclosed. The participating companies cover a broad range of sectors and categories across the food and grocery industry. To protect the confidentiality of participants, the specific sectors covered are not disclosed.

The participating companies are distributed as follows:

Figure 2.1:
Distribution of sample by number of employees

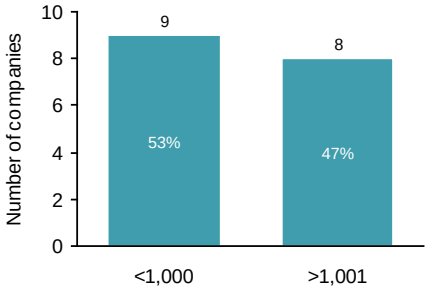
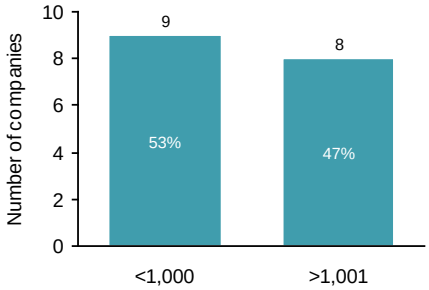


Figure 2.2:
Distribution of sample by FY13 gross revenue ($ millions)



The eight participants with FY13 revenues over $1bn and number of employees exceeding 1,000 were classifies as ‘majors’, while the other nine participants were labelled as ‘tier-2’.

It is important to note that the 2014 Report is not directly comparable to the 2013 Report as the participant group is not the same for 2014. The 2014 Report collects data from the previous four years and at times participants restate previous year’s results. We have not sought to reconcile data from previous submissions.

For further details on scope and methodology, including definition, please refer to Appendix 6.4.

3 Industry trends and challenges

The food and grocery manufacturing industry has experienced significant pressures on its performance from a range of drivers. These include:

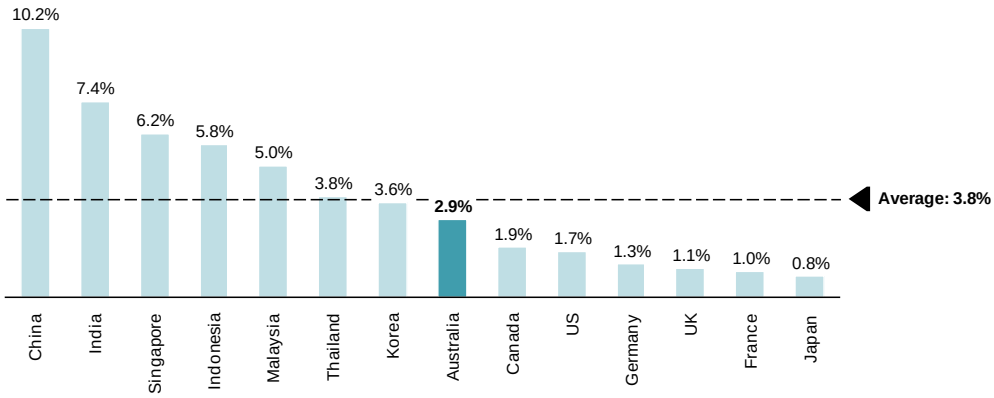
- Continued subdued confidence in the broader economic environment.
- A strong Australian currency.
- Competitive nature of the supermarket retailing sector.
- A comparatively higher cost of doing business in Australia than other countries.

This chapter provides a high-level overview of how these drivers have created an environment for ongoing structural change in the food and grocery manufacturing industry in Australia. These drivers, alongside of the planned fiscal restraint, are creating a climate of uncertainty that undermines investment levels in this industry.

3.1 Australian economic fundamentals

The Australian economy ranks as one of the highest growth economies amongst the advanced nations of the world, with an annual average Gross Domestic Product (GDP) growth rate of 2.9 per cent over the past 10 years.

Figure 3.1: Gross domestic product growth (CAGR 2003-2013, per cent)



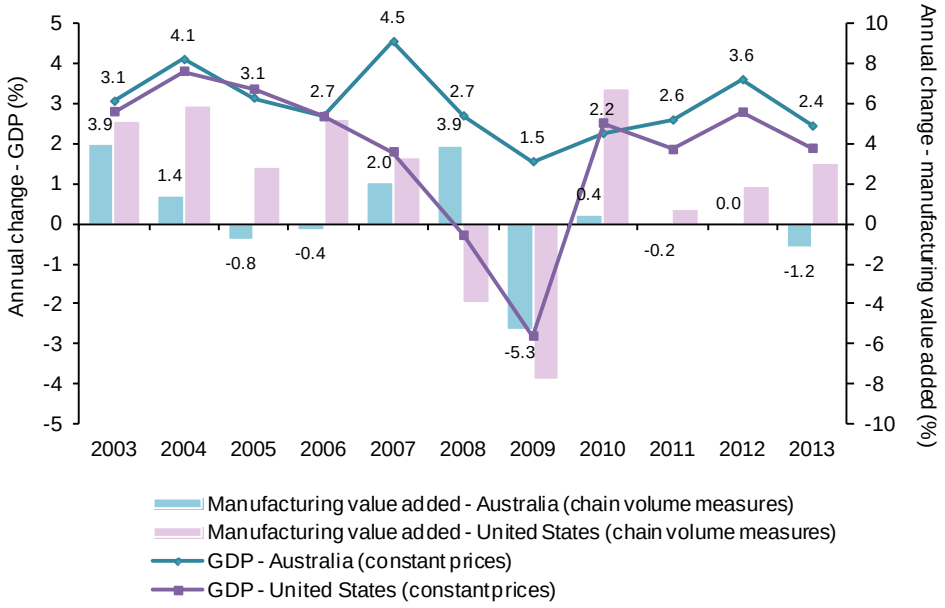
Source: International Monetary Fund

Historically resilient Australian economy will now need to adjust to new challenges and opportunities in a rapidly changing domestic and global economy.

As can be seen in Figure 3.2, while the Australian economy has moved in a similar direction to the US economy, it was more resilient during the global financial crisis (GFC). Specifically, at the height of the GFC, US GDP fell by 5.3 per cent, while Australian GDP continued to grow, but at a low growth rate of 1.5 per cent.

However, Australia's manufacturing sector did not fare as well, and similar to the US, it suffered a steep decline in value added during the GFC. Moreover, while the US manufacturing sector has regained positive, albeit low, growth in the last three years, the Australian sector has not rebound. Overall, the local sector's value added has remained close to the low levels of FY09 and further contracted by 1.2 per cent in FY13. A combination of lower investment and fiscal restraint is likely impacting manufactured goods on the home front, while cost pressures in recent times, mainly with regard to wages and energy, have reduced the Manufacturing sector's ability to compete in world markets.

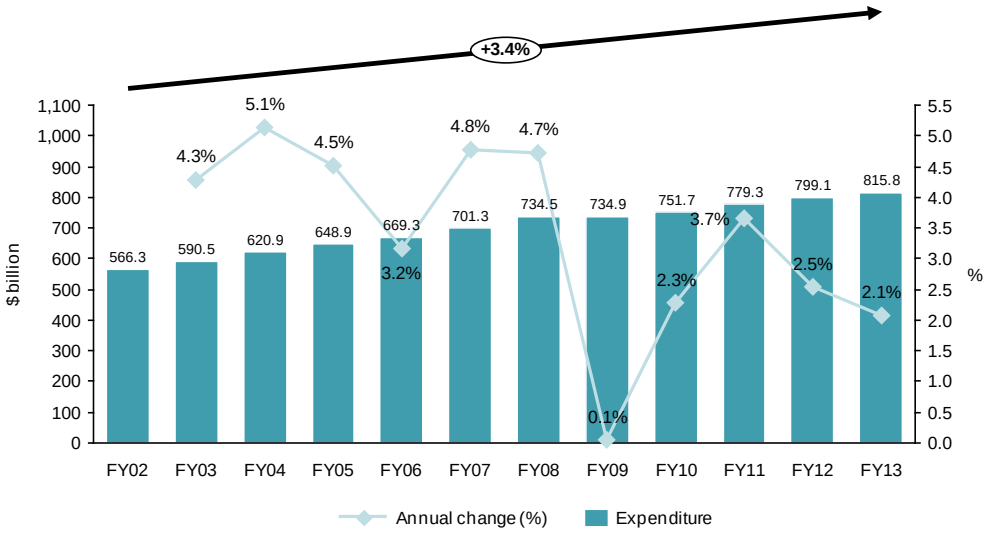
Figure 3.2: Gross domestic product and manufacturing growth – Australia versus US (FY03-13)



Source: International Monetary Fund; US Bureau of Economic Analysis; Australian Bureau of Statistics catalogues number 5206.0

Further to this, recent household consumption growth slowing to below average has put pressure on many of the local manufacturers. This has been driven by unemployment levels increasing and some decrease in wages growth. With interest rates at historically low levels, moderate growth in consumer demand is expected[4].

Figure 3.3: Household final consumption expenditure (FY03-13)

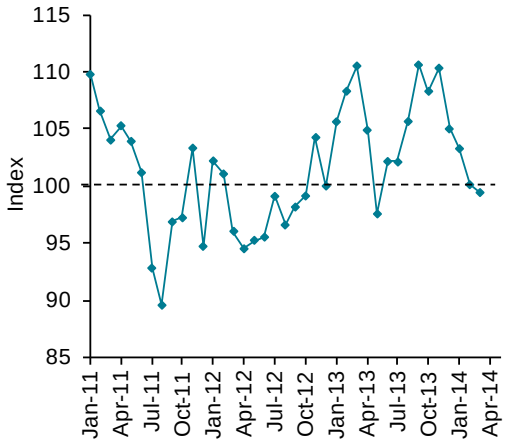


Note: 2011-12 chain volume measures
Source: Australian Bureau of Statistics, catalogue number 5204.0

Furthermore, measures of consumer sentiment have been below trend recently. A weaker labour market and fiscal constraint following the recent federal budget cuts public announcement may have an adverse impact on consumer confidence in the near term both may have the potential to impact consumer confidence and consumer spend in the near term.

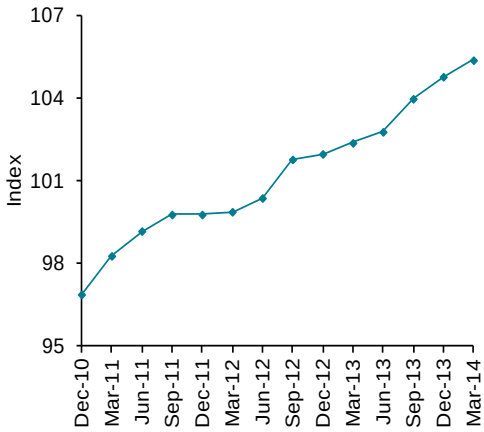
[4] Media release May 6, 2014; Reserve Bank of Australia; May 2014

Figure 3.4: Consumer Confidence Index



Note: The black dotted line mark 100. Index scores above 100 indicate that optimism level outweigh pessimism
Source: Westpac Banking Corporation, Melbourne Institute (sourced from tradingeconomics.com; accessed May 2014)

Figure 3.5: Consumer Price Index



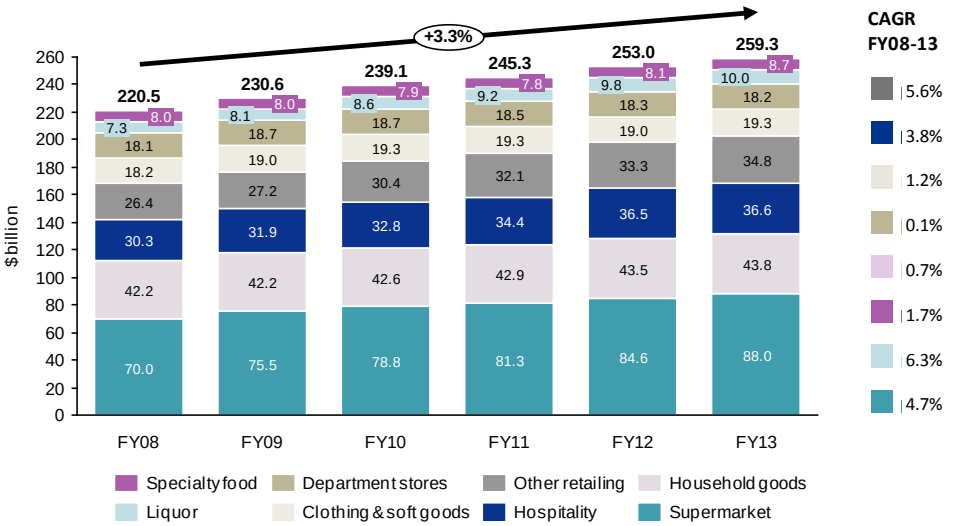
Source: Australian Bureau of Statistics catalogue number 6401.0

Consumer confidence may still feel the impacts of a weaker labour market and fiscal constraint for some time to come.

3.2 The retail and supermarket sectors

The supermarket sector is the largest in the retail group and accounts for 34 per cent of the total turnover. This sector has grown at an average annual rate of 4.7 per cent since FY08. This represents a modest growth compared to the two other large categories - of household goods and department stores - which grew at average annual rates of 0.7 per cent and 0.1 per cent, respectively, during the same period.

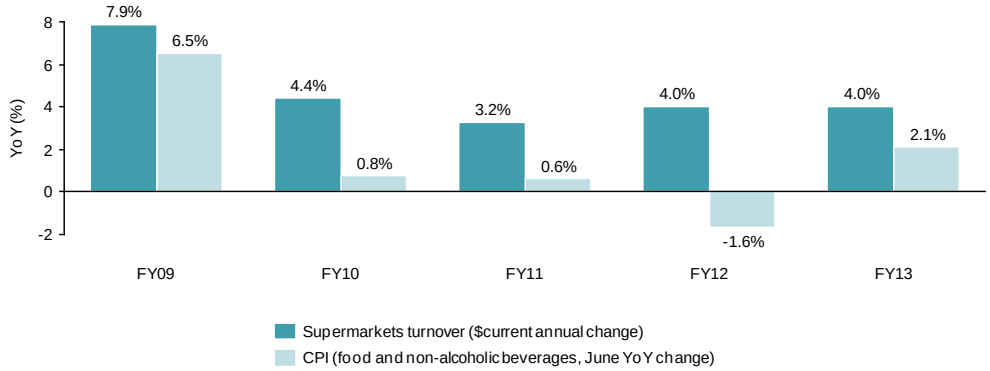
Figure 3.6: Australian retail industry turnover (FY08-13)



Note: Specialty food includes butchery and green groceries. Baked goods on same premises are excluded. "Other retailing" includes newspaper and book retailing, other recreational goods retailing, pharmaceutical, cosmetic and toiletry goods retailing and other retailing n.e.c
Source: Australian Bureau of Statistics, catalogue number 8501.0

Growth in the supermarket sector is generally relatively stable, and is underpinned by fundamental household consumption drivers like population growth, product diversification, income growth, and consumer preferences. In the last two years, this sector turnover recorded 4 per cent nominal growth. However, the Consumer Price Index (CPI) falling in FY12 by 1.6 per cent and increasing in FY13 by 2.1 per cent, may indicate that the growth in this sector could be volume-driven, impacted by change in product sales mix or other factors.

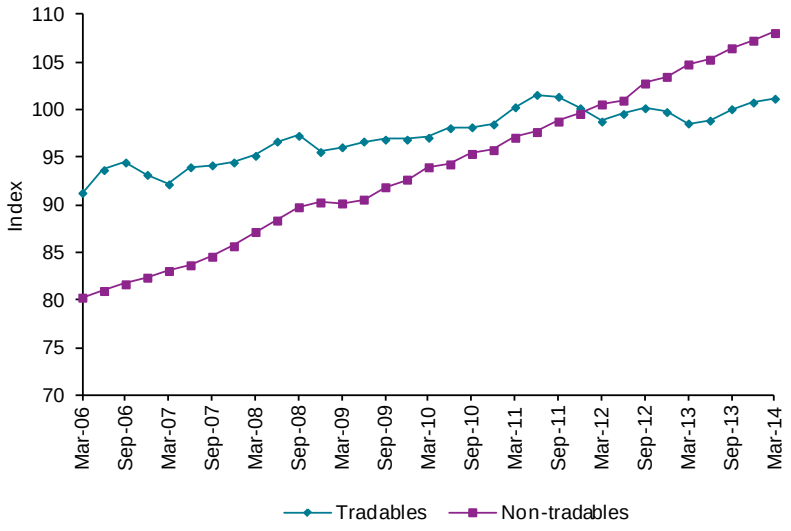
Figure 3.7: Consumer Price Index (food and non-alcoholic beverages) versus food retail turnover in nominal terms (FY09-13)



Notes: Consumer Price Index (food and non-alcoholic beverages) excludes sub-categories 'fruit and vegetables' and 'meals out and take away foods'
Source: Australian Bureau of Statistics, catalogue number 6401.0

Similar to the CPI in food retail, the price of tradeables also eased from September 2011, before regaining some ground in the last four quarters. In comparison, the price of non-tradeables has continued to grow steadily over the past decade.

Figure 3.8: Consumer Price Index tradables versus non-tradables (FY09-14)



Source: Australian Bureau of Statistics, Reserve Bank of Australia website, accessed 5 May 2014

3.3 The Australian food and grocery manufacturing industry

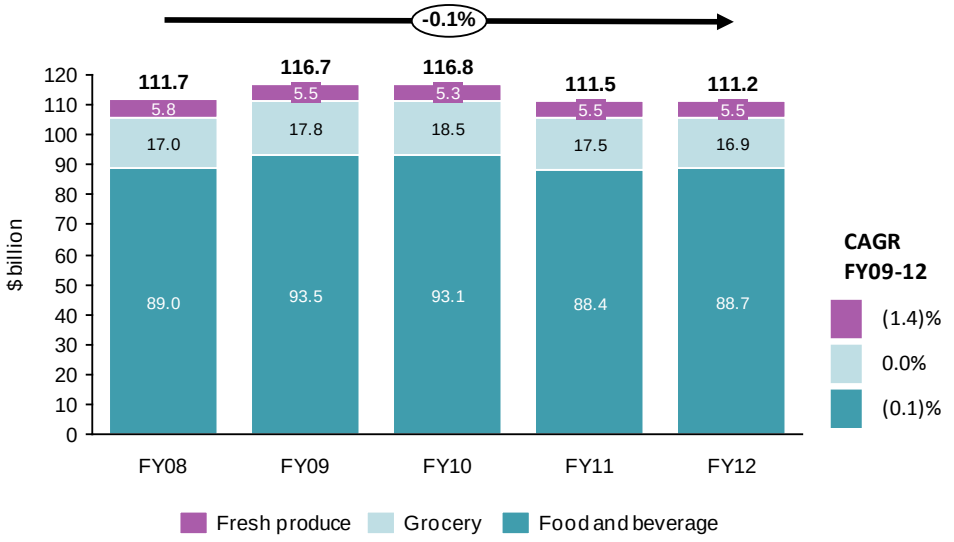
The Australian food, grocery and fresh produce manufacturing industry generated turnover of $111.2 billion in FY12. Food and beverage manufacturing comprised the largest component, contributing $88.7 billion or 80 per cent of total food and grocery sales. Of the remaining 20 per cent, grocery manufacturing contributed $16.9 billion and fresh produce contributed $5.5 billion.

The entire food, grocery and fresh produce industry represented 27.5 per cent of total Australian manufacturing turnover and employed close to 300,000 people in FY12. Around 222,000 of these workers were employed in food and beverage manufacturing[5].

[5] Australian Food and Grocery Council and KPMG | State of the Industry 2013

In contrast to the consistent growth observed in the retail supermarket sector, food and grocery sales have been relatively flat over the past 5 years. The subset, fresh food, by comparison, has exhibited declining turnover in real terms, with an average annual rate of 1.4 per cent.

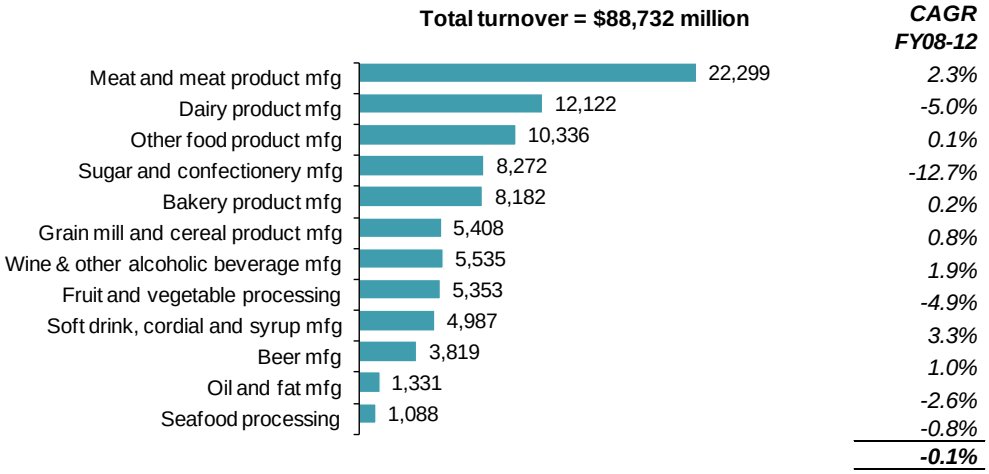
Figure 3.9: Food and beverage, grocery and fresh produce industry turnover (FY08-12)



Note: In FY12 dollar value. FY13 data was not available.
Source: Australian Food and Grocery Council and KPMG | State of the Industry 2013

After peaking in FY10, food and grocery manufacturing industry sales have continued to decline in recent years.

Figure 3.10: Overview of food and beverage sector - by turnover (FY12)

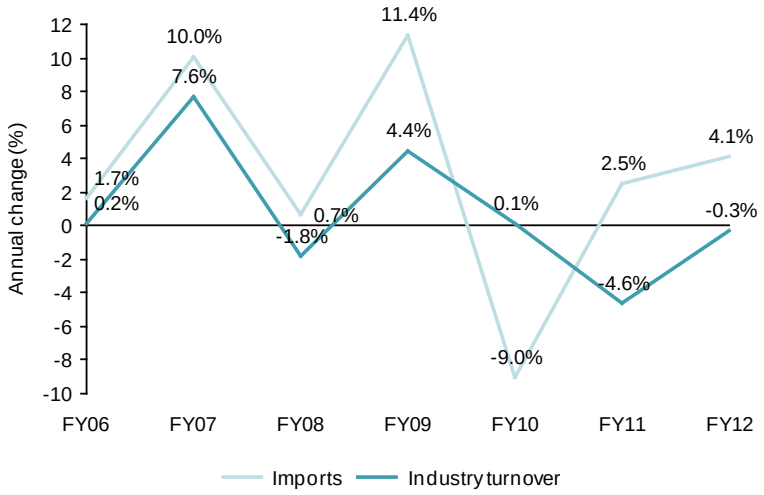


Note: In FY12 dollar value
Source: Australian Food and Grocery Council and KPMG | State of the Industry 2013

It is likely that supermarket sales have expanded, without an increase in domestic food and grocery sales due to two factors. Firstly, the retail supermarket sector has branched into new categories outside the food and grocery categories (e.g. apparel, general merchandise). Secondly, a higher cost/higher exchange rate domestic environment has affected local firms' abilities to compete, leading to increased import penetration into the market, as can be seen in the figure below.

The structure of the Australian retail market has meant that there is significant pressure on the industry's margins from retailers, backed by increased competition from imports.

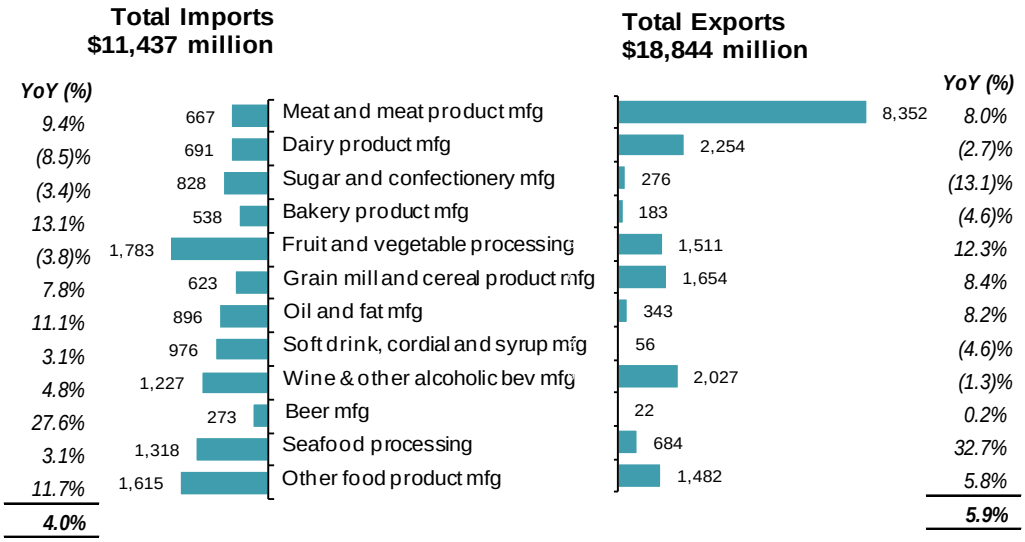
Figure 3.11: Imports versus turnover in the food and grocery manufacturing industry (FY06-12)



Source: Australian Food and Grocery Council and KPMG | State of the Industry 2013

Accordingly, between FY12 and FY13, imports in the food and beverage industry increased by 4.0 per cent

Figure 3.12: Import/export of the food and beverage industry (FY13)



Notes: 1. FY13 dollar value.
2. For this analysis the ABS categories were mapped to the State of the Industry categories
Sources: Australian Bureau of Statistics, KPMG analysis, Australian Food and Grocery Council and KPMG | State of the Industry 2013

3.4 Issues impacting the food and grocery manufacturing industry

In recent years, the food and grocery manufacturing industry has been faced with several issues across the value chain, impacting on growth and profitability. On the other hand, global developments will provide opportunities for this industry, if it can navigate into a position to access them.

3.4.1 The major retailers continue to put pressure for improved net price and increase import

While the food and grocery retailing industry is highly competitive, the opposite is true in the supermarket retailing industry – with a few key supermarket retail chains controlling a dominant market share. Under this oligopolistic environment, the supermarkets have engaged in extensive price based promotional strategies to drive sales growth, passing this through the supply chain in the form of price pressures on suppliers. The focus on price competition, combined with a strong Australian dollar, has caused a significant increase in import penetration, as discussed in Section 3.3.

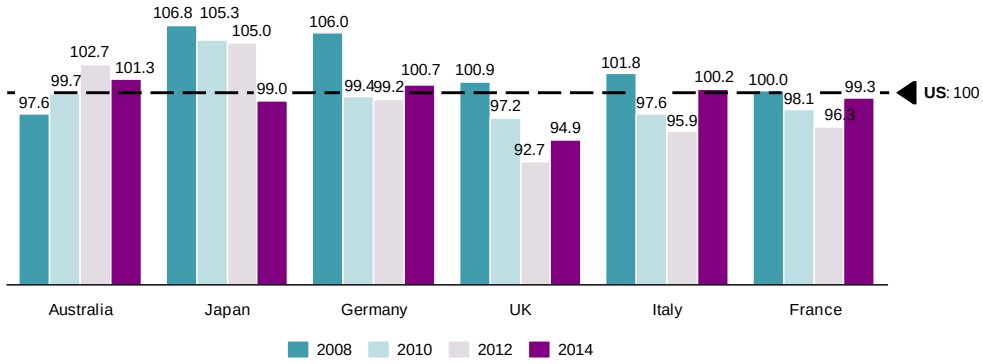
While there have been inroads into building other channels of distribution for their products (e.g. garden markets, foodservice and other direct to consumer channels), the supermarket retail channel remains the main distribution line for the food and grocery manufacturers in Australia.

The lower Australian dollar should provide some relief to trade competing suppliers. However, Australia will likely still remain a relatively high cost producer.

3.4.2 Lower competiveness of the local market given higher cost of doing business in Australia

Relative to other mature markets, analysis of the cost competiveness of Australia indicates that in the first half FY14[6], the cost of doing business in the Australian agri-food manufacturing sector was higher than all comparable countries in the study.

Figure 3.13: Cost index – Agri-food manufacturing (US=100, 2008-2014)[7]



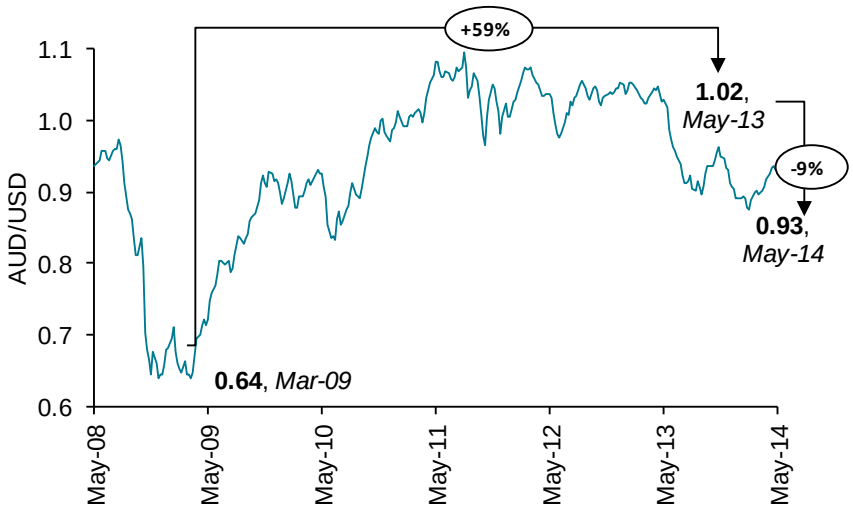
Note: US (dotted line) is the benchmark
Source: Based on information from Competitive Alternatives | KPMG's Guide to International Business Location Costs, KPMG (2014)

Similar to the trend in previous years, the costs of doing business in Australia continue to increase, and for the first time since 2008, it has surpassed Japan6. The data for 2014 takes into account 8.3 per cent depreciation of the Australian dollar against the US dollar (USD) between 2012 and 2014. Therefore, the change in the Australian agri-food costs index (if US=100) from 102.7 in 2012 to 101.3 in 2014 reflects an increase in costs in local currency of 7.6% over this period.

[6] Competitive Alternatives | KPMG's Guide to International Business Location Costs, KPMG (2014)

[7] The cost index is calculated by modelling a sample food processing operator, using 26 location-sensitive costs and comparing the relative local currency prices to an equivalent operation in the US

Figure 3.14: Cost index – AUD/USD exchange rate trend

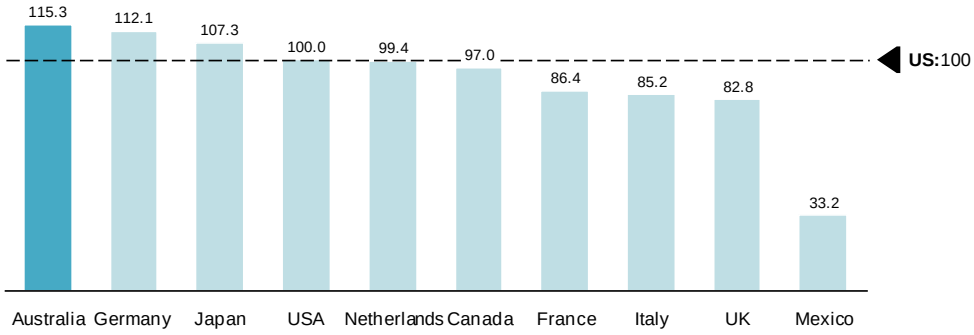


Note: Growth rate reflect total increase in the exchange rate (rather than CAGR)
Source: OnedA

Except for changes in exchange rate, other major cost trends that impacted the cost index are:

- **Wages & salaries cost**[8]: Out of all countries included in the *2014 Competitive Alternatives* report for the agri-food industry, Australia has the highest wages and salaries. Labour costs have continued to increase as the Australian wage price index increased by 14.5 points from December 2009 to December 2013[9].

Figure 3.15: Cost index – wages and salaries for agri-food manufacturing (US=100)



Source: KPMG estimates based on Competitive Alternatives | KPMG's Guide to International Business Location Costs, KPMG (2014)

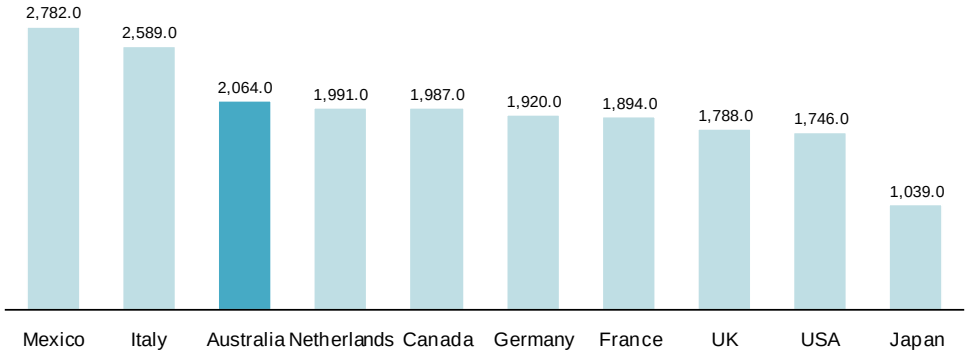
- **Transportation costs**[10]: Again, Australia ranks as one of the higher cost countries this time in terms of transportation costs. The *2014 Competitive Alternatives* report assess transportation costs as a combination of assumed global and regional product distribution channels comprised of land and sea delivery as well as air freight. Among the countries in the study, Australia has the third highest cost of surface freight per load and air freight price per kilogram.

[8] Labour accounts for 45-60 per cent of total location-sensitive costs amongst those countries included in the 2014 Competitive Analysis report

[9] Wage price index: Ordinary hourly rates of pay excluding bonuses (Private sector: Manufacturing industry), Australian Bureau of Statistics, catalogue number 6345.0

[10] identified as representing 7 to 24 per cent of total location-sensitive costs amongst those countries included in the 2014 Competitive Analysis report

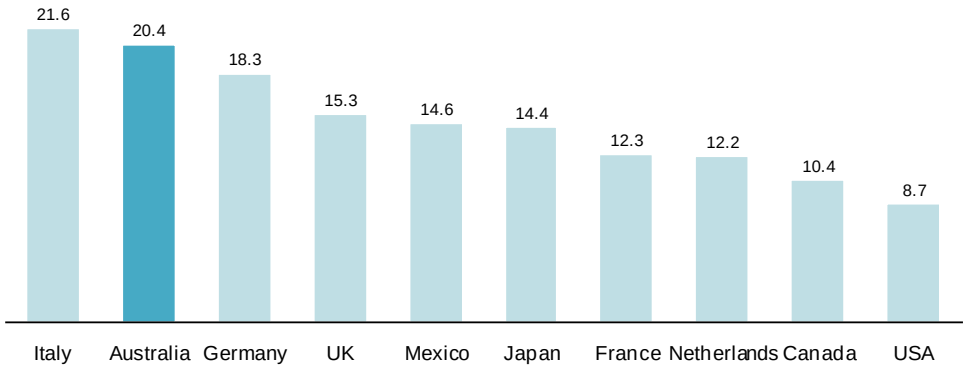
Figure 3.16: Global distribution costs as measured by surface freight per load in $US



Note: Average for manufacturing operations that utilize full load delivery logistics for each mode of distribution. The data assumes standard 40' container, or equivalent, and is based on first half of FY14 data
Source: KPMG estimates based on Competitive Alternatives | KPMG's Guide to International Business Location Costs, KPMG (2014)

- **Utility costs**[11]: Electricity costs in Australia are second only to Italy. While these costs have been consistently rising, with 70 per cent increase between 2008 and 2012. In 2014, these costs were 30 per cent higher than the average costs across all the other countries in the study6.

Figure 3.17: Electricity costs in US$ cents per kWh



Note: Average for manufacturing operations that utilize full load delivery logistics for each mode of distribution, measuring per standard 40' container, or equivalent, and based on first half of FY14 data
Source: KPMG estimates based on Competitive Alternatives | KPMG's Guide to International Business Location Costs, KPMG (2014)

Utility costs in Australia were 30 per cent higher than the average costs across all other countries in the 2014 Competitive Alternatives Report.

- **Raw materials costs**: the commodity prices of key inputs for food and grocery producers such as wheat and sugar is also a key cost item. From FY10 to FY12, wheat prices increased by 40 per cent and remained at these levels through FY13. Adverse weather conditions and global shortages helped drive these higher prices. In the same time, sugar prices increased to a 30-year high in FY11. Despite a steady growth in consumption, large world sugar stocks and increasing production have meant that sugar prices have started to ease, with prices dropping back 17 index points by FY13.

[11] Representing 1 to 8 per cent of total location-sensitive costs across the countries included in the 2014 Competitive Alternatives report

Figure 3.18:
Wheat (domestic) commodity costs

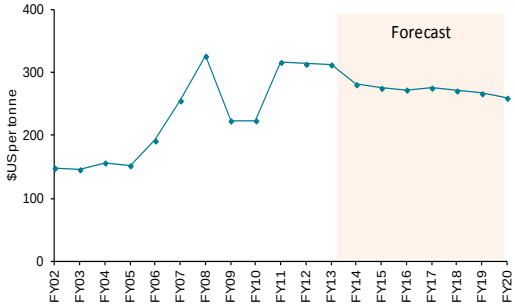
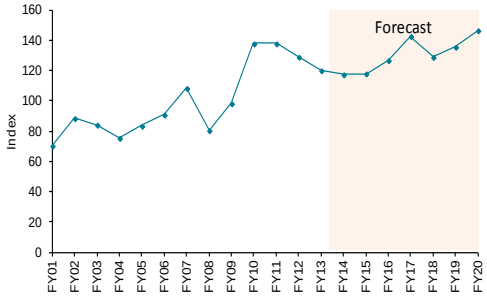


Figure 3.19:
Sugar commodity costs (World price)



Source: IBISWorld Business Environment Profiles

- **Regulation**: The World Bank's Ease of Doing Business Index shows Australia ranks 11th in an index designed to measure the conductivity of the regulatory environment to the starting and operation of a local firm[12]. The Australian Industry Group's 2014 CEO survey[13] indicates far higher levels of estimated burden due to government regulation in FY14 than previous years. The highest regulatory burdens are seen in industrial relations, employment, workcover and workplace health and safety. Tax compliance and environment regulations are also seen as placing a medium to high burden on business. Recognising the current burden that regulation has on business, the Australian Government put in place a plan to cut $1 billion in red tape every year – including introducing two annual parliamentary repeal days to "cut unnecessary and costly legislation and regulation"[14].

3.4.3 Low level of investment will likely to require a 'catch-up'

The food, beverage and tobacco manufacturing industry spend around $3.1 billion on capital investment in FY12, representing around 1.5 per cent of total capital investment across all industries in that year5,[15]. The majority of this investment was in food product manufacturing, which increased by 26.5 per cent from $2.0 billion in FY11 to $2.5 billion in FY12. While this was a large increase, the industry needed to regain ground lost after the GFC. Anecdotally, investments have been focussed on automation and other cost reduction programs due to pressures in the domestic retail market.

The figure below shows that total private investment (i.e. fixed and financial capital) in the food, beverage and tobacco manufacturing industry has been relatively flat over the past 10 years, with the amount invested in FY13 at an almost identical level as in FY03. The level of annual investment in this industry has fallen from a high of $2.9 billion in FY11 to $2.5 billion in FY13.

In stark contrast, the level of mining investment has increased in nearly every year since FY03, with the level of mining investment in FY13 eight-fold its FY03 level.

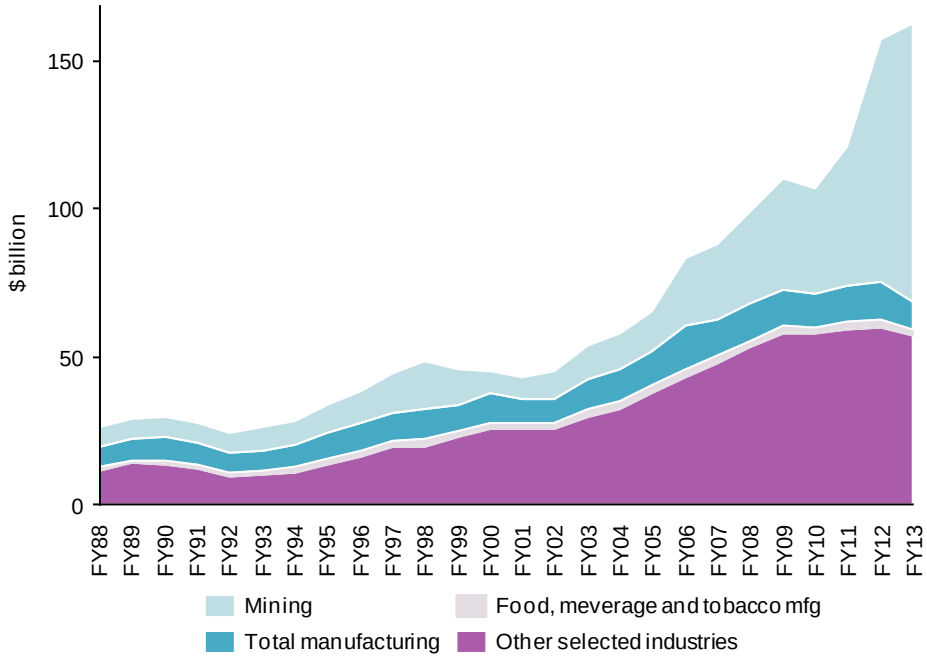
[12] World Bank, *Ease of Doing Business Index 2013* (http://www.doingbusiness.org/rankings - accessed 11 May 2014)

[13] Ai Group, *National CEO Survey Burden of Government* Regulation, March 2014

[14] Australian Government, *Cutting Red Tape - The Australian Government's online deregulation resource*, (http://www.cuttingredtape.gov.au/repeal-day/2014-autumn-repeal-day, accessed 11 May 2014)

[15] Capital investment is measured by the total value of a producer's acquisitions, less disposals, of fixed assets during the reference period, plus certain additions to the value of non-produced assets realised by the productive activity of businesses. It excludes intangible assets. Total industries definition for this measurement excludes finance and insurance services

Figure 3.20: New annual private investment by Industry (FY88-FY13)



Note: 1. Values in terms of FY12 dollar value

2. The ABS defines Other Selected Industries as all other industries except finance and insurance services

Source: Australian Bureau of Statistics, Private New Capital Expenditure and Expected Expenditure, Australia, Dec 2013, Catalogue no. 5625, March 2014; and KPMG estimates

Interestingly, the level of annual manufacturing investment and mining investment were at very similar levels in each year between FY88 and FY05, with the exception of a small spike in mining investment between FY97 and FY99. However, since FY05, manufacturing investment has remained relatively flat, while mining investment has expanded rapidly. The level of mining investment in FY13 was ten-fold the level of investment in manufacturing.

Finally, at an aggregated level, other sectors in the economy have also increased their level of annual investment, with investment level growing three-fold from the early 1990s to FY13.

This indicates that, to continue to remain competitive, the food and grocery industry may have some catching up to do in terms of investment.

3.5 Conclusion

While the Australian economy has been resilient during the recent GFC, a weak global economy, high labour and capital costs, and the strong exchange rate have all combined to put pressure on businesses, particularly those that are trade exposed.

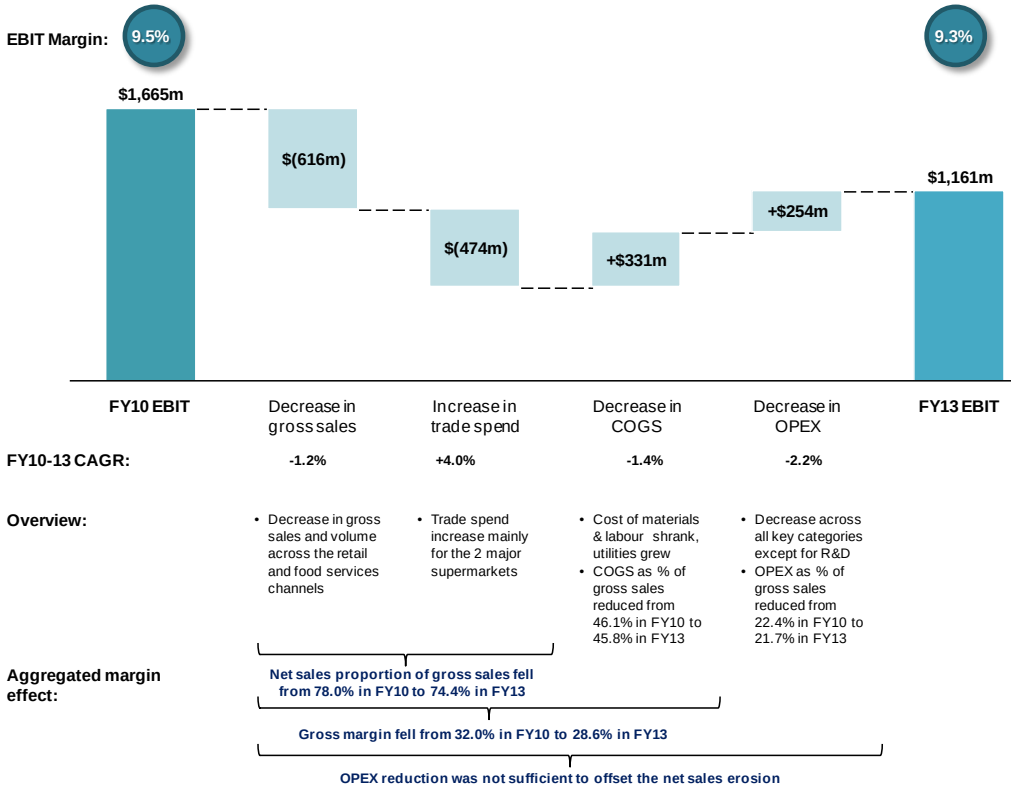
There has been some recent relief in the form of lower exchange rates and a weakening in the labour market. However, the food and grocery industry continues to face cost pressures through its production processes and supply chain, which are further exacerbated by retailer pressure – particularly price discounting which is primary funded by suppliers. Furthermore, the combination of higher input costs and increased import penetration have negatively impacted competitiveness and profitability of the industry, and this has meant that investment in this industry has suffered.

While these trends are widely recognised in the industry, the impact on the financial performance of the industry participants is unclear. The aim of this study is to report on the overall performance of the food and grocery industry by undertaking detailed analysis on confidential firm level data, aggregated and reported at an industry level.

4 Performance of participants

4.1 Overview

This chapter provides a view on the performance of the industry based on the information provided by the 17 participating companies. The following diagram and Appendix 6.1 show a consolidated financial summary.



Note: Percentage figures are stated as per cent of net sales unless stated otherwise
Source: Participant data, KPMG analysis

In aggregate across the 17 participants, the earnings before interest and taxes (EBIT) margin declined from 9.6 per cent in FY10 to 6.9 per cent of gross sales in FY13 and 12.3 per cent to 9.3 per cent of net sales.

- The key factor attributable to this decline was a decrease in gross sales from FY10 to FY13, mainly as a result of reduced volumes in the retail and foodservice channels for the major players, while tier-2 players continued to grow.

- The effect of the decline in gross sales was exacerbated by a consistent increase in trade spend (from 22.0 per cent in FY10 to 25.6 per cent of gross sales in FY13), which negatively impacted net sales.

- With lower exposure to channels with higher 'demand' for discounts such as the major retailers, tier-2 net sales in absolute values continued to increase while the majors' net sales fell.

- Reduction in the overall value of costs of goods sold as well as in operating costs as a result of cost-cutting initiatives mainly from the majors (as indicated by operating cost margins) and plant closures were not sufficient to protect profitability levels.

FY13 data has shown some positive indicators:

- Gross sales deterioration has slowed after a significant fall in FY12, with a mean growth of 0.6 per cent at the participant level.

- Improvement in the cash conversion cycle is showing better movement of inventory and quicker collection of debts.

- Higher return on assets and return on capital employed (although it appears this trend is not sustainable and has been driven by extended utilisation of existing assets rather than improvement to assets/ investment in new assets).

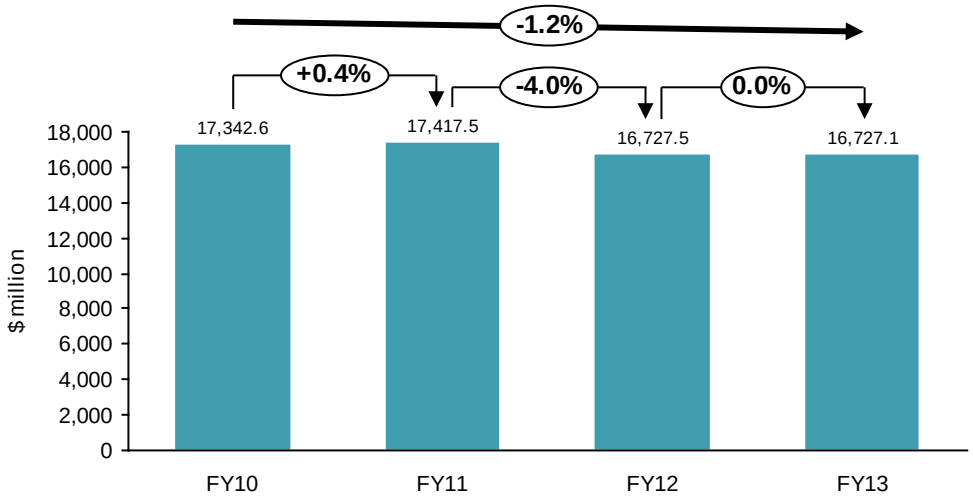
- Capital expenditure continued to grow with a higher share of investments directed towards sustaining existing assets and growth initiatives rather than cost saving programmes.

4.2 Sales

Gross sales of the participants were $16.7 billion in FY13, contracting by 1.2 per cent CAGR from FY10. Similar to the trend in the overall food and grocery industry however, after a decrease of 4.0 per cent in FY12, it appears that the deterioration has slowed, with FY13 gross sales at par with FY12 results.

Overall, FY13 gross sales remained similar to FY12 levels across all channels, with some increase in export that has offset a shrinking foodservice channel. Sales levels in FY10 and FY11 were relatively high when compared to the remainder of the period in scope for the study. The increase in FY11 appears to be especially significant in the direct to consumer channel.

Figure 4.1: Gross sales trend (FY10-13)



Source: Participant data, KPMG analysis

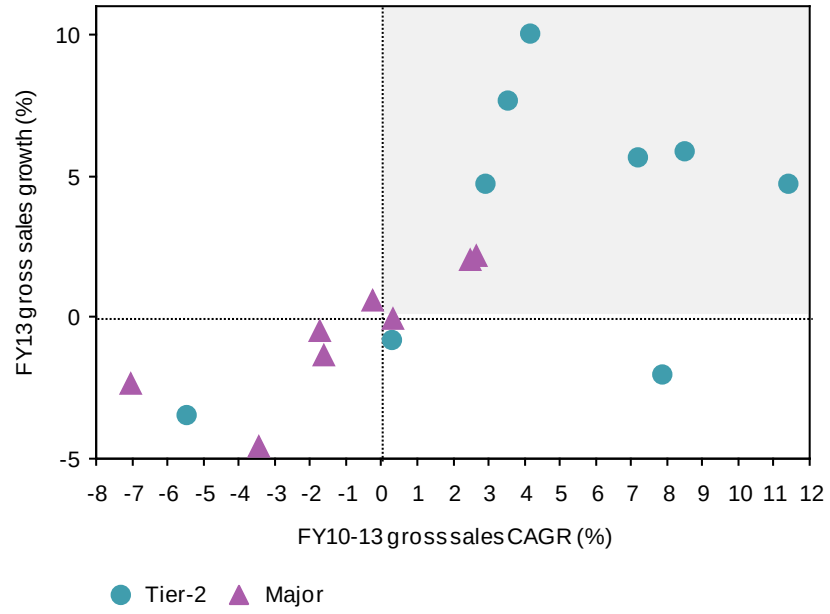
After contracting by 4.0% in FY12, gross sales deterioration has slowed in FY13 with gross sales being on par with FY12 results.

Overall, it appears that the decrease in sales over the period has been mainly driven by the major players, whereas the tier-2 participants actually grew. Specifically, the major players' gross sales declined at a 0.9 per cent mean CAGR from FY10 to FY13, whilst tier-2 mean CAGR increased by 4.2 per cent for the same period.

In FY13, approximately 52 per cent of the participants experienced growth in gross sales, with a mean of 0.6 per cent rate at the participant level. Consistent with the trend in the past years, the majority of these participants can be classified as tier-2, recording a mean growth rate of 4.7 per cent.

A gross sales trend appears to be consistent across the participants. Participants who have had positive FY10-13 gross sales CAGR continued to grow through FY13 as well.

Figure 4.2: Gross sales growth by participant group (per cent)

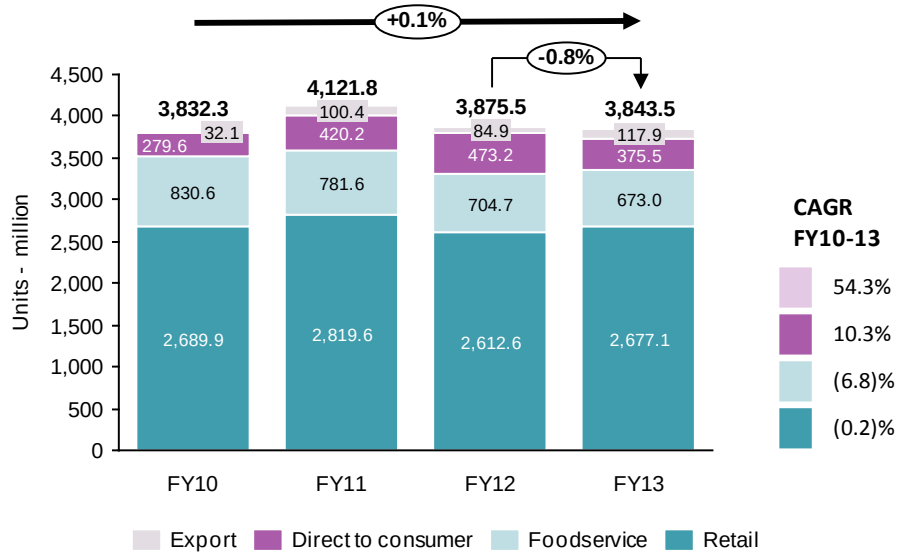


Source: Participant data, KPMG analysis

Similar to the trend in the past 4 years, in FY13 the gross sales of tier-2 players continue to grow with a mean 4.7 per cent growth rate while majority of the majors continue to shrink a mean 0.2. per cent.

Over the FY10-13 period, total volumes increased by 0.1 per cent. Participants' volume increases appear to be driven by growth outside of the retail channel. Volume sales to the retail channel contracted by 0.2 per cent over the full period, although they resumed growth of 2.5 per cent in FY13.

Figure 4.3: Volumes by channel (FY10-13)



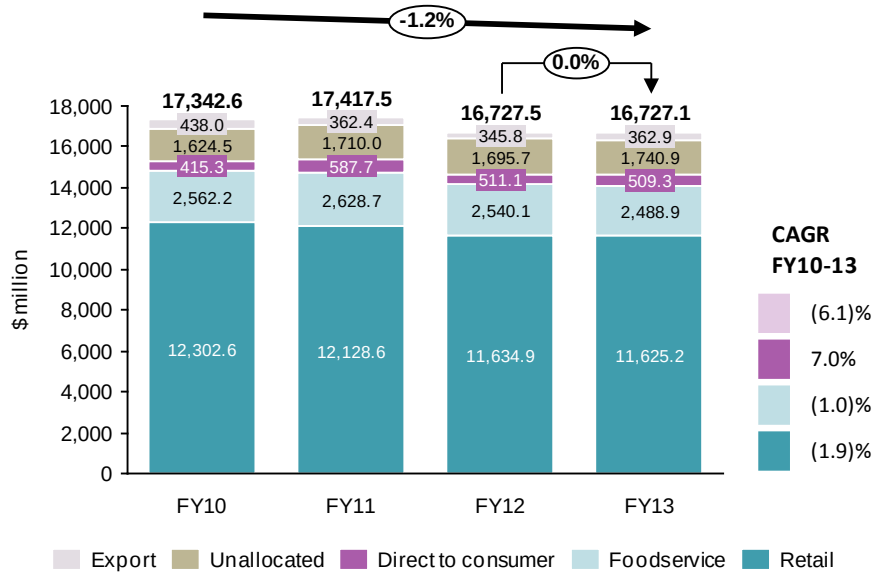
Source: Participant data (n=10), KPMG analysis

Volumes increase by 0.1 per cent is driven by growth in the export and the direct to consumer channels while volumes remained stable in FY10 to FY13.

Despite the slight growth in overall volumes, erosion of gross sales since FY10 could indicate that volume growth was experienced in products of lower unit prices, or that unit prices reduced during the period[16].

The decline in retail and foodservice volumes for the participant group is mirrored in a total gross sales decline of 1.9 per cent for retail and of 1.0 per cent for foodservice over the full period. Despite a significant volume increase for export, sales for this channel declined significantly at a 6.1 per cent CAGR from FY10 to FY13[16]. This decrease is in contrast to the 1.6 per cent increase in exports of the food and grocery industry over the same period[17]. Except for the export channel that grew in FY13, gross sales in the other channels continue to shrink since FY12.

Figure 4.4: Gross sales by channel (FY10-13)



Source: Participant data, KPMG analysis

Volume increase was not translated into growth of gross sales, indicating volume grew mainly for lower unit prices products or prices have fallen during this period.

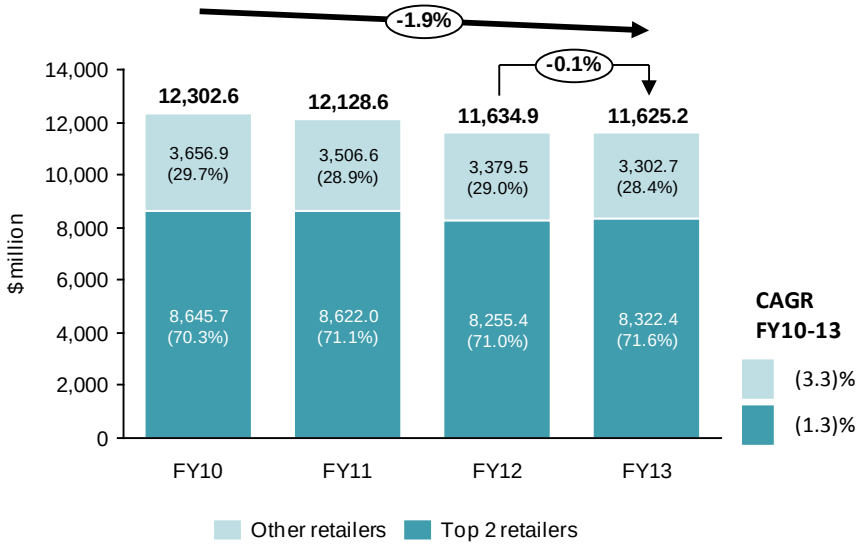
Sales to the two leading retailers account for 70-72 per cent of the participant group's gross sales and decreased by 1.3 per cent per annum between FY10 and FY13.

The remaining composition of gross sales in the retail channel consists of a relatively long tail of other retailers (e.g. other grocery, pharmacy, petrol and convenience, liquor, department store, general merchandise, discount, and speciality). These customers as a group contracted by CAGR 3.3 per cent as well as reducing their contribution to gross sales for the retail channel from 30 per cent in FY10 to 28 per cent in FY13.

[16] This trend is indicated also when analysing gross sales by channel only for the 10 participants that provided the volume data, as Figure 5.4 provides analysis for the 17 participants who contributed to the study

[17] Excluding 'Fresh', as based on *Australian Food and Grocery Council and KPMG | State of the Industry 2013*

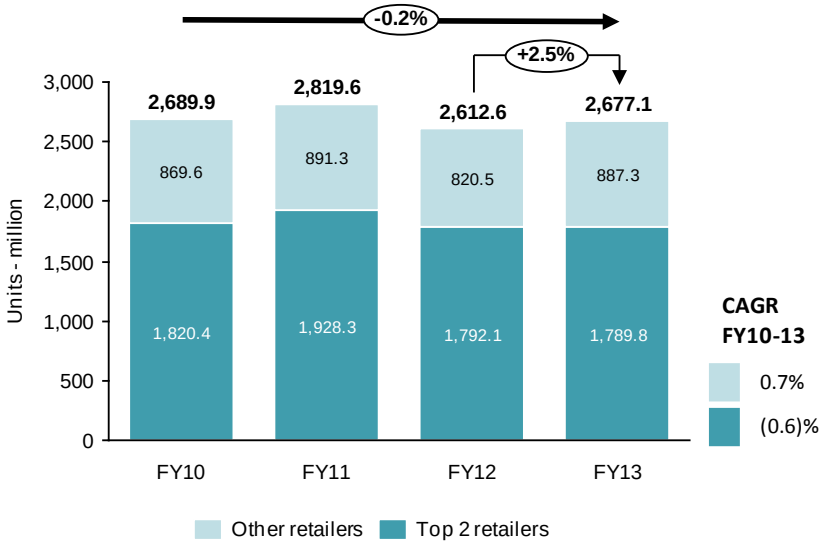
Figure 4.5: Retail gross sales by channel (FY10-13)



Source: Participant data, KPMG analysis

Over FY11-12, volume trend for the two main supermarket retailers was favourable within the retail channel – volumes sold grew at a stronger rate in FY11 and contracted in a lower rate in FY12 compared to other retailers. This trend reversed during FY13 – as other retailers' volume grew significantly by 8.1 per cent, volume sold to the major retailers slightly shrank by 0.1 per cent.

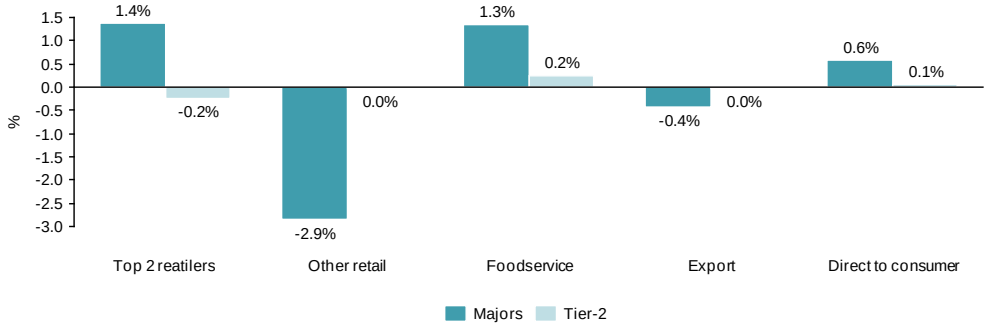
Figure 4.6: Retail sales volume split by sales channel (FY10-13)



Source: Participant data (n=16), KPMG analysis

Analysis by participant group indicates that while the gross sales mix remained overall stable for the tier-2 participants across all channels since FY10, the contribution of the two largest retailers (as well as the foodservice and direct to consumer channels) have increased in importance for the major players.

Figure 4.7: Change in share of sale channel as a percentage of gross sales by channel by participant group (FY10-13)

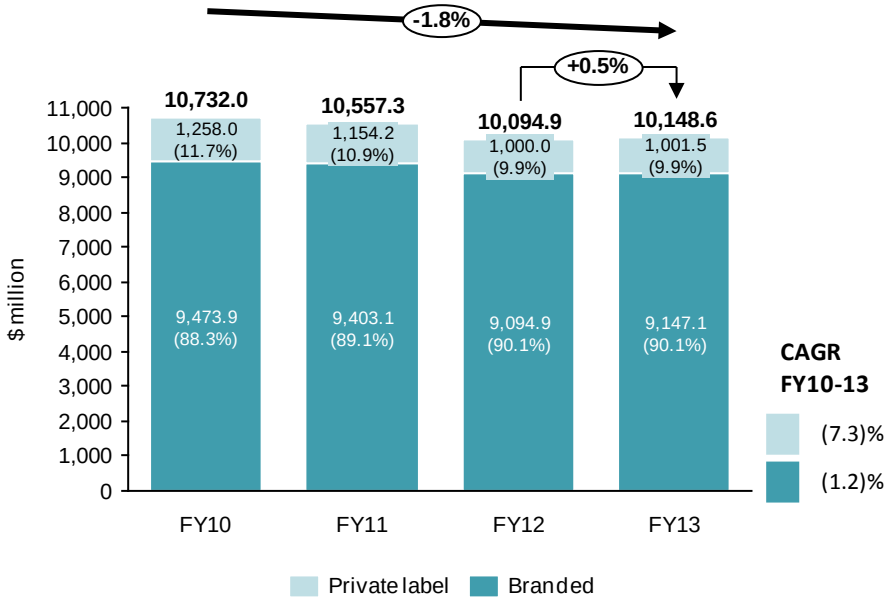


Note: Analysis is based on averages per participant group
Source: Participant data (n=16), KPMG analysis

4.2.1 Private label versus branded products

The participants generated sales through the production and sale of both branded products and private label products for the retailers. Branded products account for 89 per cent of the participants' retail channel gross revenues on average). The share of branded products in gross revenue remained relatively stable at 89 per cent until FY12 when it grew to 90 per cent as private label sales declined (excluding sales for other retailers that were not classified).

Figure 4.8: Gross retail sales by branded products versus private label (FY10-13)

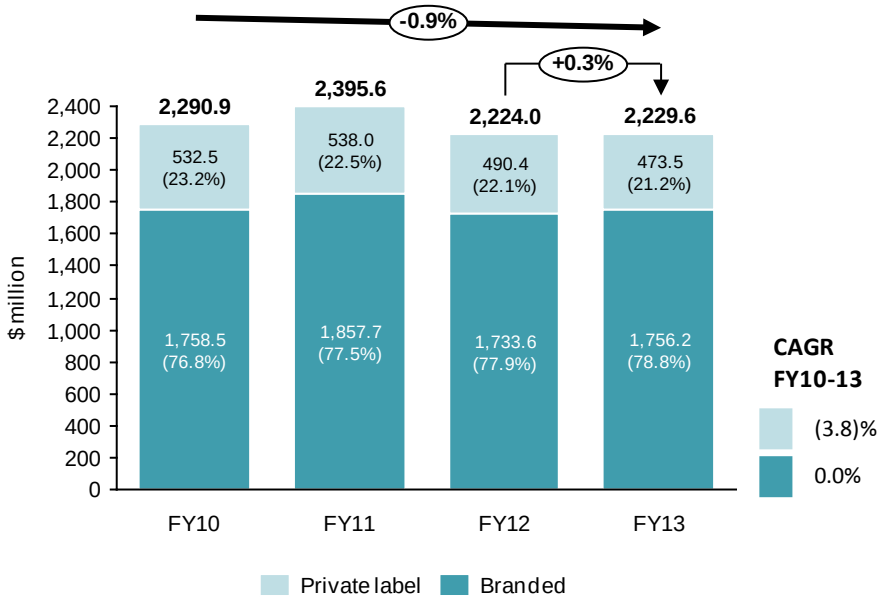


Source: Participant data (n=16), KPMG analysis

Private label products sales stabilised in FY13, representing 10 per cent of gross sales since FY12.

Alongside the decrease in private label sales between FY10 and FY12, volume has shrunk as well. Interestingly, a slight increase in gross sales in FY13 with lower volumes as compared to FY12 suggests a higher average revenue contribution per unit, which could be the result of an increase in prices or a change in mix, as indicated by the trend in new SKUs presented in Figure 4.10.

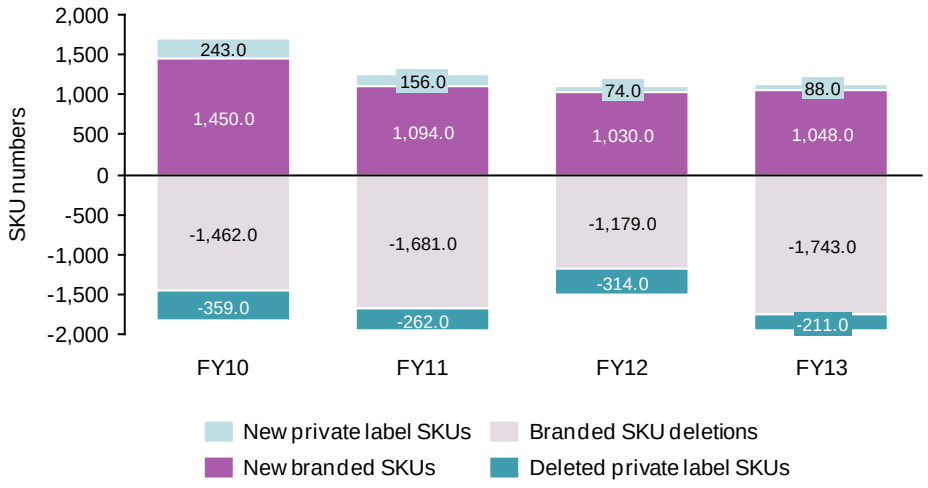
Figure 4.9: Retail volumes by branded products versus private label (FY10-13)



Source: Participant data (n=16), KPMG analysis

The number of branded SKU deletion in FY13 was the highest over the past four years, while the number of private label SKUs that were deleted that year was the lowest.

Figure 4.10: SKU trend (FY10-13)

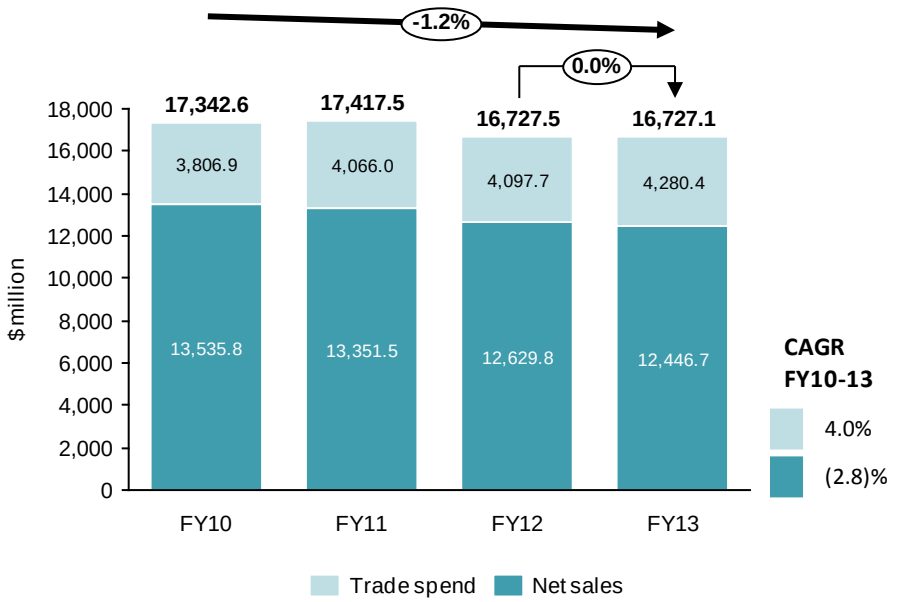


Source: Participant data (n=16), KPMG analysis

4.2.2 Trading discounts and promotional allowances (trade spend)

Trade spend increased considerably at 4.0 per cent CAGR between FY10 and FY13, with its share of gross sales consistently growing over the same period, and increasing from 22.0 per cent in FY10 to 25.6 per cent in FY13. Our survey participants rated increase in rebates/deductions and discounts as the key contributors to trade spend growth over the period.

Figure 4.11: Share of trading discounts, promotional allowances and net sales as a proportion of gross sales (FY10-13)



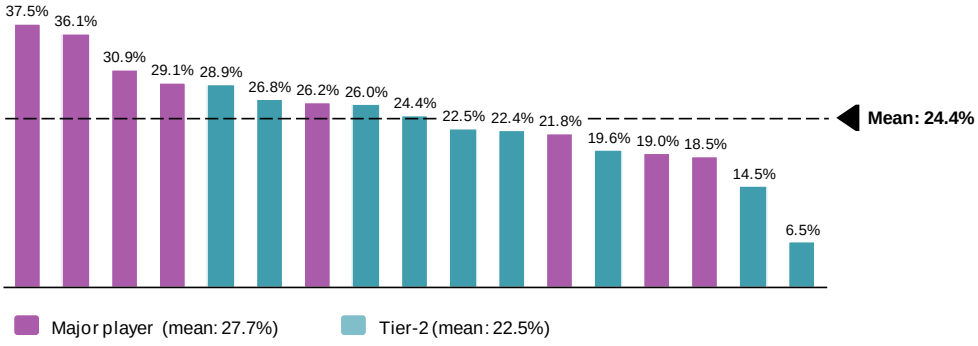
Source: Participant data, KPMG analysis

Despite a decrease in sales since FY11, trade spend continued to increase, significantly eroding net sales.

Trade spend is increasingly used by the participants to retain sales volumes, but the data indicates it has significantly eroded sales. In FY11, faster trade spend growth resulted in a downward pressure on net sales, i.e. $259.2 million increase in trade spend compared to $74.9 increase in gross sales. In FY12, the first year that gross sales declined, the impact on net sales was exacerbated by further growth in trade spend of $31.7 million and a reduction of gross sales of $690 million. Although gross sales remained flat in FY13 it was offset by an increase of $182.6 million in trade spend. This resulted in an overall decline of 1.4 per cent in net sales from FY12 to FY13.

Interestingly, it is the major players that had a higher rate of trade spend as a share of their gross sales.

Figure 4.12: Participants trade spend as a percentage of gross sales (per cent) (FY13)



Source: Participant data, KPMG analysis

Comparison of the percentages of gross sales spent on trade spend by the participants suggests that the highest proportion is consistently spent on the top two retailers. Trade spend as share of gross sales of each channel has increased over the past year – consistent with the overall growth of trade spend share of gross sales in total in FY13. Trade spend for the top 2 supermarkets with 3.8 per cent CAGR

from FY10 to FY13. The other retail channels which includes among others, other grocery, pharmacy, petrol and convenience, liquor, department store, general merchandise, discount, and speciality, also increased overall from 21.2 per cent to 23.8 per cent over the same period.

Table 4.1: Trade spend as per cent of gross sales by channel (FY10-13)

	FY10	FY11	FY12	FY13	FY10-FY13 CAGR of absolute values
Top 2 retailers	24.7%	26.0%	27.4%	28.7%	3.8%
Other retailers	21.2%	21.9%	23.5%	23.8%	0.5%
Foodservice	11.1%	6.5%	8.4%	9.2%	-7.0%
Exports	5.5%	5.1%	3.3%	4.3%	-13.7%

Note: Share of gross share is relative to each channel (rather than total gross sales of the participant group)
Source: Participant data (n=16), KPMG analysis

Trade spend is on average 4.1 per cent higher for the two largest retailers compared to the rest of the retail channel.

However, it is important to note that trade spend do not consistently result in increased volumes as shown below. Analysis of the data at the participant level indicates that only in 56 per cent of the cases, an increase in trade spend has resulted in growth in volume.

Table 4.2: Trade spend growth vs. volumes growth by channel (FY11-13)

Trade Spend vs Volumes by channel				
% year-on-year Δ	FY11	FY12	FY13	FY10-FY13 CAGR of absolute values
Top 2 retailers				
Trade Spend	5.3%	0.9%	5.3%	3.8%
Volume	5.9%	(7.1)%	(0.1)%	(0.6)%
Other retailers				
Trade Spend	(1.2)%	3.6%	(1.0)%	0.5%
Volume	2.5%	(7.9)%	8.1%	0.7%
Foodservice				
Trade Spend	(39.8)%	24.0%	7.9%	(7.0)%
Volume	(5.9)%	(9.8)%	(4.5)%	(6.8)%
Exports				
Trade Spend	-23%	(38.6)%	36.3%	(13.7)%
Volume	212.7%	(15.4)%	38.9%	54.3%
Total Trade Spend	**6.8%**	**0.8%**	**4.5%**	**4.0%**
Total Volume	**7.6%**	**(6.0)%**	**(0.8)%**	**0.1%**

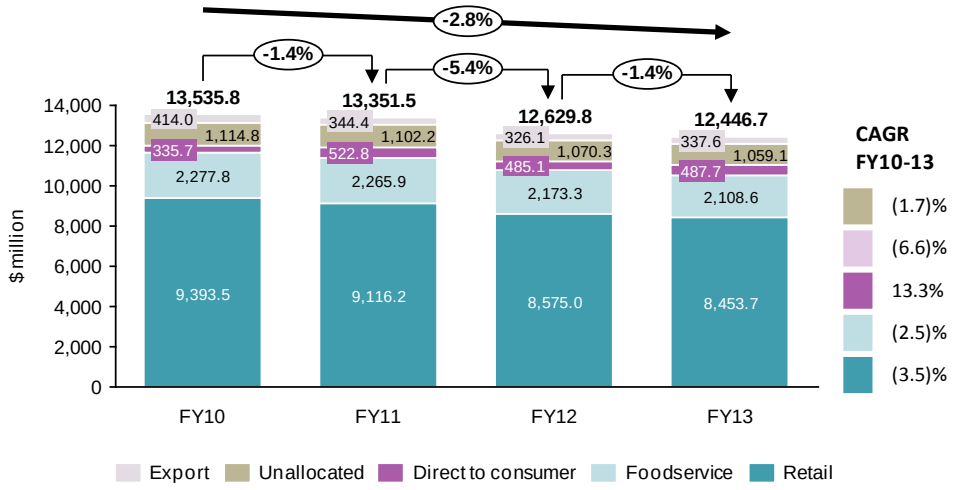
Note: Total includes additional channels and unallocated trade spend
Source: Participant data (volume data partial), KPMG analysis

Trade spend does not appear to result in higher volumes.

4.2.3 Net sales

Net sales declined by 2.8 per cent CAGR between FY10 and FY13, predominantly driven by a 3.5 per cent decline in retail sales. In contrast to gross sales, net sales declined in FY11 due to the higher trade spend.

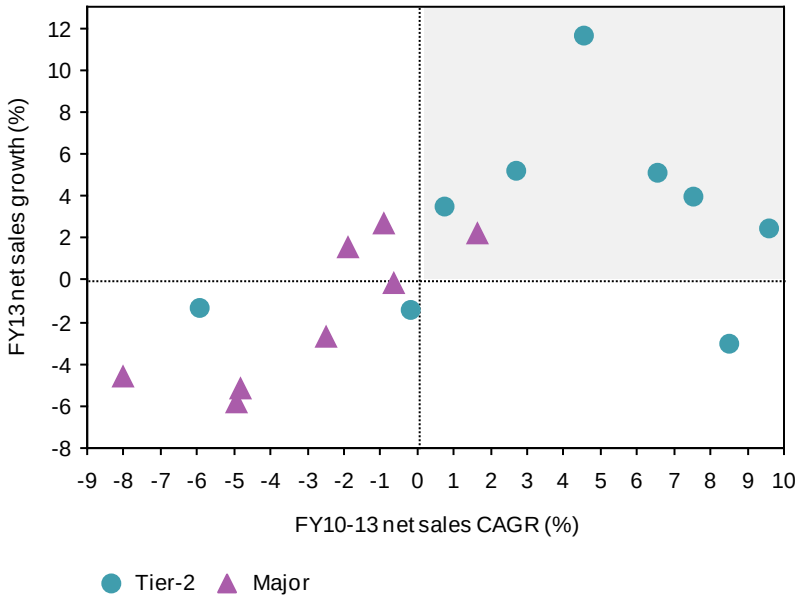
Figure 4.13: Net sales by channel (FY10-13)



Source: Participant data, KPMG analysis

However, while most of the major players' net sales have declined in FY10 through FY13, recording a mean -2.2 per cent CAGR, tier-2 net sales has increased by 4.6 per cent CAGR.

Figure 4.14: Net sales growth by participant group (per cent)

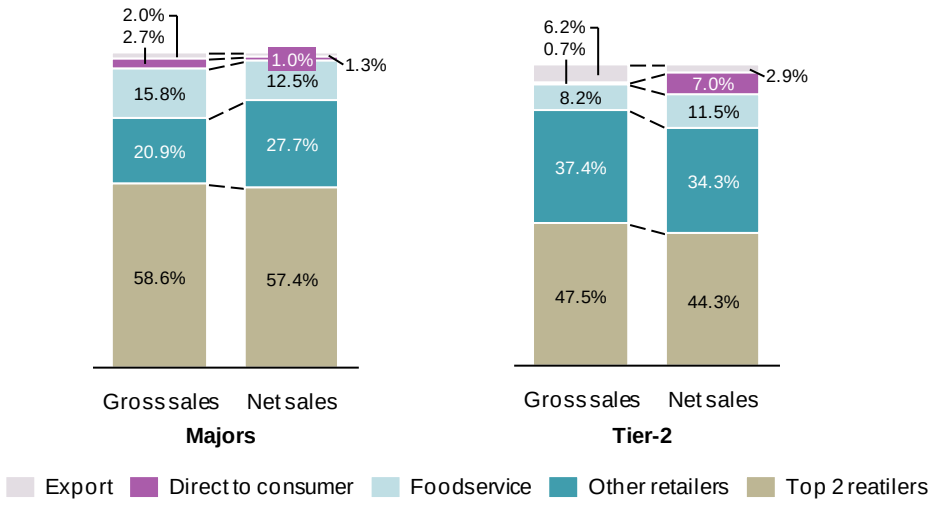


Source: Participant data, KPMG analysis

Similar to the trend in the past 4 years, in FY13 the net sales of tier-2 players continued to grow with a mean 3.5 per cent growth rate while the majority of the majors continued to shrink.at mean 1.4 per cent.

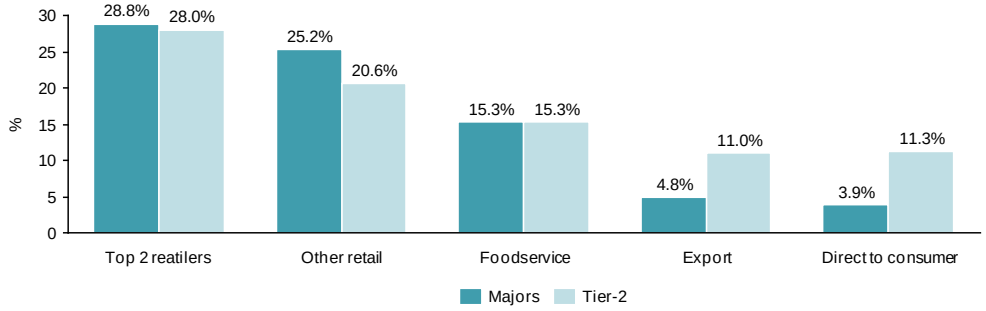
In part, this is due to the different sales mix of these two categories. Specifically, the majors have a higher exposure to the two largest supermarket chains, while tier-2 players have a more balanced channel breakdown with increased presence in channels that have lower share of trade spend.

Figure 4.15: Gross and net sales mix by participant group (per cent) (FY13)



Note: Analysis is based on averages per participant group
Source: Participant data (n=16), KPMG analysis

Figure 4.16: Trade spend share of gross sales per channel by participant group (FY13)



Source: Participant data (n=16), KPMG analysis

4.3 Costs

Costs including trade spend represent over 93 per cent of gross sales and in total they contracted by CAGR 0.2 per cent from $15.7 billion to $15.6 billion during FY10-13. Decrease in gross sales however has outpaced the fall of costs over the period.

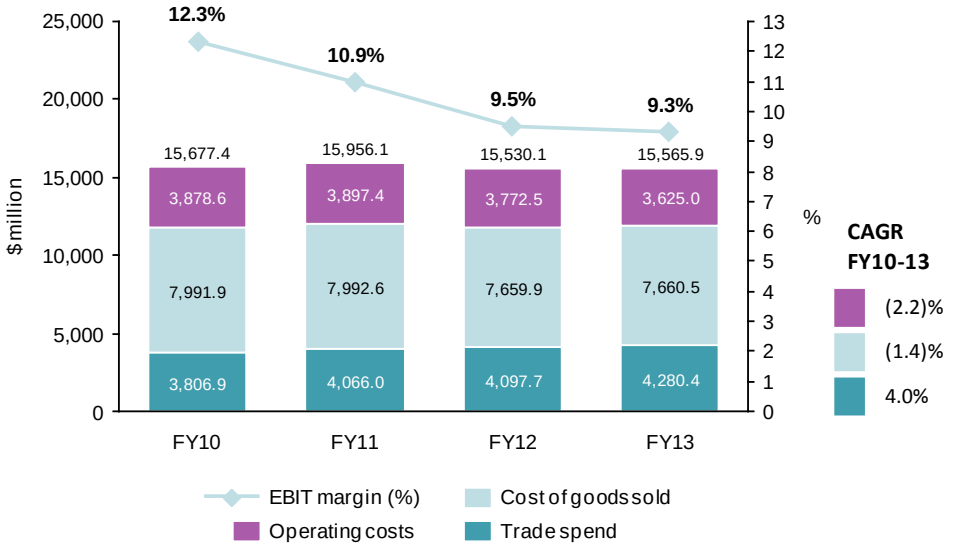
Total costs have been segmented into two broad categories for the analysis:

- Cost of Goods Sold (COGS); and
- Operating costs.

While overall net sales have fallen at a 2.8 per cent CAGR from FY10 through FY13, tier-2 net sales have increased by 3.8 per cent over the same period. This may be the result of the major players' higher exposure to the leading retail chains.

The following figure breaks down the individual cost elements into these categories:

Figure 4.17: Costs breakdown (FY10-FY13)



Source: Participant data, KPMG analysis

Over the last four years, the industry has focused heavily on cost reduction, with the aggregated costs of goods sold and operating costs reduced by 1.7 per cent CAGR over FY10 to FY13. At the same time however, trade spend costs grew by 4 per cent CAGR, which almost completely offset any improvement in cost reductions.

4.3.1 Cost of goods sold

In absolute terms, cost of goods sold for the participant group decreased at a CAGR of 1.4 per cent, from $8.0 billion in FY10 to $7.7 billion in FY13. This is compared with 1.2 per cent decrease of gross sales over the same period, and as a result – an improvement of cost of goods sold as a share of gross sales from 46.1 per cent in FY10 to 45.8 per cent in FY13. Cost of sales' proportion of net sales slightly increased from 28.7 per cent in FY10 to 29.1 per cent in FY13.

Cost of sales can be divided into three components – cost of materials, conversion cost and finished goods:

- Cost of materials encompass cost of commodities, other raw material, packaging, manufacturing variances;

- Conversion cost related to costs involved in the conversion of materials into finished goods such as direct labour, utilities, manufacturing related depreciation and other manufacturing costs; and

- Finished goods related to goods procured locally and internationally for the purpose of direct resale to the customer. For this purpose of this study, we have focused on finished goods sourced internationally.

Eight out of the 17 participants in the sample generate revenues through the sale of imported finished goods. Based on the information provided by these participants, in FY13 this cost category would account for approximately 9.0 per cent of COGS. As this category share has increased over the past years, it appears that local capacity reductions have been partly substituted by imports.

Table 4.3: Split of cost of goods sold by category (FY10-13)

	FY10	FY11	FY12	FY13
Cost of materials	71.5%	69.1%	67.2%	65.8%
Conversion cost	23.7%	25.0%	24.7%	25.2%
Imported finished goods	4.8%	5.9%	8.1%	9.0%
Total ($m)	**7,991.9**	**7,992.6**	**7,659.9**	**7,660.5**

Note: Compounded annual growth rates based on absolute figures
Source: Participant data, KPMG analysis

Cost of materials

Cost of materials is the largest cost driver for cost of goods sold, with an average rate of 27.6 per cent of total net sales. Being the biggest cost item in this category, commodity prices and other raw material prices are the primary drivers for cost of materials. Therefore, it is not surprising that the survey participants have voted for changes in commodity prices as the key (commonly negative) driver of input costs over the past three years. Over the period, the total spend on raw materials decreased by 12.0 per cent CAGR in absolute terms, or by 8.3 per cent of net sales. As indicated in Section 3.4.2, easing of pricing of some of the key inputs in FY13 has helped to lower commodity costs.

Table 4.4: Cost of materials share of net sales by category (FY10-13)

	FY10	FY11	FY12	FY13	FY10-FY13 CAGR of absolute values
Raw materials	34.0%	24.5%	26.2%	25.7%	-12.0%
Packaging	8.0%	7.6%	7.6%	7.5%	-5.5%
Stock Write Off	0.5%	0.5%	0.5%	0.5%	-6.9%
Other Costs (incl manufacturing variances)	6.0%	6.4%	5.8%	5.7%	-4.9%

Source: Participant data (n = 12), KPMG analysis

Conversion cost

Direct labour costs have remained relatively flat as a percentage of net sales while volumes sold by the sample group slightly increased by 0.1 per cent per annum between FY10 and FY13. However, taking into account the variances in sizes of the participants, overall it appears that the majority of the players have seen an increase in volume sold despite the decrease in labour costs. This suggests that the participants were able to reduce some direct labour costs through measures such as plant closures, co-manufacturing, capacity consolidation and productivity improvement. This reduction in direct labour is further supported by a finding in the *State of the Industry Report 2013* where the food and grocery industry experienced an overall decline in employment levels by 1.6 per cent from FY10 to FY125. However, it is important to note that similar to previous years, labour cost per employee continued to increase in FY13, as reported in Section 3.4.2.

Utility and other manufacturing costs have increased in both dollar terms and share of sales. This is consistent with the increase in energy prices in Australia in the recent years6, while our survey participants also identified the carbon tax as another negative driver to utility costs.

Table 4.5: Cost of conversion share of net sales by category (FY10-13)

	FY10	FY11	FY12	FY13	FY10-FY13 CAGR of absolute values
Direct Labour	7.2%	7.2%	7.5%	7.4%	-2.3%
Depreciation	1.1%	1.2%	1.3%	1.4%	4.2%
Utilities	2.2%	2.4%	2.7%	2.8%	6.3%
Other Manufacturing Costs	2.9%	4.2%	3.9%	4.5%	11.8%

Source: Participant data (n = 12), KPMG analysis

4.3.2 Operating costs

Over the last 2 years, total operating costs have been contracting, with 2.2 per cent CAGR over the FY10-13 period.

Table 4.6: Total operating costs as share of net sales (FY10-13)

	FY10	FY11	FY12	FY13	FY10-FY13 CAGR of absolute values
Warehousing, Logistics & Distribution	9.7%	10.3%	10.8%	10.4%	-0.6%
Marketing	8.0%	8.4%	8.2%	8.2%	-2.0%
Sales & Sales Support	2.5%	2.6%	2.5%	2.4%	-4.3%
R&D	0.2%	0.2%	0.2%	0.2%	3.6%
Royalties [1]	1.8%	2.1%	2.0%	1.9%	-0.6%
Corporate. Costs (incl. salaries & on-costs)	4.2%	4.0%	4.5%	4.4%	-1.3%
Depreciation & Amortisation	0.3%	0.3%	0.4%	0.5%	20.0%
Other costs	1.3%	1.7%	1.5%	1.3%	-2.9%

Notes: 1. Share of all cost items are based on aggregated data. Accordingly, the average of royalties also reflects participants that do not who bear the cost of royalties
2. Some of the costs related to 'Depreciation & Amortisation' are included in other cost categories as some participants were not able to curve out these costs separately
Source: Participant data (n=15), KPMG analysis

All key expense categories except for R&D and depreciation & amortisation continue to contract through FY12 and FY13.

The largest components of operating costs are warehouse, logistics and distribution (WLD) and marketing expenses, constituting 10.4 and 8.2 per cent of net sales in FY13, respectively.

- WLD costs relate to the costs that participants incurred to transport and store the goods for sale.

- Marketing expenses includes advertising spend and salaries, bonuses and secondary benefits paid to management, corporate support and other indirect labour for marketing.

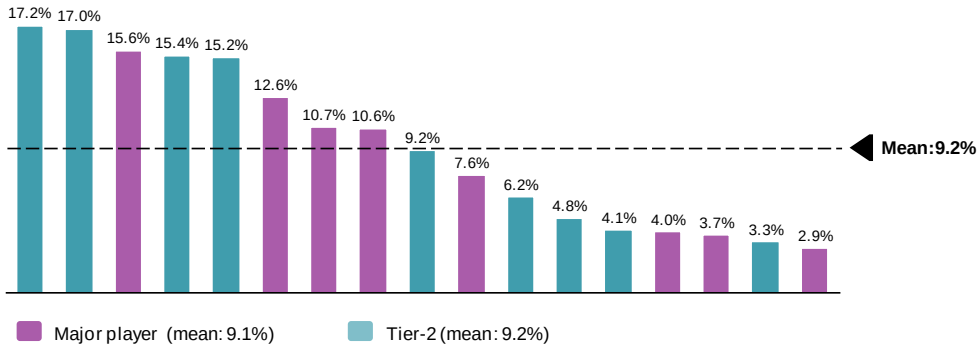
WLD costs peaked at FY11 and subsequently declined slightly in FY12 by 0.9 per cent, before falling another 5.3 per cent in FY13. At the same time, WLD costs share of net sales grew by 0.7 per cent over the full period. In part, this continued growth is due to the relatively fixed nature of the costs for the infrastructure and the significant component related to increasing fuel costs. The survey participants also indicated the burden of rising costs on legislative compliance and energy costs that are being passed to the manufacturers as another driver underpinning the increase in this category.

In FY13, overall marketing expenses have remained relatively stable in their share of net sales and in absolute values. However, analysis of the participants indicates that marketing spend has reduced for nine participants, while the share of net sales fell only for seven of these participants. This suggests that the efforts undertaken by the participants to re-align the cost of marketing, and especially its key component - the labour costs, were not sufficient to preserve margins.

It is also important to note that in some cases, reductions in marketing spend may have been reallocated to trade spend to support volume growth. However, FY13 performance results at the participant level do not indicate uplift in volumes in close to half of the times when growth spend increased.

A comparison at the participant level indicates that as percentage of FY13 net sales, the major players' trade spend share exceeds that of the tier-2 players, while their marketing expense share is lower in comparison to the tier-2 players.

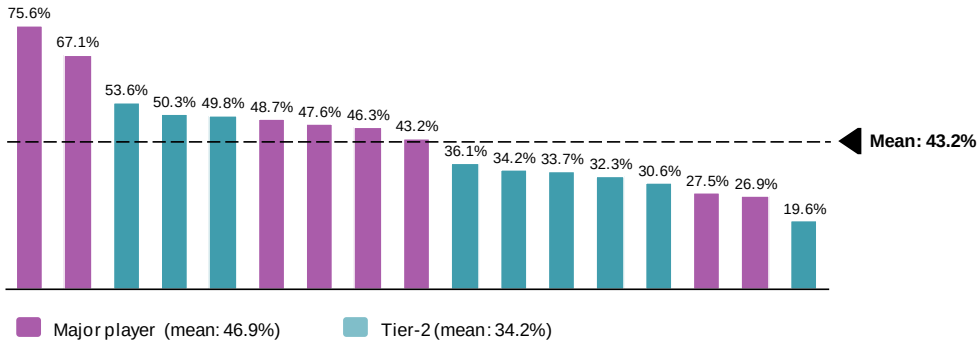
Figure 4.18: Participants marketing expense as a percentage of net sales (per cent) (FY13)



Source: Participant data, KPMG analysis

In addition, at the participant level, only in 58 per cent of cases, an increase in the aggregated trade spend and marketing expenses has resulted in an increase in net sales. 86 per cent of these cases were tier-2 players.

Figure 4.19: Participants total trade spend and marketing expense as a percentage of net sales (per cent) (FY13)



Source: Participant data, KPMG analysis

FY13 saw an increase in R&D expenditure as well as in depreciation and amortisation in both absolute values and share of net sales. This may indicate a positive trend in the industry that in recent years has been mainly focused on cost reduction. Six out of 10 participants who provided R&D data for FY13 have continued to expand their R&D investment. Interestingly, most of these participants can be classified as tier-2 participants.

4.4 Profitability

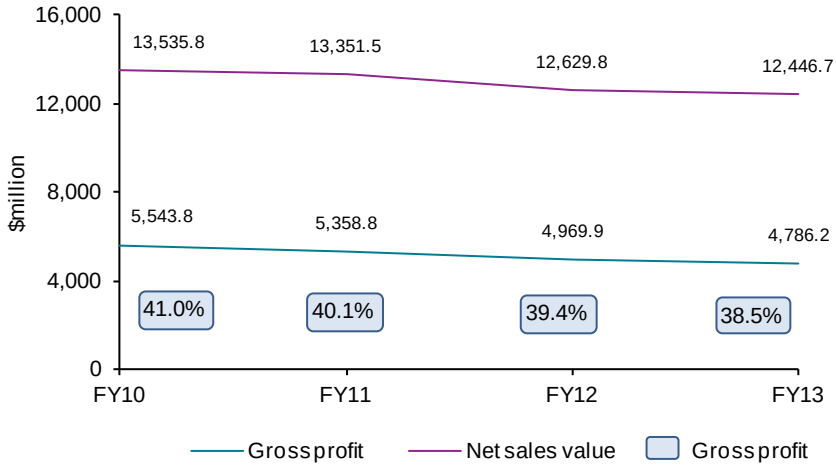
On an overall level, savings achieved across the operating costs and some categories of the cost of goods sold were not sufficient to offset the decline in sales and increase trade spend.

4.4.1 Gross margin

In dollar terms, gross profit decreased by 4.8 per cent CAGR, from $5.5 billion in FY10 to $4.8 billion in FY13. Gross margin as a proportion of net sales decreased from 41.0 per cent in FY10 to 38.5 per cent in FY13. With FY13 flat sales, the erosion of gross margin over the past year appears to be mainly driven by the increase in trade spend. Anecdotally, retailer demands for improved trading terms was voted by the survey participants alongside competition from branded and private label suppliers as the main drivers for gross margin decrease over the past three

years. Increase in spend on utilities and other manufacturing costs have also contributed to the erosion of gross margin.

Figure 4.20: Gross profit ($) and gross margin (per cent) versus net sales (FY10-13)

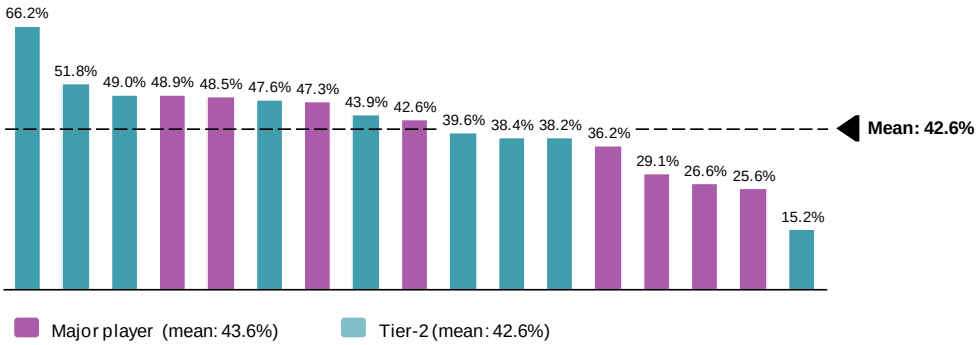


With flat gross sales and decreasing COGS (as a share of gross sales), the increase in trade spend was the major driver of the decline in gross margin from 41.0 per cent in FY10 to 38.5 per cent in FY13.

Source: Participant data, KPMG analysis

On average, in FY13 the major players' gross margin was higher by 1.0 per cent than the tier-2 players' gross margin. Furthermore, throughout the survey period, tier-2 gross margin has eroded at a higher rate than the major players. As tier-2 players sales grew faster over this period, this may indicate that the majors were more efficient in cost reduction initiatives during this time.

Figure 4.21: Participants gross margin (per cent) (FY13)

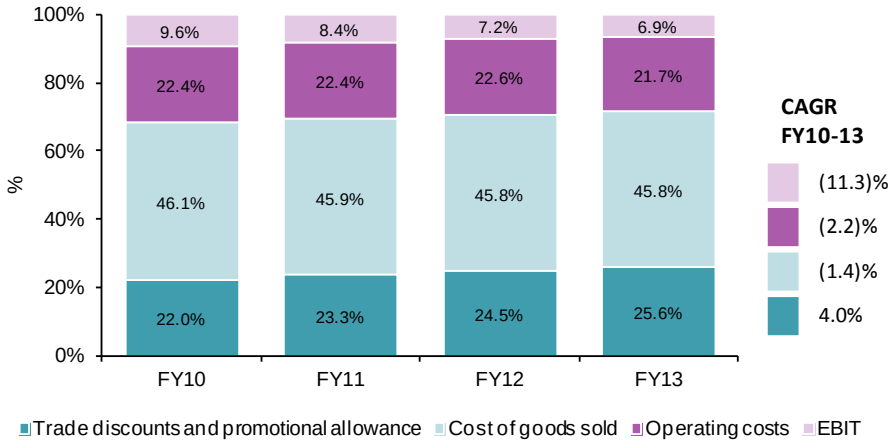


Source: Participant data, KPMG analysis

4.4.2 EBIT

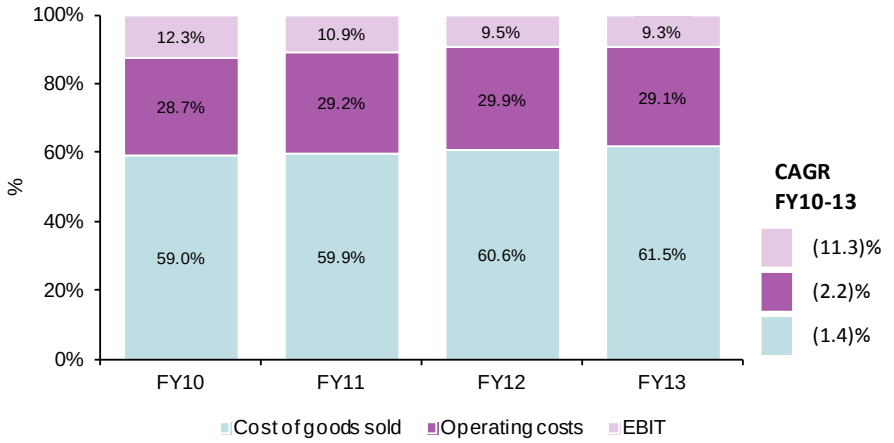
Aggregated EBIT declined at a CAGR of 11.3 per cent during FY10-13. As a percentage of net sales, EBIT margin declined from 12.3 per cent to 9.3 per cent over the same period. Cost efficiencies achieved in FY13 have offset some of the margin erosion that already occurred at the gross margin level. Our survey participants rated changes in product margin – whether positive or negative – as the main driver of change to EBIT margin over the past three years. Anecdotally, inability to offset retailer demand for discounts was mentioned as a key negative underlying driver to product margin, while cost efficiency initiatives were the common driver underpinning positive margin improvement.

Figure 4.22: Cost categories and EBIT as a proportion of gross sales (FY10-13)



Notes: Compounded annual growth rates are based on absolute figures
Source: Participant data, KPMG analysis

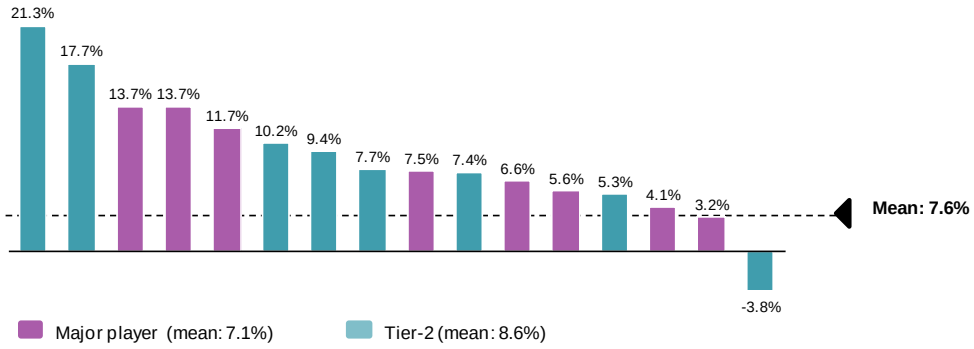
Figure 4.23: Cost categories and EBIT as a proportion of net sales (FY10-13)



Notes: Compounded annual growth rates are based on absolute figures
Source: Participant data, KPMG analysis

At the participant level, although overall the majors have been more efficient in operating cost reduction; tier-2 players have demonstrated a consistently higher EBIT margin. In FY13, the mean tier-2 EBIT margin as a proportion of net sales was 8.6 per cent, 1.5 per cent higher than the majors FY13 EBIT margin.

Figure 4.24: Participants EBIT as a proportion of net sales (per cent) (FY13)



Source: Participant data (n=16), KPMG analysis

4.5 Balance sheet

The following table depicts the aggregated balance sheet for the participants for the period FY10-13.

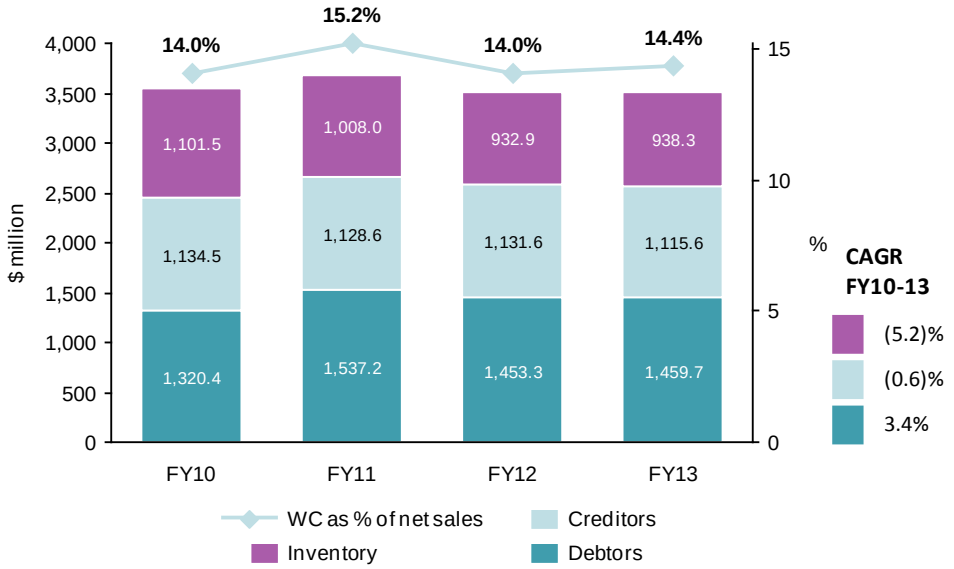
Table 4.7: Balance sheet (FY10-13)

	FY10	FY11	FY12	FY13	CAGR
Cash & cash equivalents	581	291	447	482	-6.0%
Trade debtors	1,320.4	1,537.2	1,453.3	1,459.7	3.4%
Inventory	1,101.5	1,008.0	932.9	938.3	-5.2%
Tax assets	75.5	72.7	71.1	69.3	-2.8%
Property, plant and equipment	2,537.6	2,517.4	2,451.3	2,457.4	-1.1%
Goodwill & Intangibles	2,921.6	2,719.1	2,423.1	2,028.3	-11.5%
Other assets	461.3	290.5	458.7	372.1	-6.9%
Total assets	**8,999.2**	**8,435.8**	**8,237.8**	**7,807.5**	**-4.6%**
Creditors	1,134.5	1,128.6	1,131.6	1,115.6	-0.6%
Borrowings	1,548.3	1,892.1	1,736.0	1,742.5	4.0%
Tax payable	158.5	92.5	63.2	95.9	-15.4%
Other liabilities	878.3	876.2	888.2	857.3	-0.8%
Total liabilities	**3,719.6**	**3,989.5**	**3,819.0**	**3,811.4**	**0.8%**
Net capital	**5,279.6**	**4,446.4**	**4,418.9**	**3,996.1**	-8.9%

Source: Participant data (n=15), KPMG analysis

4.5.1 Working Capital

Figure 4.25: Working capital, excluding cash (FY10-13)



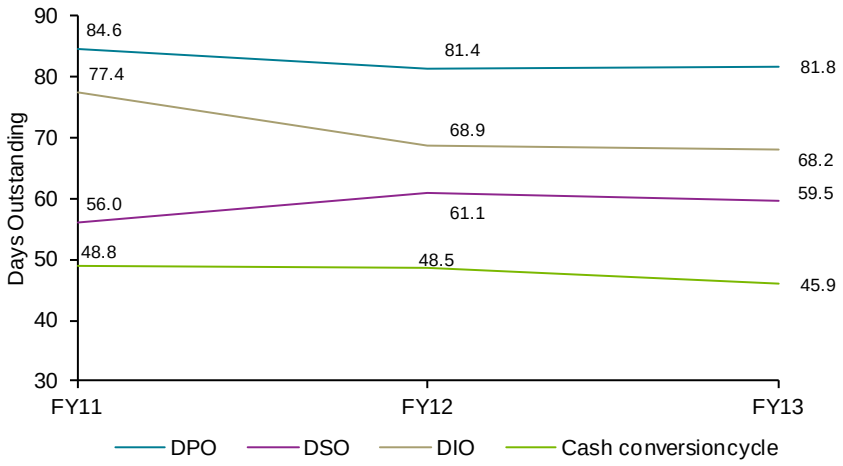
Note: Compounded annual growth rates are based on absolute figures
Source: Participant data (N=15), KPMG analysis

Working capital as a percentage of net sales increased from 14.0 per cent in FY10 to 14.4 per cent in FY13. This has been mainly driven by inventory reductions alongside the decrease in net sales. Overall, total working capital has fallen by 0.1 per cent CAGR between FY10 and FY13 as the increase in debtors has offset the decrease in creditors and inventory.

Days of purchases outstanding have shortened from 70 to 69 between FY11 and FY13, suggesting a slightly tighter credit environment with suppliers demanding shorter payment periods. Days of sales outstanding has on the other hand increased from 56 in FY11 to 60 in FY13, which suggests a widening debt collection period.

Days of inventory outstanding continued to decline over the past three years from 77 in FY11 to 68 in FY13.

Figure 4.26: Working capital days (FY10-13)



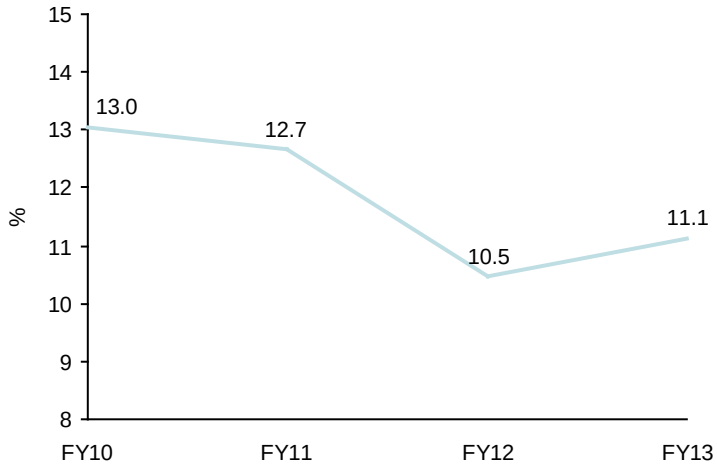
Source: Participant data (n=15), KPMG analysis

The cash conversion cycle decreased, driven by lower inventories and offset partly by higher debtors' days.

4.5.2 Return on assets

For the Australian manufacturers, total assets for the participant group declined by 4.6 per cent CAGR, mostly due to higher impairment of goodwill and intangibles. Over the same period, profitability (EBIT) for the sample group decreased at an average rate of 9.6 per cent. As a result, the return on assets decreased to 11.1 per cent in FY13 from 13.0 per cent in FY10.

Figure 4.27: Return on assets (FY10-13)



Note: Sample includes only participants manufacturing in Australia
Source: Participant data (n=14), KPMG analysis

4.6 Capital expenditure

Capital expenditure (capex) consistently increased between FY10 and FY13 at a rate of 11 per cent CAGR, outpacing depreciation levels. Capex share of net sales also increased over the same period from 3.3 per cent to 4.9 per cent. The four categories of capex investigated for participants manufacturing in Australia are:

- 'Stay in business' capex representing investments made to maintain existing assets and their value;

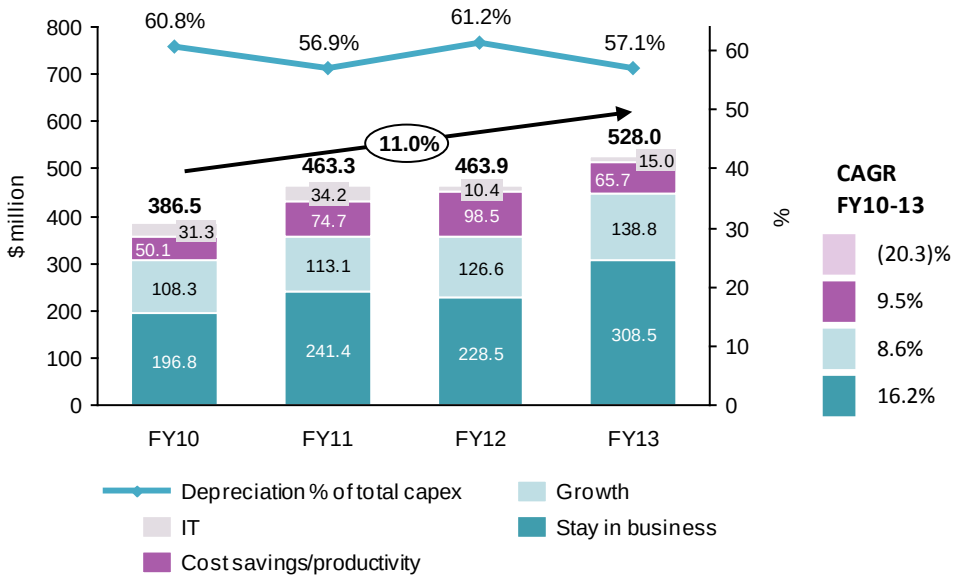
- Growth capex related to investments in R&D, new product development or new capability;

- Cost savings/productivity capex encompassing investments made to reduce the cost or increase the value of the total asset base and generate a basis for profit growth; and

- Information technology representing capital expenditure related to the implementation of IT systems.

The main driver for the growing capital expenditure over the past four years was for maintaining of existing assets, growing at a 16.2 per cent CAGR. While in FY12 the focus was on cost reduction and productivity, in FY13 there is some shift in investing in growth related initiatives. Investment in R&D, new products and new capabilities has been the only investment category that has consistently grown year by year.

Figure 4.28: Split of capital expenditure by purpose and depreciation (FY10-13)



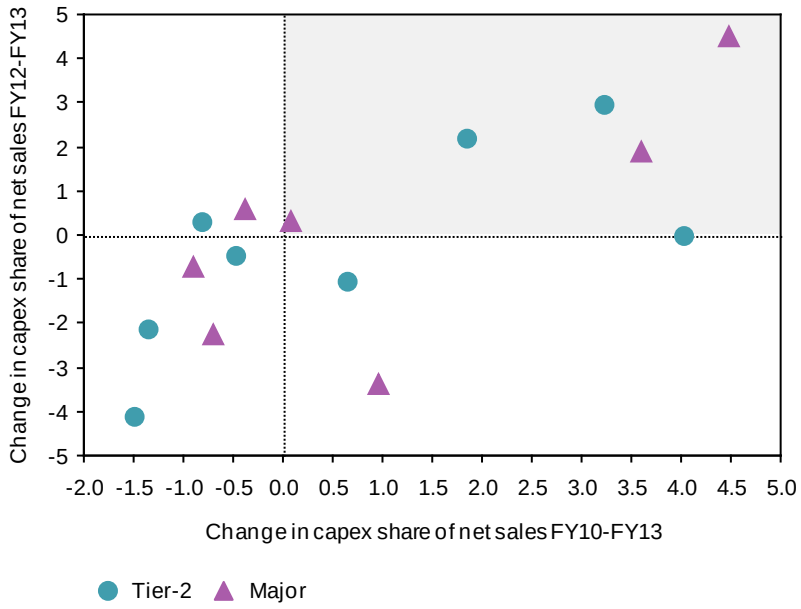
Note: Sample includes only participants manufacturing in Australia
Source: Participant data (n=15), KPMG analysis

In FY13 the focus of investments shifted to growth related initiatives.

It is important to note that in our FY13 sample group, approximately half of the participants increased their capital expenditure in terms of absolute values and share of net sales, splitting evenly between major players and tier-2 players. Six of these participants have invested their capital expenses in either 'stay in business' and/or growth ideas. The significant investment of several tier-1 players in these two categories has resulted in change of balance and the shift away from cost reduction focus.

Furthermore, the mean investment level of tier-2 players has been consistently higher than that of the major players over the past four years.

Figure 4.29: Participants change in capital expenditure share of net sales (per cent)



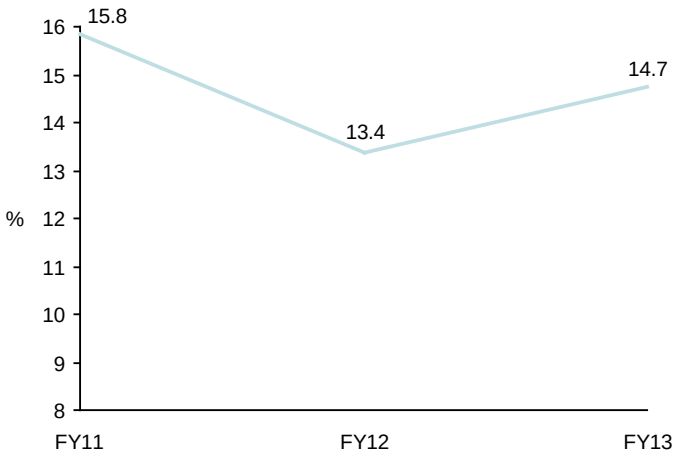
Note: Sample includes only participants manufacturing in Australia
Source: Participant data (n=15), KPMG analysis

The 2.9 per cent increase in the number of new SKUs in FY13 after a decrease in the number of new SKUs launched every year since FY11 supports this evident trend in growth (please refer to Figure 4.10 for details).

4.6.1 Return on capital employed (ROCE)

Looking at the local manufactures from the sample group, there appears to be an improvement to the return on capital employed in FY13. However, the increase in ROCE appears not to be sustainable as it was mainly driven by write-down of non tangible assets, rather than investment in new assets (whether directly or via acquisitions). This is also supported by the flattening private investment in the food, beverage and tobacco manufacturing industry in recent years, as indicated in Section 4.4.3.

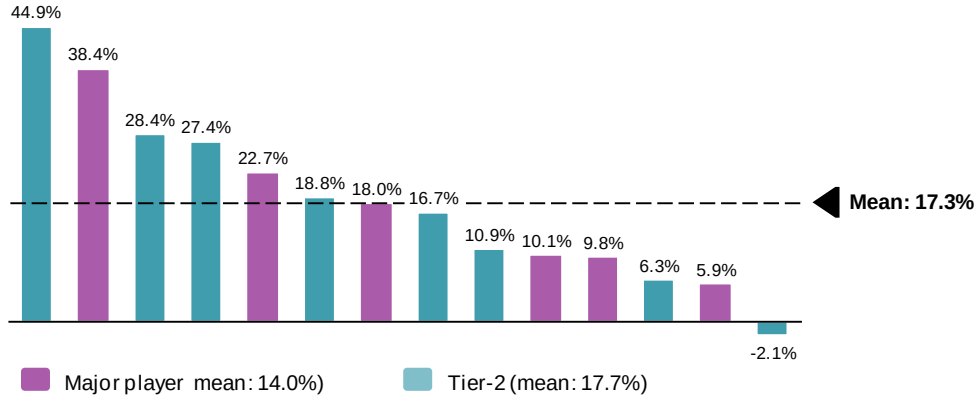
Figure 4.30: Return on capital employed (FY10-13)



Note: Sample includes only participants manufacturing in Australia
Source: Participant data (n=14), KPMG analysis

The tier-2 players in our sample reported a higher return on capital employed compared to the major players. It should be noted that only six of the participants had actually improved their return on capital employed over the past year, half of which are tier-2 players.

Figure 4.31: Participants' FY13 return on capital employed (per cent)



Note: Sample includes only participants manufacturing in Australia
Source: Participant data (n=14), KPMG analysis

5 Key themes in the industry

Further analysis has been undertaken to better understand the key issues impacting the current and future financial performance of the participants. This includes:

- Comparison of the profitability and efficiency of the participant group against an international peer group; and
- Australia's exposure in terms of export and international trade.

5.1 Profitability and efficiency of the participating group relative to international comparators

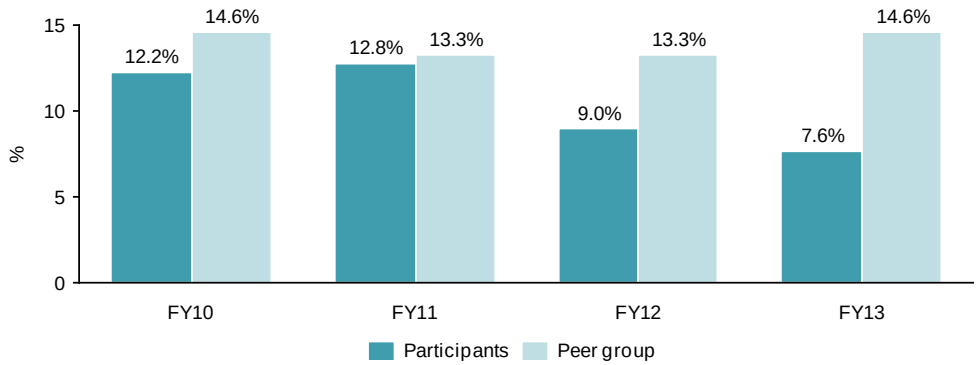
5.1.1 Profitability

The results of the participants were compared to the EBIT performance of 30 international organisations listed in the Capital IQ database as of April 2013. These companies are listed in Appendix 6.3. Comparables values are based on the median of the EBIT margin (EBIT/net sales) of the data sets.

On an EBIT level, the Australian participants record a relatively low margin versus the international peer group, and alarmingly, this disparity has been growing. Specifically, while in FY10 the mean EBIT margin of net sales for Australian survey participants was lower at 2.4 per cent than their international peers, in FY13 the gap has widened to 7.0 per cent. Furthermore, in FY13, despite an improvement in the EBIT margin performance for the international peer group of 1.3 per cent as compared to FY12, the Australian survey participants mean the EBIT margin has fallen by a further 1.4 per cent.

In part, the disparity between the Australian participants and their international peers is driven by the country's higher and rising cost base. This higher cost base of Australian food and grocery manufacturers is also supported by KPMG's *Competitive Alternative* studies of 2008-14, as further analysed in Section 3.4.2. In addition, the relatively small Australian domestic market provides limited opportunities for food and grocery manufacturers to generate scale efficiencies compared to other regions.

Figure 5.1: EBIT margin (FY10-13)



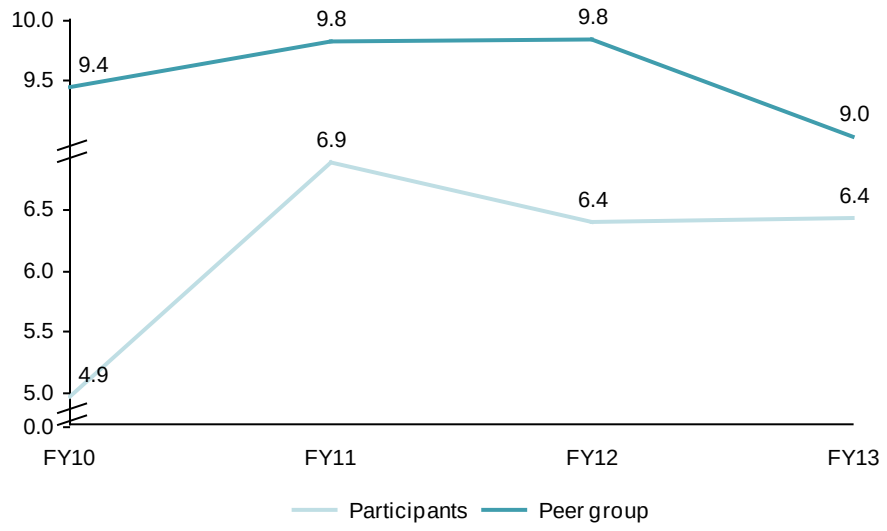
Note: Analysis is based on the mean of EBIT margin for manufacturers
Source: Participant data (n=16), CapitalIQ database, KPMG analysis

5.1.2 Efficiency

In terms of efficiency, the international peers have been consistently outperforming our Australian participants in terms of working capital turnover, generating higher sales from their working capital investment. In FY13, while the international peer

group ratio has fallen, the Australian overall performance remained stable as compared with FY12.

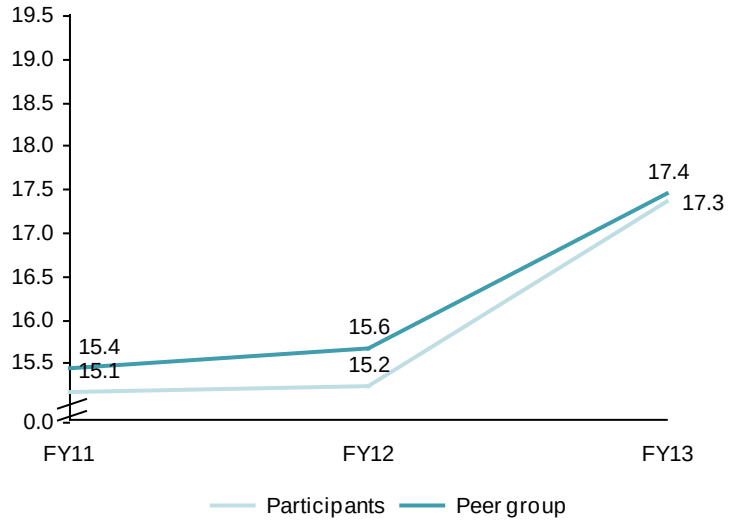
Figure 5.2: Working capital turnover (FY10-13)



Note: Analysis is based on the mean of working capital turnover
Source: Participant data (n-15), CapitalIQ database, KPMG analysis

In terms of return on capital employed, it appears that the Australian trend has been similar to the international improvement in ROCE over the past three years. Not surprisingly, the Australian sample participant group ROCE remains still slightly lower than the international peer group.

Figure 5.3: Return on capital employed trend (FY10-13)

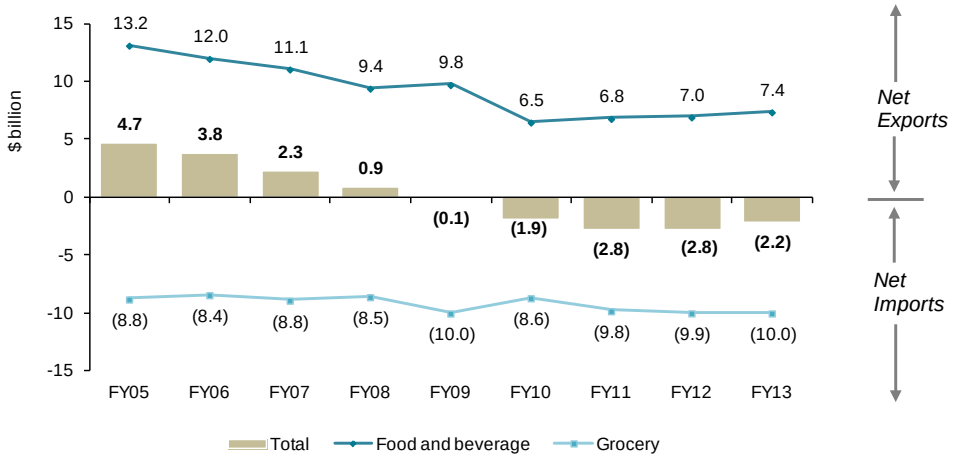


Note: Analysis is based on the mean of ROCE for manufacturers
Source: Participant data (n-14), CapitalIQ

5.2 Export and international trade

The food and grocery manufacturing industry is trade exposed. In FY13, export goods reached $24.3 billion with imports of $26.5 billion, accounting for 22 and 23 per cent of that year's turnover, respectively. With a slight easing of the high Australian exchange rate and cost pressures in FY13, food and grocery exports increased by 2.2 per cent while the imports fell by 0.4 per cent.

Figure 5.4: Trade Balance ($2012-13, FY05-13)



Source: Australian Food and Grocery Council and KPMG | State of the Industry 2013

There has been increased food and grocery import penetration, as the industry has struggled to compete on the home front in a high cost, high exchange rate environment.

The costs pressures discussed in Section 3.2 have impacted the food and grocery industry international competitiveness.

- The high value of the Australian dollar has had an impact on trade exposed industries like food and grocery manufacturing (with both a high export share of sales and significant import competition in the domestic market).

- High production costs have also affected this sectors ability to compete in world markets. Key drivers of these recent high costs in Australia are the increasing wages and energy costs.

In addition, the local market suffers from low productivity levels that hurdle Australia's ability to compete in the international market. For example, since 2008 New Zealand labour productivity levels for food, beverage and tobacco product manufacturing has surpassed Australia, while the gap continues to expand[18].

These cost pressures and productivity issues are a likely factor in Australia's declining market share in Australia's key export countries over the last decade[19]:

- In China, Australia has lost market share to Indonesia, New Zealand and France.

- In Indonesia, by FY12 Australia's market share has halved from a peak of over
15 per cent in FY06, with both Argentina and Brazil overtaking Australia in recent years.

- In Japan, Australia's market share has dropped back slightly, with China continuing to dominate this market, and both Thailand and Brazil gaining ground.

- In Malaysia, Australia has lost market share to Indonesia. Both started with around 13 per cent of this market in FY03, with Indonesia doubling its share of 28 per cent by FY12, and Australia's share halving in the same period.

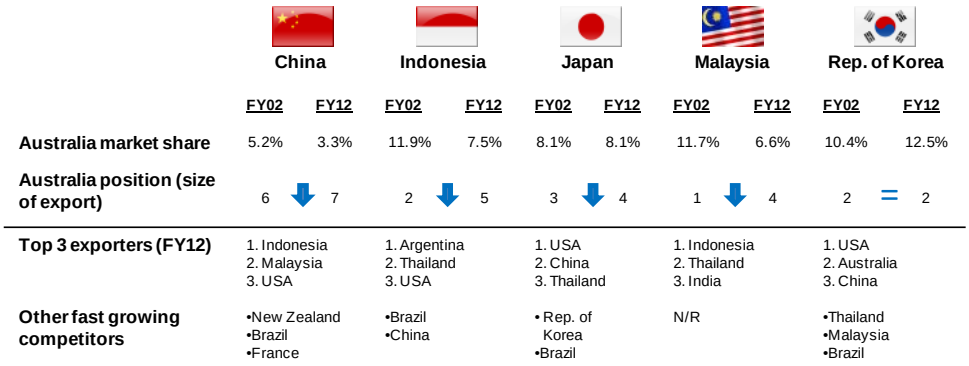
- In contrast to the other markets stated above, Australia's share of the Korean market has increased over the past 10 years. However, it has dropped back to 12.5 per cent from a peak of nearly 18 per cent in FY06.

The food and grocery manufacturing industry has been losing market share as a food exporter to neighbours and emerging economies such as Brazil. These competing export countries are also likely to be major players in an evolving global food and grocery market place.

[18] Average labour productivity is defined as nominal gross value added of the industry divided by labour input, as defined in New Zealand Productivity Commission paper from December 2003 - Investigating New Zealand-Australia productivity differences: New comparisons at industry level

[19] Analysis refers to the period of FY02 to FY12, and is based on United Nations Statistical Division, 2013.

Figure 5.5: Australia market share of process food imports trend in key export destinations



	China		Indonesia		Japan		Malaysia		Rep. of Korea	
	FY02	FY12	FY02	FY12	FY02	FY12	FY02	FY12	FY02	FY12
Australia market share	5.2%	3.3%	11.9%	7.5%	8.1%	8.1%	11.7%	6.6%	10.4%	12.5%
Australia position (size of export)	6 ↓	7	2 ↓	5	3 ↓	4	1 ↓	4	2 =	2
Top 3 exporters (FY12)	1. Indonesia 2. Malaysia 3. USA		1. Argentina 2. Thailand 3. USA		1. USA 2. China 3. Thailand		1. Indonesia 2. Thailand 3. India		1. USA 2. Australia 3. China	
Other fast growing competitors	•New Zealand •Brazil •France		•Brazil •China		• Rep. of Korea •Brazil		N/R		•Thailand •Malaysia •Brazil	

Note: Growth is based on the past 5 year trend
Source: United Nations Statistical Division, 2013

The Government aims to improve Australia's international trade position, and is currently engaged in a series of trade agreement negotiations at a bilateral and regional level. Since its election in September 2013, the Abbott Government has concluded negotiations regarding Free Trade Agreements (FTAs) with South Korea and Japan. Furthermore, the government has strongly indicated its desire for a prompt conclusion to the long-running FTA negotiations with China.

In addition to recently concluded and ongoing bilateral FTA negotiations, Australia is one of 12 countries currently involved in negotiations for the establishment of the Trans-Pacific Partnership (TPP) Agreement. The TPP aspires to be a more comprehensive trade agreement than traditional bilateral FTAs. In particular, the TPP seeks to address non-tariff impediments to trade, which includes regulatory restrictions on goods that can limit a level playing field between multiple trading parties. Addressing such 'technical barriers to trade' will likely require signatory parties to commit to amending domestic legislation or regulations, to standardise trading procedures throughout the TPP signatory countries. In addition to the TPP, Australia is also a party to the Regional Comprehensive Economic Partnership (RCEP) negotiations. This grouping aspires to a regional trade agreement that includes the 10 ASEAN countries, as well as New Zealand, Japan, India, South Korea, China and Australia.

It should be noted that based on public information, it appears that none of the abovementioned trade agreements include specific clauses to encourage export for food and grocery manufacturers. However, the comprehensive nature of the TPP and RCEP agreements provide considerable opportunities to the local manufacturers. Industry welcomes the opportunity to engage with Australia's trade negotiators to ensure an outcome that is fair and advantageous to Australian food and beverage exporters.

Looking forward, Australia's proximity to Asia combined with a growing Asian population and prosperity and the depreciation in the Australian dollar, present significant export opportunities for the Australian food and grocery manufacturing industry. With the significant structural changes that are occurring in the global economy, there will be opportunities for the Australian food and grocery industry to meet a likely increased level of demand from our neighbours. For example, the ANZ reports that the export potential for agriculture products could at least double Australia's agri-food exports, earning more than $700 billion additional export revenue over the next 40 years[20]. In addition to volume growth to meet increasing

[20] ANZ *Greener Pastures: the global soft commodity opportunity for Australia and New Zealand*, 2012.

demand, greater value could be realised by focus on higher value food products, added-value processing done domestically, and higher levels of service.

However, given the sluggishness in investment in this industry in recent times and Australia's current high cost environment and productivity issues, there will need to be significant thought given to the strategy going forward. This is especially the case given significant investments in productivity and growth made by the competition from countries such as New Zealand and Brazil. Both industry and government need to work together to ensure maximising the prospect of realising these opportunities and mitigate the risk of the opportunities being lost to competing trading nations.

6 Appendices

6.1 Summary of key financials

Table 6.1: Table of key items

Key financials								
					% year-on-year Δ			
$m	FY10	FY11	FY12	FY13	FY11	FY12	FY13	CAGR
Gross Sales	**17,342.6**	**17,417.5**	**16,727.5**	**16,727.1**	***0.4%***	***-4.0%***	***0.0%***	***-1.2%***
Trade spend	3,806.9	4,066.0	4,097.7	4,280.4	*6.8%*	*0.8%*	*4.5%*	*4.0%*
As % of gross sales	*22.0%*	*23.3%*	*24.5%*	*25.6%*				
Net Sales Value	**13,535.8**	**13,351.5**	**12,629.8**	**12,446.7**	***-1.4%***	***-5.4%***	***-1.4%***	***-2.8%***
Total Cost of Goods Sold	7,991.9	7,992.6	7,659.9	7,660.5	*0.0%*	*-4.2%*	*0.0%*	*-1.4%*
As % of gross sales	*46.1%*	*45.9%*	*45.8%*	*45.8%*				
As % of net sales	*59.0%*	*59.9%*	*60.6%*	*61.5%*				
Gross Margin	**5,543.8**	**5,358.8**	**4,969.9**	**4,786.2**	***-3.3%***	***-7.3%***	***-3.7%***	***-4.8%***
As % of gross sales	*32.0%*	*30.8%*	*29.7%*	*28.6%*				
As as % of net sales	*41.0%*	*40.1%*	*39.4%*	*38.5%*				
Operating Costs	**3,878.6**	**3,897.4**	**3,772.5**	**3,625.0**	***0.5%***	***-3.2%***	***-3.9%***	***-2.2%***
As % of gross sales	*22.4%*	*22.4%*	*22.6%*	*21.7%*				
As % of net sales	*28.7%*	*29.2%*	*29.9%*	*29.1%*				
EBIT	**1,665.3**	**1,461.4**	**1,197.4**	**1,161.2**	***-12.2%***	***-18.1%***	***-3.0%***	***-11.3%***
As % of gross sales	*9.6%*	*8.4%*	*7.2%*	*6.9%*				
As % of net sales	*12.3%*	*10.9%*	*9.5%*	*9.3%*				
Volume (units, m)								
Retail Channel	2,689.9	2,819.6	2,612.6	2,677.1	*4.8%*	*-7.3%*	*2.5%*	*-0.2%*
Total Channels	3,832.3	4,121.8	3,875.5	3,843.5	*7.6%*	*-6.0%*	*-0.8%*	*0.1%*
Other items								
Total Assets	8,999.2	8,435.8	8,237.8	7,807.5	*-6.3%*	*-2.3%*	*-5.2%*	*-4.6%*
Inventory	1,101.5	1,008.0	932.9	938.3	*-8.5%*	*-7.5%*	*0.6%*	*-5.2%*
Return on assets	13.0%	12.7%	10.5%	11.1%	n/a	n/a	n/a	n/a
Capital expenditure	387.0	464.0	465.2	529.2	*19.9%*	*0.3%*	*13.8%*	*11.0%*

Table 6.2: Split of cost of goods sold as per cent of gross sales (FY10-13)

	FY10	FY11	FY12	FY13	CAGR
Cost of materials	32.9%	31.7%	30.8%	30.2%	-4.1%
Conversion cost	10.9%	11.5%	11.3%	11.5%	0.6%
Imported finished goods	2.2%	2.7%	3.7%	4.1%	21.2%

Note: Compounded annual growth rates based on absolute figures
Source: Participant data, KPMG analysis

Table 6.3: Split of cost of materials as per cent of gross sales (FY10-13)

	FY10	FY11	FY12	FY13	CAGR
Raw materials	26.5%	18.7%	19.7%	19.0%	-12.0%
Packaging	6.2%	5.8%	5.7%	5.5%	-5.5%
Stock write off	0.4%	0.4%	0.4%	0.3%	-6.9%
Other costs (incl. manufacturing variances)	4.7%	4.9%	4.3%	4.2%	-4.9%

Note: Compounded annual growth rates based on absolute figures
Source: Participant data (n = 12), KPMG analysis

Table 6.4: Split of cost of conversion as per cent of gross sales (FY10-13)

	FY10	FY11	FY12	FY13	CAGR
Direct labour	5.6%	5.5%	5.7%	5.5%	-2.3%
Depreciation	0.9%	0.9%	1.0%	1.0%	4.2%
Utilities	1.7%	1.8%	2.0%	2.1%	6.3%
Other manufacturing costs	2.3%	3.2%	2.9%	3.3%	11.8%

Note: Compounded annual growth rates are based on absolute figures
Source: Participant data (n = 15), KPMG analysis

Table 6.5: Split of total operating costs as per cent of gross sales (FY10-13)

	FY10	FY11	FY12	FY13	CAGR
Warehousing, logistics & distribution	7.6%	8.0%	8.3%	7.9%	-0.6%
Marketing	6.3%	6.5%	6.3%	6.2%	-2.0%
Sales & sales support	2.0%	2.0%	1.9%	1.8%	-4.3%
R&D	0.1%	0.1%	0.2%	0.2%	3.6%
Royalties	1.4%	1.6%	1.5%	1.5%	-0.6%
Corporate costs (incl. salaries & on-costs)	3.3%	3.1%	3.5%	3.4%	-1.3%
Depreciation & amortisation	0.2%	0.3%	0.3%	0.4%	20.0%
Other costs	1.0%	1.3%	1.1%	1.0%	-2.9%

Note: Compounded annual growth rates are based on absolute figures
Source: Participant data (n = 15), KPMG analysis

6.2 International peer group list for profitability and efficiency benchmarking

Diageo plc
The Coca-Cola Company
Pepsico, Inc.
Cott Corporation
Lassonde Industries Inc.
Unilever plc
Danone
Kellogg Company
Suedzucker AG
Ülker Bisküvi Sanayi Anonim Sirketi
George Weston Limited
Kraft Foods Group, Inc.
Mondelez International, Inc.
H. J. Heinz Company
JBS S.A.
Marfrig Global Foods S.A.
Fonterra Co-Operative Group Ltd.
Reckitt Benckiser Group plc
Heineken NV
The Hillshire Brands Company
L'Oreal SA
Henkel AG & Co. KGaA
SABMiller plc
Coty Inc.
Johnson & Johnson
McCormick & Company, Incorporated
General Mills, Inc.
Church & Dwight Co. Inc.
Campbell Soup Company
Parmalat SpA

Note: The peer companies were sourced from an aggregated database and KPMG did not seek to verify the information provided by the database with secondary resources, such as an annual report
Source: CapitalIQ

6.3 Scope and Methodology

6.3.1 Scope

This study included organisations from AFGC membership (the participants). Organisations include food and grocery manufacturing companies with production facilities in Australia covering several industry sectors. The participants agreed to provide data, which included confidential data, to the study and agreed to participate in the validation check process through a key point of contact.

Data request lists agreed as part of this project are contained at Appendix 6.4.

6.3.2 Project Overview

6.3.2.1 Planning and design of method

The planning phase included a review of the method, results and key learnings from the Australian Food and Grocery Council Competitiveness & Sustainable Growth report conducted in 2013. A refined method was developed together with a project plan, updated guidelines and an updated data set with a refined data collection template tool. Further, the KPMG project team facilitated a workshop with a sample of Finance Executives from the AFGC membership to provide feedback and suggestions on how to enhance the data collection template tool and further refine the definitions to assist members with their submission. The study design was agreed with the AFGC.

6.3.2.2 Member participation

Members received information outlining the study from the AFGC and a request to participate. Once a member had agreed to participate, they were provided with the data templates required and a key contact person from the KPMG team to assist with the data collection and validation activities.

6.3.2.3 Collection of data

The nature of the data can be summarised into four key areas covering Financial, Channel, Product and a qualitative questionnaire on the key drivers[21]. The data was collected through a standardised data collection template sent out to the members. The template were not altered for (or by) individual participants. Together with the template, participants were provided with a guidance document containing instructions and definitions of the metrics used.

The data was uploaded directly to KPMG's secure server. KPMG provided each participant with a unique username and password that could not be traced back to the participating organisation. The participant was assigned a number to protect the identity of the participating organisation. The file transfer server was accessible only by the participant and the KPMG project analysts.

[21] Please refer to Appendix 6.4 for a description of the data requested

6.3.2.4 Analysis of the data

This section outlines the approach that KPMG used to analyse the data as well as the key assumptions.

Accuracy of the data provided

It was assumed that the data submitted by participants was complete. KPMG did not seek to verify the data provided for accuracy and representation. KPMG did however perform a high level data integrity check on the information provided. The data provided was checked for balancing of the profit and loss statement and balance sheet across the various input sheets within the data request template. To reduce inconsistencies, the data request template automatically calculated the key line items based on pre-populated fields and formulae. KPMG consulted with the participants' data analysts to clarify any ambiguity and/or request for data to be resubmitted if required.

Once the participant data was deemed to be clean, it was combined in a central database.

Presentation of the results

Unless indicated otherwise, all analyses of participant data relate to the full participant group. KPMG consolidated the data from all participants to form a combined database.

Exclusion from the analyses

In cases where KPMG was not provided with sufficient information, the participant was excluded to ensure integrity of the data analysis. Therefore, some analyses are based on a smaller sample. The sample size is marked in these instances.

In Section 4 relating to Cost, there were limitations in the data provided on the breakdown of costs, therefore the analysis included only those participants that were able to provide a full breakdown to enable this analysis to be performed.

Estimations

To the extent where incomplete information was submitted and no additional granularity could be provided, KPMG either excluded the provided information from the analyses or obtained estimations from the participants to avoid inconsistencies in the data.

Further, where there were changes to firm's reporting and cost allocation methods KPMG sought to clarify these changes and adjust the data to ensure comparability to previous years.

Normalisations

To the extent possible and relevant, KPMG has requested management to quantify the impact of any one-off items such as impairments on operational performance. The relevant line items were updated accordingly to identify the underlying performance of the participant.

Comparability from 2013 report

The 2014 Report is not directly comparable to the 2013 Report as the participant group is not the same for 2014. The 2014 Report collects data from the previous 4 years and at times participants restate previous year's results. We have not sought to reconcile data from previous submissions.

6.3.2.5 Assumptions and definitions

Treatment of varying fiscal years

Due to the lack of monthly data, and differing participant year-end periods, KPMG did not seek to match time-series data. As such, it was assumed that there is no significant variation in different firm year ends.

Table 6.6: Definitions of metrics used

Metric	Definition
Gross Sales	Customer list price before discounts
Trading discounts	Retailer claim back from the supplier. Trading discounts comprise of longer term and fixed trade spend such as trading terms, cash discounts, and settlement discount
Promotional allowances	Short term and variable retail claims, such as mark downs, scan deals (supplier support for products on sale) or catalogue support
Trade Spend	Sum of trading discounts and promotional allowances
Net sales	Gross sales *less* trade spend
Cost of Goods Sold (COGS)	Sum of cost of materials, conversion costs and costs of imported finished goods
Cost of materials	Sum of commodities, other raw material, packaging, stock write off, and other costs (incl. manufacturing variances or other costs of materials)
Conversion costs	Sum of direct labour (manufacturing-related), utilities, depreciation, and other manufacturing costs
Imported finished goods	Imported goods that are purchased for re-sale
Gross profit	Net sales *less* cost of goods sold
Operating costs	Sum of warehousing, logistics & distribution (incl. primary freight), marketing, sales & sales support, R&D, royalties, corporate costs, depreciation & amortisation, and other costs
EBIT	Gross profit *less* operating costs
Working capital	Sum of Inventory and trade debtors *less* creditors
Working capital turnover	Net sales divided by working capital
Return on Assets (ROA)	EBIT *divided by* total assets
Total assets	Total of cash & cash equivalents, trade debtors, inventory, net property plant & equipment, goodwill & intangibles, tax assets and other assets
Total liabilities	Total of creditors, borrowings, tax payable and other liabilities
Capital employed	Total assets *less* current liabilities
Capital expenditure (capex)	The total of capex related to (1) stay in business, (2) new product development, R&D or new capability, (3) cost savings productivity, and (4) information technology (IT)

Channel definition

Participants were asked to present their data segmented into four key channels: Retail, Foodservice, Export and Direct to Consumer. Participants allocated gross sales, net sales and volumes to these channels. Despite some variation in channel categorisation by participants, allocation to these channels was achieved. The descriptions of these channels are as follows:

- **Retail:** sales attributable to supermarket, convenience stores, bulk discount stores and independents. Examples include Coles and Woolworths (top two retailers), and other retailers (e.g. other grocery, pharmacy, petrol and convenience, liquor, department store, general merchandise, discount, and speciality).

Retail sales were further broken down by branded and private label products.

- *Branded*: Sales attributable to branded products to the five main retailers

- *Private label*: Sales attributable to private label product sales to the five main retailers

- **Foodservice:** Sales attributable to food and beverage manufacturers, hospitality, restaurants and cafes (HORECA) and caterers:

- *Products:* Sales of finished goods to foodservice customers, i.e., HORECA, defence, hospitals, wholesalers (Bidvest), schools and other

- *Ingredients*: Sales of ingredients to foodservice customers that utilize these ingredients as inputs to another manufacturing process, i.e., sale of sugar to be used in a manufacturing of soft drinks by a beverage manufacturer

- **Export:** Sales attributable to export activities

- **Direct to Consumer:** Sales value and volume metrics of finished goods sold directly to the consumer.

6.4 Survey

Figure 6.1: Questionnaire

Check Items still outstanding. Please review Check sheet.

	Questions	Answer		
1	How many employees do you have in Australia?		Total Headcount - (includes directly employed and indirectly employed e.g. third party/contractors)	
2	Do you manufacture products in Australia?			
	If "yes" to above,			
2a	Select from drop down the % of products manufactured in Australia in FY09			
2b	Select from drop down the % of products manufactured in Australia in FY12			
2c	For only imported goods for re-sale please estimate the annual growth % over the next five years			
			Impact	Comments
3	Please rate top three contributors to your Gross Margin performance over the past 3 years. Of these top three contributors, has the impact been positive or negative?	1		
		2		
		3		
4	Please rate the top three contributors to your EBIT margin performance over the past 3 years. Of these top three contributors, has the impact been positive or negative?	1		
		2		
		3		
5	Please rate the top three contributors to changes in trade spend over the past 3 year. Of these top three contributors, has the impact been positive or negative?	1		
		2		
		3		
6	Please rate the top three contributors to changes in promotional spend over the past 3 years. Of these top three contributors, has the impact been positive or negative?	1		
		2		
		3		
7	Please rate the top three contributors to changes in manufacturing input costs over the past 3 years. Of these top three contributors, has the impact been positive or negative?	1		
		2		
		3		
8	Please rate the top three contributors to changes in manufacturing conversion costs over the past 3 years. Of these top three contributors, has the impact been positive or negative?	1		
		2		
		3		
9	Please rate the top three contributors to changes in operating costs over the past 3 years? Of these top three contributors, has the impact been positive or negative?	1		
		2		
		3		
10	Please rate the top three contributors to changes in CAPEX over the past 3 years? Of these top three contributors, has the impact been positive or negative?	1		
		2		
		3		

Figure 6.2: F1 – Income statement

Check items still outstanding. Please review Check sheet.

F1 - Income Statement / Volume

Financial Year period

Financial year period for participant (i.e Sept - Aug etc)

Volume	FY10	FY11	FY12	FY13	Material Change Indicaor	Explanatory notes and other comments	KPMG Definition & Guidance
Volume-units (millions)							What the shopper (end-consumer) buys (1 unit = 1 item)
Volume-sales (millions)							What the customer (i.e. supermarket) buys (i.e 10 units = 1 carton)
Volume-tonnes (millions)							Total weight of product sold

Income Statement	FY10 ($ millions)	FY11 ($ millions)	FY12 ($ millions)	FY13 ($ millions)	Material Change Indicaor	Explanatory notes and other comments	KPMG Definition & Guidance
Gross Sales							Customer list price before discounts
Trading Discounts & Trading Terms							Fixed discounts including Trading Terms, Cash Discounts, Settlement Discounts. Enter values as positive
Promotional Allowances							Variable discounts including Case deals, Coop, new line fees etc. Enter values as positive
Net Sales Value	0	0	0	0	0		
Raw Materials							Raw materials used in manufacturing
- Commodities							Oil, Wheat, Butter, Milk Powder, Sugar etc
- Other raw material							All other raw materials
Packaging							All packaging related costs
Stock write off							Saleable product that is written off including unsaleable customer returns, surplus packaging, damaged goods, short shelf life
Other (manufacturing variances or other costs of materials)							Other cost of materials not already captured above. Please provide short description of the costs in this category
Total Cost of Materials							
Direct Labour							Labour costs directly attributed to the manufacture of product
Utilities							All energy related costs, incl ullage gas, electricity, water etc
Depreciation							All factory related depreciation
Other Manufacturing Costs							All other manufacturing-based heads and costs including manufacturing based head-office costs
Total Conversion Cost							
Imported goods for re-sale							Any imported goods that are purchased for re-sale
Total Cost of Goods	0	0	0	0	0		Sum of "Total Cost of Materials" & "Total Conversion Cost" & "Finished goods ready for sale"
Gross Margin	0	0	0	0	0		
Warehousing, Logistics & Distribution							All supplychain costs.
- Warehousing							Warehousing costs to receive, store and pick products ready for dispatch to customers (including salaries & on-costs) including warehousing costs outsourced to third parties
- Transport / Logistics							Transport costs to ship to customers including internatil and thrid party spend. This includes primary freight charges (ie from Coles & Woolworths), salaries & on-costs, delivery contractors
- Other expenses							Other supplychain related costs
Marketing							All marketing spend
-Advertising & Promotion							All advertising spend including media, production costs, print, agency costs, Point of sale and scan data
-Salaries & On-costs							Salaries and on-costs of employees that are directly related to marketing of the products. This includes; brand, category management, product management
Sales & Sales Support							Salaries and on-costs of employees that are directly related to selling the products.This includes sales teams, merchandising field teams
R&D							Research & Development spend (including salaries and on-costs)
Royalties							Any royalty payable for agreements including brand licensing
Corporate Costs							All corporate spend
-Salaries & On-costs							Salaries and on-costs of employees that are related to corporate, finance, HR, I.T and procurement
-Other corporate costs							Overhead costs; rent, amenities, shared services, corporate re-charge
Depreciation & Amortisation							Depreciation related to non-manufacturing assets and amortisation resulting from write-downs of any goodwill and intangibles
Other costs							Other Operating costs that do not fall in the above categories. Please provide a short description of the types of expenses that fall in this category
Total Operating Costs	0	0	0	0	0		
EBIT	0	0	0	0	0		
Total Depreciation	0	0	0	0	0		
EBITDA	0	0	0	0	0		

Enter as positive values

Enter as positive values

Legend

Participant input cells

Calculated cells - do not input values

Calculated cells - do not input values

Figure 6.3: F2 – Balance sheet

Check Items still outstanding. Please review Check sheet.

F2 - Balance Sheet / Capex

Balance Sheet line items	FY10 ($ millions)	FY11 ($ millions)	FY12 ($ millions)	FY13 ($ millions)	Material Change Indicaor	Explanatory notes and other comments	KPMG Definition & Guidance
Cash & cash equivalents							Total of cash and cash equivalents. If in overdraft, enter as negative values
Trade debtors							
Inventory							
Tax assets							
Other assets							Other assets not reflected in the above asset categories
Total Current Assets	**0**	**0**	**0**	**0**	**0**		
Property, Plant and Equipment (PPE)	0	0	0	0	0		Net PPE (see rows 25 - 27)
Goodwill & Intangibles	0	0	0	0	0		Net Goodwill and Intangibles (see rows 28 - 30)
Other assets							Other assets not reflected in the above asset categories
Total Non- Current Assets	**0**	**0**	**0**	**0**	**0**		
Total Assets	**0**	**0**	**0**	**0**	**0**		
Creditors							
Borrowings							
Tax payable							
Other liabilities							Other liabilities not reflected in the above liability categories
Total Current Liabilities	**0**	**0**	**0**	**0**	**0**		
Borrowings							
Other liabilities							Other liabilities not reflected in the above liability categories
Total Non-Current Liabilities	**0**	**0**	**0**	**0**	**0**		
Total Liabilities	**0**	**0**	**0**	**0**	**0**		
Net Capital Employed							Total assets less liabilities i.e equity value

Calculating net "PPE" and "Goodwill & Intangibles"	FY10 ($ millions)	FY11 ($ millions)	FY12 ($ millions)	FY13 ($ millions)	Material Change Indicaor	Explanatory notes and other comments	KPMG Definition & Guidance
Property, Plant and Equipment (BV)							Book value of PPE
less accumulated depreciation							Accumulated depreciation for PPE. Enter as negative values
Net PPE	0	0	0	0	0		
Goodwill & Intangibles (BV)							Book value of goodwill & intangibles
less accumulated amortisation							Accumulated amortisation for PPE. Enter as negative values
Net Goodwill & Intangibles	0	0	0	0	0		

Capex spend	FY10 ($ millions)	FY11 ($ millions)	FY12 ($ millions)	FY13 ($ millions)	Material Change Indicaor	Explanatory notes and other comments	KPMG Definition & Guidance
Stay in Business							Spend related to keeping current operations running and includes Regulatory, Safety, Maintenance / Replacement
NPD/R&D/New Capability							Any capex related to NPD, new capability development, capitalised R&D
Cost Savings/Productivity							Any capex related to cost savings and productivity initiatives spend
IT							Capex related to IT spend
Total Capex	**0**	**0**	**0**	**0**	**0**		

Legend

- Participant input cells
- Calculated cells - do not input values
- Calculated cells - do not input values

Figure 6.4: N1 – Channel information

Check Items still outstanding. Please review Check sheet.

N1 - Channel information

Channel	Gross Sales ($ millions) FY10	FY11	FY12	FY13	Net Sales Value ($ millions) FY10	FY11	FY12	FY13	Volume - units (millions) FY10	FY11	FY12	FY13	Volume - cases (millions) FY10	FY11	FY12	FY13	Volume - tonnes (millions) FY10	FY11	FY12	FY13	KPMG Definition & Guidance
Total Retail	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0	
WOW	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0	
Branded																					Sales and volume metrics from Branded products to WOW
Private Label																					Sales and volume metrics from Private Label products to WOW
Coles	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0	
Branded																					Sales and volume metrics from Branded products to Coles
Private Label																					Sales and volume metrics from Private Label products to Coles
Metcash	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0	
Branded																					Value and volume metrics from Branded products to Metcash
Private Label																					Value and volume metrics from Private Label products to Metcash
Aldi	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0	
Branded																					Value and volume metrics from Branded products to Aldi
Private Label																					Value and volume metrics from Private Label products to Aldi
Costco	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0	
Branded																					Value and volume metrics from Branded products to Aldi
Private Label																					Value and volume metrics from Private Label products to Aldi
Other Retail customers																					Value and volume metrics of all other Retail Customers i.e convenience stores, petrol stations, Route Trade, milk bars, pharmacies etc
Total Foodservice	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0	
Product																					Value and volume metrics of finished goods to Foodservice customers ie. HORECA, Defence, Hospitals, Wholesalers (Bidvest), Schools etc
Industrial (Ingredients)																					Value and volume metrics of ingredients to Foodservices customers that utilize these ingredients as inputs to another manufacturing process i.e sale of sugar to be used in a manufacturing of soft drinks by a beverage manufacturer
Total Export																					Value and volume metrics of finished goods exported
Direct to Consumer																					Value and volume metrics of finished goods sold direct to consumers
Total from channels	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0	

Variance checks against P&L data																					
Sales ($ millions)	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0	
Net sales value ($ millions)																					
Volume - units (millions)																					
Volume - cases (millions)																					
Volume - tonnes (millions)																					

Participant commentary re. Sales & Net Sales Value related	Participant commentary re. Volume related explanatory notes

Legend

- Participant input cells
- Calculated cells - do not input values
- Calculated cells - do not input values

Figure 6.5: N2 – SKU information

Check Items still outstanding. Please review Check sheet.

N2 - SKU information

Product/SKU Information	FY10	FY11	FY12	FY13	Explanatory notes and other comments	KPMG Definition & Guidance
Product Count						Total number of products for the year
New Branded SKUs						New Branded SKUs introduced that are a result of new products, new formulas. New SKUs resulting from changes in weight/volume/packaging of current products are EXCLUDED
Branded SKU Deletions						See Guidance in the above cell
Total Branded SKUs						Total Branded SKUs in relevant financial year
New PL SKUs						New PL SKUs introduced that are a result of new products, new formulas. New SKUs resulting from changes in weight/volume/packaging of current products are EXCLUDED
Deleted PL SKUs						See Guidance in the above cell
Total PL SKUs						Total PL SKUs in relevant financial year

Legend

- Participant input cells
- Calculated cells - do not input values
- Calculated cells - do not input values

6.5 Glossary

$ / AUS	Australian dollar
ABS	Australian Bureau of Statistics
AFGC	Australian Food and Grocery Council
CAGR	Compounded Annual Growth Rate
Capex	Capital expenditure
CPI	Cost Price Index
EBIT	Earnings Before Interest And Tax
FTA	Fair Trade Agreements
FY	Financial Year
GDP	Gross Domestic product
GM	Gross Margin (per cent)
GFC	Global Financial Crisis
HORECA	Hospitality, restaurants and cafes
Major	A participant with gross sales over $1bn in FY13 and employee number over 1,000
Mfg	Manufacturing
n.e.c	Not elsewhere classified
OPEX	Operating cost
Participants	The 17 AFGC members taking part in this survey
RCEP	Regional Comprehensive Economic Partnership
R&D	Research and Development
ROA	Return on Assets
SKU	Stock Keeping Unit
Tier-2	A participant with gross sales below $1bn in FY13 and less than 1,000 employees
TPP	Trans-Pacific Partnership
USD	US dollar
WLD	Warehouse, logistics and distribution

6.6 List of data sources

Australian Bureau of Statistics

Gross Domestic Product: Catalogue number 5206.0 (March 2014)

Gross Value Added, Manufacturing: Catalogue number 5206.0 (March 2014)

Household final consumption expenditure: Catalogue number 5204.0 (November 2013)

Consumer Price Index: Catalogue number 6401.0 (March 2014)

Wage Price Index: Catalogue number 6345.0 (March 2014)

Retail turnover: Catalogue number 8501.0 (March 2014)

Private New Capital Expenditure: Catalogue no. 5625, (March 2014)

Australian Food and Grocery Council and KPMG

State of the Industry (2013)

Australian Government

Cutting Red Tape - The Australian Government's online deregulation resource: http://www.cuttingredtape.gov.au/repeal-day/2014-autumn-repeal-day, (accessed 11 May 2014)

Australian Government Department of Foreign Affairs and Trade (DFAT)

About the RCEP negotiations, http.dfat.gov.au/rcep (accessed 12 November 2013)

Australian Industry Group

National CEO Survey Burden of Government Regulation, March 2014

ANZ

Greener Pastures: the global soft commodity opportunity for Australia and New Zealand, 2012.

International Monetary Fund

World Economic Outlook (April 2014)

IBISWorld Business Environment Profiles

Domestic price of wheat (April 2014)

World price of sugar (April 2014)

KPMG

Competitive Alternatives | KPMG's Guide to International Business Location Costs (2012, 2014)

New Zealand Productivity Commission

*Investigating New Zealand-Australia productivity differences: New comparisons at industry level (*December 2013)

OandA

Historical exchange rates: http://www.oanda.com/ (accessed May 2014)

Reserve Bank of Australia

Statement by Glenn Stevens, Governor: Monetary Policy Decision (May 5, 2014)

Tradeables and Non-tradeables CPI: Australian Bureau of Statistics, Reserve Bank of Australia website (accessed 5 May 2014)

US Bureau of Economic Analysis;

Industry Value-added: GDPbyInd_VA_NAICS_1997-2013 (accessed 5 May 2014).

Westpac Banking Corporation, Melbourne Institute

Consumer Sentiment Index (sourced from tradingeconomics.com; accessed May 2014)

World Bank,

Ease of Doing Business Index 2013: http://www.doingbusiness.org/rankings - (accessed 11 May 2014)

United Nations

Trade statistics, Statistical Division (accessed November 2013)

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