Australian Food and Grocery Council

2020: INDUSTRY AT A CROSSROADS

one voice - adding value

ATKEARNEY

The *2020: Industry at Crossroads* report was produced in November, 2011 by the Australian Food and Grocery Council (AFGC) and A.T. Kearney Australia.

The significant contribution of A.T. Kearney is gratefully acknowledged.

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This report was compiled using information and data sourced from secondary data sources and from interviews with almost 30 large, medium and small leading food and grocery manufacturers in Australia. These companies included multi-national and wholly Australian-owned and operated companies as well as relevant industry associations. AFGC would like to thank these companies and organisations for their contributions.

Chief Executive's Foreword

Not many people realise Australia's $108 billion food and grocery sector is the nation's largest manufacturing industry – providing around 24 million nutritious, affordable meals to Australians every day.

Fewer still would know that this vital sector – employing more than 312,000 people, including half in rural and regional areas – is under intense pressure.

Without question, the food and grocery manufacturing industry is at a 'Critical Crossroads'.

Industry is weathering a "perfect storm" from an extraordinary number of pressures right across the supply chain including:

- Rising costs of wages, water and energy
- The high Australian dollar making imported products cheaper
- Near record high global commodity prices – sugar, dairy, cocoa, oilseeds and wheat
- Intense supermarket discounting in a range of products forcing down retail prices and seriously impacting manufacturer margins – supermarkets expect manufacturers to accept no or very small price increases to support their reduced prices
- The rise in market share of private label products in the world's second most concentrated retailer market
- Increasing Government regulation – e.g. the proposed Blewett Labelling Review recommendations could force industry into expensive and multiple labelling changes.

Although industry supports a price on carbon, the timing of the Federal Government's carbon tax also delivers another cost increase to Australian manufacturers that will not affect imported goods. It is estimated that the carbon tax will decrease operating profit before income tax by 4.4% on average for food and grocery manufacturers, but for some sectors of the industry (dairy, meat) the figure is as high as 11.6%.

All of these issues, combined with a very depressed retail market, are putting huge pressure on the profitability of Australian manufacturers which, in turn, puts jobs and future innovation at risk.

We've already seen job cuts in the sector over recent months. Leading food and grocery manufacturers – the economic lifeblood and social fabric of many regional towns – are assessing how to maintain operations and competitiveness in the current environment. If companies have to downsize there are regularly flow-on implications for the wider agrifoods and dependent farming sectors.

To illustrate these intense challenges, future trends and the urgent solutions needed, the Australian Food and Grocery Council (AFGC) commissioned A.T. Kearney to produce this *2020: Industry at a Crossroads* report.

The industry-first, fact-based economic analysis highlights key trends as well as the longer-term impacts facing food and grocery manufacturers. The report acutely highlights that our industry's competitiveness and future sustainability is under threat, emphasising the urgent need to have a greater national policy focus to allow the industry to continue to grow and employ.

Industry applauds the important work being done by Federal Agriculture Minister Senator Joe Ludwig on the National Food Plan to ensure Australia has a thriving, innovative and profitable food and grocery manufacturing industry providing a wide range of safe, nutritious, sustainable and affordable products now and into the future.

Federal Industry Minister Kim Carr's Food Processing Industry Innovation Strategy is also focused on ensuring Australia's food and grocery manufacturing industry continues to attract investment and build new capabilities. We should leverage the fact that Australia's economy is much healthier than most others in the world, we have a world-class regulatory system, we produce great primary produce at competitive prices and we are in close proximity to the growing Asian market. Australia has the capacity to produce high quality, healthy, green food and groceries for Australia's growing population and to contribute to feeding the world. But this will not happen unless there is commitment from government, industry and consumers.

I urge all political leaders – both Federal and State – to seriously consider this report and rethink their business-as-usual approach towards the sector. They must consider what responsive national policy settings, investment, skills and innovation support are needed to keep this essential industry healthy and robust to ensure future growth and job creation. To do nothing is simply not an option – now is the time for bold leadership and change!

Kate Carnell, AO, AFGC Chief Executive

AFGC

"One Voice, Adding Value"
The Australian Food and Grocery Council (AFGC) is Australia's peak national industry association, representing the $108 billion food, beverage and grocery manufacturing industry.

AFGC's aim is for the Australian food, beverage and grocery manufacturing industry to be world-class, sustainable, socially-responsible and competing profitably domestically and overseas. AFGC represents one of the few manufacturing sectors that continue to grow and has significant potential for even further growth into the future.

We provide a strong, united voice for industry to Government, NGOs, retailers/trading partners, industry groups and the media, as well as lead the charge for members in Canberra and in State and Territory Parliaments. AFGC is respected for advancing scientific policies and research to support industry positions. As part of our advocacy role, we advance best practice policy, promote industry's views and make submissions to governments on the development of policy and regulation impacting members.

We help members stay competitive and well-informed on important issues including retailer margins, food regulation, labelling and sustainability issues. AFGC has been proudly representing the interests of Australia's largest manufacturing sector since 1995 and is dedicated to keeping the industry strong, innovative and profitable.

For more information, visit www.afgc.org.au

A.T. Kearney

A.T. Kearney is a global management consulting firm that uses strategic insight, tailored solutions and a collaborative working style to help clients achieve sustainable results. Since 1926, we have been trusted advisors on CEO-agenda issues to the world's leading corporations across all major industries. A.T. Kearney has offices in major cities in 38 countries, including Sydney and Melbourne in Australia.

A.T. Kearney consults on a wide range of consumer and retail issues for national and global companies - our capabilities are in areas such as the following and more:

- Growth & Channel Strategy
- Retail Operations
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- Supply Chain Strategy and Operations
- Procurement Solutions
- Organisation and Transformation
- Strategic Information Technology

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1 Executive Summary

Pressures and Challenges Facing the Industry Today

Over the last five years, the Australian food and grocery manufacturing industry has come under intense pressure from a confluence of forces and pressures across the value chain. These include a highly concentrated retail market, a strong Australian dollar, labour scarcity pressures, escalating energy prices and high yet volatile commodity prices. As a result of these pressures, the **industry** has **grown** at a much **slower rate** (2.1 per cent per annum) than the **demand** for food and grocery items (3.8 per cent per annum) in Australia.

The **gap** between locally-manufactured supply and demand is being **filled by lower cost imports (which have on average a 25 per cent cost differential advantage)** of both private label and branded products (including through parallel importing). As a consequence, **since 2008 Australia** has become a **net importer** of manufactured **food and grocery** products.

Industry **employmen**t has therefore **declined** as a **share** of the Australian **workforce** from 3.2 per cent in 2005 to 2.8 per cent in 2010, a **10 per cent** decline over that period.

The Outlook and Implications for Future Competitiveness

Looking forward, under a ‗business as usual' scenario without any policy framework reforms, the key pressures facing industry are expected to continue unabated over the coming decade:

- ***The retail environment is expected to remain as challenging, if not more challenging, for food and grocery manufacturers over the coming decade***
  - The retail market is expected to remain highly concentrated, with Coles and Woolworths forecast to have a combined supermarket share of over 80 per cent in many categories
  - Private label is forecast to grow strongly and could potentially account for 40-50 per cent of total supermarket sales by 2020, consistent with developments in more mature markets.
- ***The Australian dollar is expected to remain high against the currencies of its major trading partners***
  - The **relative cost position** of Australian manufacturers is forecast to remain significantly higher than lowest cost regional competitors, with on average a 22 per cent cost differential
  - Imports are forecast to continue to rise from $25 billion per annum to $47 billion by 2020, increasing the net trade deficit further.
- ***Energy prices are expected to increase sharply in the next few years***
  - In real terms, energy prices are forecast to increase by 8 per cent between 2011 and 2012 and then 42 per cent between 2012 and 2013 in part due to the introduction of a carbon tax. From 2014, prices are forecast to increase more modestly at 1 per cent per annum (in real terms) through to 2020.
- ***Labour scarcity pressures are expected to continue***
  - Nominal labour costs forecast to grow by~3.6 per cent per annum.
- ***Global commodity prices are expected to remain high and continue to experience high levels of volatility***
  - This will maintain margin pressure for local food and grocery manufacturers as they struggle to pass on rising input costs.

Given the outlook for industry, it is not surprising that **55 per cent** of surveyed food and grocery manufacturers are **negative** about the future.

If nothing changes and there are no policy reforms, the industry is forecast to be significantly less competitive in 2020 as a lack of growth translates into possible job losses and an inability to reinvest in major plant upgrades and innovation.

Real industry turnover is forecast to **decline by 0.2 per cent per annum** over the coming decade from $108 billion in 2009 to between $105 billion and $106 billion in 2020. Over that same period **real retail demand is forecast to grow at 3.7 per cent per annum** with the growth gap being increasingly filled by imports and retailers' private label products.

As a consequence, the **industry is forecast to shed 100,000 to 130,000 jobs to „right size"**. Towns in regional New South Wales, Victoria and Queensland are expected to be most impacted by any employment loss as these are the manufacturing hubs for the most highly exposed product categories.

The most vulnerable product categories and (by implication food and grocery manufacturers) are those that are highly trade exposed and/or are subject to high levels of retailer pressure and are already exhibiting signs of marginal profitability. The **product categories** that are **most highly exposed** include processed fruit and vegetable products, seafood processing, animal and bird feed, grain mill products, sanitary paper products, sugar, cleaning and personal care products, wine, cheese and dairy.

A less competitive industry will also have **flow on impacts** on up-stream industries. A further 5,000 to 6,000 jobs losses are forecast in upstream industries by 2020 if there are no policy reforms. The most significant upstream impact is expected to be on highly exposed' parts of the agriculture industry (domestic market focused, providing input to high risk product categories, with long planting cycles and high switching costs) where between 940 and 1,100 job losses are forecast.

Given the challenges facing the industry and the implications for growth and profitability, it is highly uncertain whether the industry as a whole has the appetite' to make the scale of investment required in capital and innovation to maintain its competitiveness.

Should this scenario eventuate, Australia will see an acceleration of the fundamental shift to being a major net importer of food and grocery items. This has significant longer term implications for Australia's food security and safety since many of these lower cost countries are not subject to the same levels of regulation and scrutiny as their Australian equivalents.

The Path Forward

Despite the extremely challenging outlook for the food and grocery manufacturing industry in 2020, there is a recipe' for positive change.

There are a range of options both industry and Government must consider to ensure Australia continues to support a viable, competitive, innovative and robust food and grocery manufacturing sector that will continue to deliver high quality products for Australia and the export market.

For Government the AFGC urges it to consider:

- Establishing a co-regulatory Code of Practice for Supermarket Trading Relationships overseen by a Supermarket Ombudsman to ensure branded products continue to have access to supermarket shelf space on a fair and equitable basis
- Streamlining the regulatory system and red tape burdens on industry. For example, expensive, complex labelling changes impact on industry's competitiveness
- Removing infrastructure bottlenecks which impede transport logistics efficiencies of food and grocery products
- Providing tax incentives (for example accelerated depreciation of assets) to encourage business to take advantage of the high Australian dollar to invest in large-scale plant equipment upgrades from overseas
- Creating incentives to encourage investment in innovation

- Providing a more competitive and flexible labour market – especially as many parts of the sector are seasonal
- Facilitating skills development and training opportunities to ensure careers in food and grocery manufacturing become more attractive
- Having a greater focus on water and food safety and security.

For industry these options include:

- Demonstrating the value of „Tier 1" products versus private label brands by focusing on relentless innovation & marketing to drive increased levels of brand equity with consumers
- Exploring new technologies to better understand consumer behaviour and tapping into broader consumer trends such as the 55+ age group and the healthy fresh/convenience categories
- Employing a multi-channel strategy, investing in and developing new and innovative channels to market using both direct and indirect mediums
- Winning categories through cost leadership by developing more sustainable, efficient supply chains and improving productivity.

All of these reforms must be encapsulated in the Federal Government's broad-based National Food Plan which needs to be urgently fast-tracked. The Government needs to adopt a long-term strategic framework to ensure this essential sector remains robust, competitive and continues to grow and create employment in the future.

Key Facts and Figures

Over half (**55 per cent)** of surveyed food and grocery manufacturers **are negative about the outlook** for the **industry** in Australia.

The 2020 forecasts in these tables are based on a ‗business as usual' environment in Australia over the next decade assuming no policy reforms or changes.

Industry Size and Growth

	2009	2020F	*Growth / Change*
Retail Demand	$131B	$194B	3.7% p.a.
Industry Turnover	$108B	$105-$106B	-0.2% p.a.
Upstream (Dependent) Industry Turnover	$80B	NA	1-2% reduction off current base
Industry Imports	$25B	$47B	5.8% p.a.
Import Share of Turnover	*23%*	*45%*	*NA*

Employment Snapshot

	2009	2020F	Estimated Job Losses
Food and Grocery Manufacturing Employment	312,000	180,000-210,000	100,000-130,000
Share of Australian Workforce	*2.9%*		
Upstream (Dependent) Industry Employment	360,000		
Total Indirect and Direct Industry Employment	672,000		

Retail Environment

	2009	2020F
Supermarket Share of top 2 players	78%	80%
Private Label Share of Supermarket Sales	25% (2010)	40%

Relative Cost Position of Australian Manufacturing compared with Regional Alternatives

	2011	2020F
Average Cost Differential	25% higher	22% higher
Range across select product categories	9-28% higher	8-24% higher

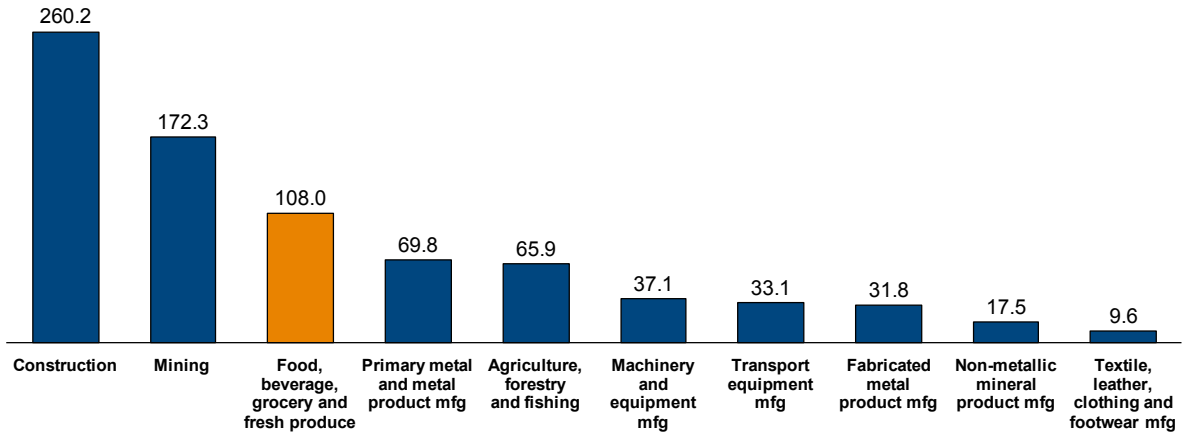
Industry Survey Results on Capital Investment and Research and Development

% of Respondents	2011	5 Year Outlook
Level of Capital Expenditure (CAPEX) <$10m p.a.	60%	53% said ‗will remain at current levels'
CAPEX Purpose – first priority - Productivity and cost reduction - Expand capacity - Extend new product capability	 53% 32% 11%	 67% 17% 0%
Level of R&D Investment <$10m p.a.	88%	52% said ‗likely to increase' while 37% said ‗stay at current levels'
Barriers to R&D Investment - Cost involved - Lack of grants	 82% 41%	

2 Current Pressures and Challenges Facing the Industry

The Australian processed food and beverage, grocery and fresh produce sector (the defined industry[1,2]) is a significant contributor to the Australian economy. In 2008-09, the industry had a reported turnover of $108 billion (see Figure 1) and represented 26 per cent of total manufacturing in Australia. In terms of turnover, the industry is significantly larger than other manufacturing sectors in the economy, including the primary metal and metal product manufacturing sector, and is two-thirds the size of the mining sector.

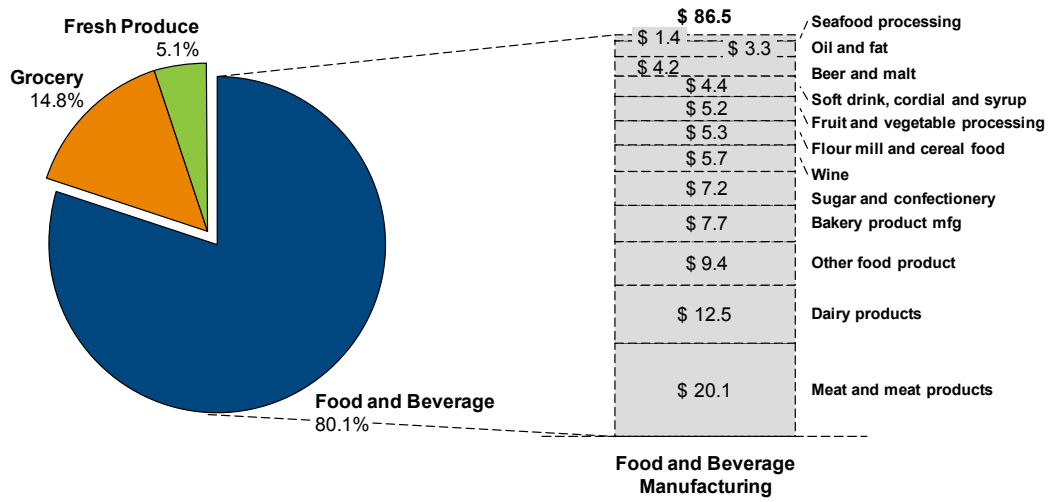
Figure 1: Comparable Industry Turnover
(A $billion, 2008-09)



Source: ABS Catalogue Number 8155.0, Catalogue Number 7503.0

Of the three broad sub-sectors within the Australian food and grocery industry, the processed food and beverage sector contributes the largest proportion to total industry turnover (80.1 per cent), followed by the non-food grocery sector (14.8 per cent), and the fresh produce sector (5.1 per cent).

Figure 2: Industry Turnover by Sub-Sector
(2008-09)

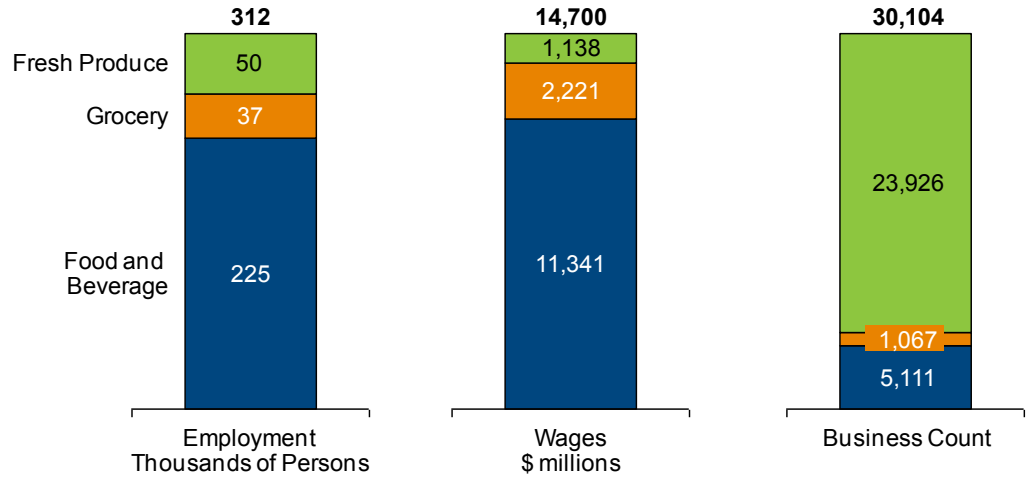


Source: Australian Bureau of Statistics, Catalogue number 8159.0 and 7503.0, IBIS World Industry Reports

[1] Refer to Appendix B for a full listing of sub-sectors/ product groups in the defined industry.
[2] Throughout the remainder of this report, the Australian processed food and beverage, grocery and fresh produce industry is referred to as the food and grocery industry'.

The industry is a significant provider of employment for Australians. In 2009, the industry represented 30,104 businesses which employed 312,194[3] people (approximately 2.8 per cent of the paid work-force) and paid $14.7 billion in wages and salaries.

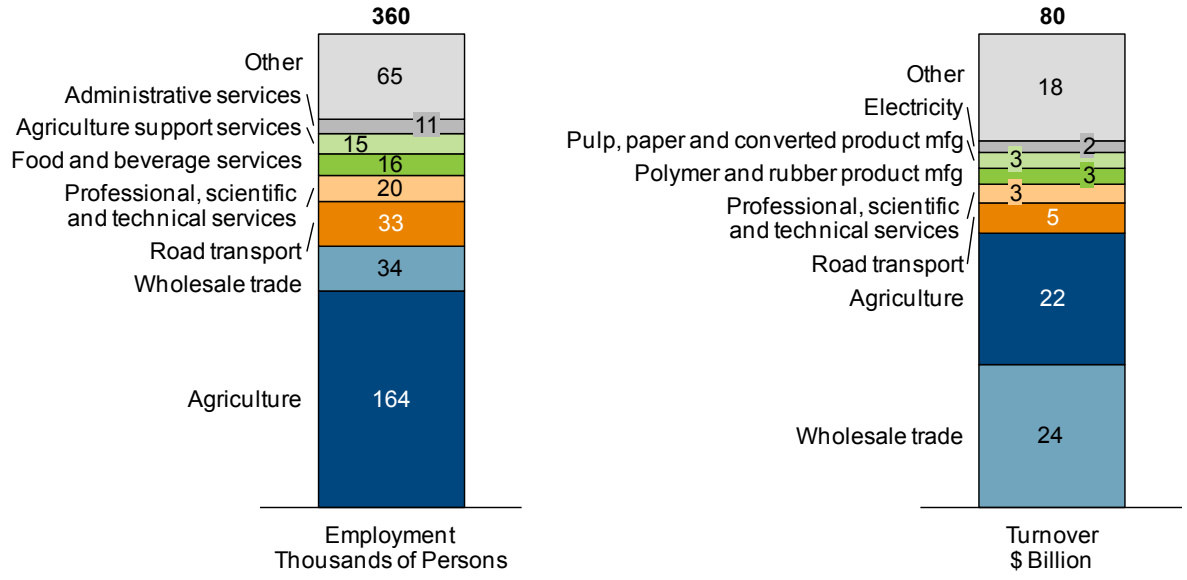
Figure 3: Industry Employment, Wages and Business Count
(2008-09)



Source: ABS Catalogue Number 6291.0.55.001, 8159.0 and IBIS World Reports

Indirectly, the industry contributes to an additional 359,600 jobs and $80 billion in annual turnover for upstream input or dependant sectors such as agriculture, wholesale trade and road transport. When these upstream impacts are accounted for, the industry is responsible for the employment of approximately 670,000 to 675,000 Australians.

Figure 4: Indirect Employment and Turnover, Upstream Industries[4]
(2008-09)



Source: ABS Catalogue Number 5209.0.55.001, 8155.0

[3] In developing an estimate for employment for this paper, ABS Catalogue number 6291.0.55.003: Labour Force Australia was utilised to obtain employment data for the food and beverage sector. This differs from the source, ABS Catalogue Number 8159.0: Experimental Estimates for Manufacturing Industry used in the State of Industry Report 2010. Employment includes full time and part time employees.

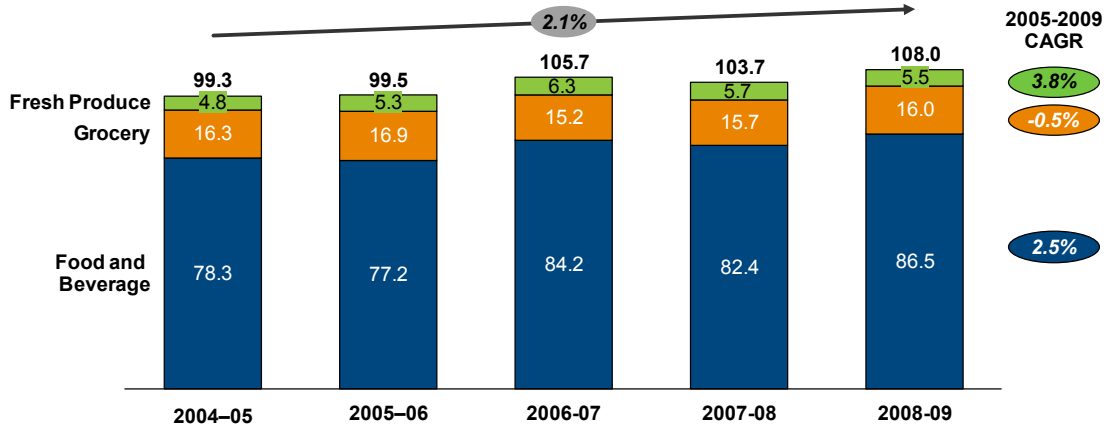
[4] The fresh produce component of Agriculture has been excluded in order to avoid double counting of employment and turnover

2.1 Industry under Pressure

Over the last five years, the food and grocery manufacturing industry has come under significant pressure. As a consequence of these pressures, the industry has grown at a slower rate than the demand for food and grocery items in Australia.

Real industry turnover (in FY2009 dollar terms[5]) has grown at an average annual rate of 2.1 per cent per annum between 2005 and 2009 (see Figure 5). This growth rate is well below the average rate of real Australian GDP growth during the same period (4.5 per cent per annum) and is in line with population growth of 1.9 per cent per annum. [6]

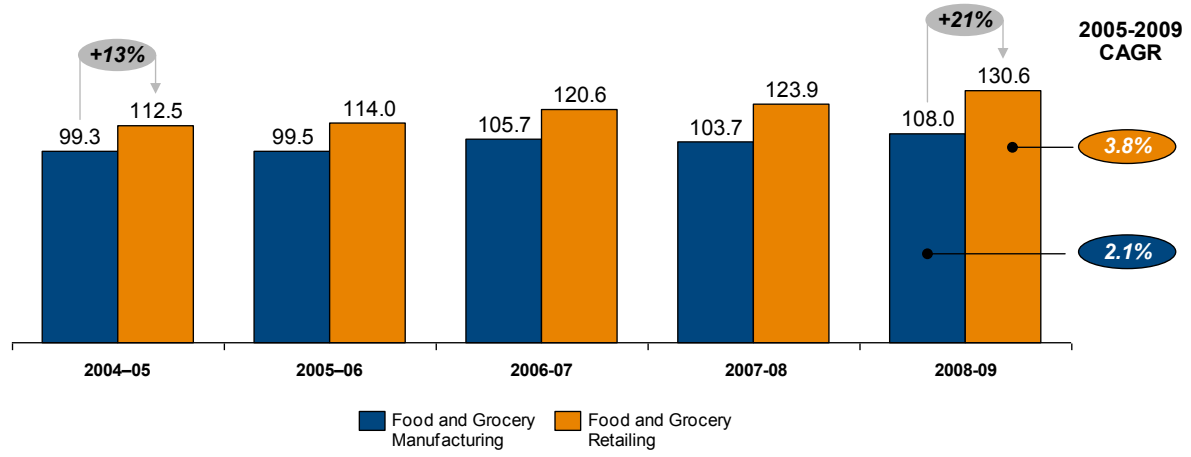
Figure 5: Real Industry Turnover by Sub-Sector
(Inflation adjusted to 2008-09 A $ billion)



Source: ABS Catalogue Number 8159.0, and 7503.0

Although real industry turnover has tracked to population growth, per capita consumption of food and grocery items has increased between 2005 and 2009. This is evidenced in growth in real retail demand for food and grocery items of 3.8 per cent per annum between 2005 and 2009, which is materially higher than the industry's real growth during that same period.

Figure 6: Food and Grocery Retailing and Manufacturing in Australia
(Inflation adjusted to 2008-09 A$ billion)



Source: Australian Bureau of Statistics, Catalogue Number 8501.0; Total spend on food through the retail channel and the food-service channel and total spend on pharmaceuticals, cosmetics and toiletries products

[5] Hereafter real dollars or real industry turnover are in FY2009 dollars
[6] ABS Catalogue number 1350.0 and 3101.0

The difference between demand for Australian food and grocery items and Australian manufactured supply reflects a number of pressures facing the industry. As a consequence of these pressures, imported food and grocery items have become significantly more cost competitive and attractive to retailers. Australian food and grocery manufacturers have responded to this dynamic by rationalising operations through a combination of consolidation and productivity initiatives to cut costs.

The unprecedented high of the Australian dollar against the currencies of its major food and grocery trading partners has made imported food and grocery items significantly cheaper and more cost competitive, which has led to strong growth in imports over the last five years. Retailer private label growth has also contributed to growth in imports, since the economics of manufacturing private label goods are better in emerging, lower cost labour markets or in markets with greater manufacturing scale than in Australia.

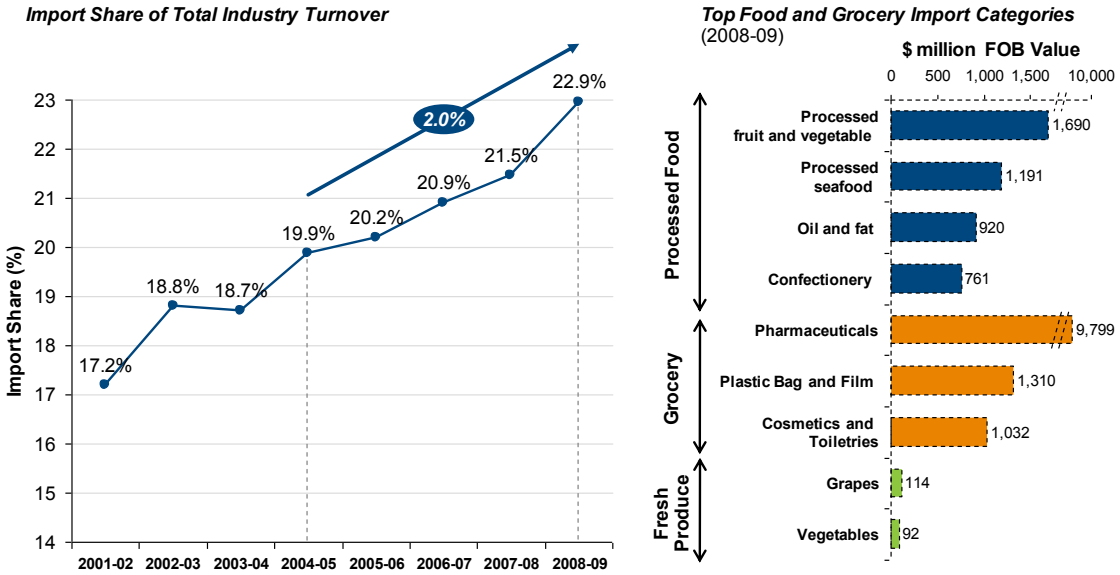
As a result, Australia has become a net importer of processed food and grocery products as shown in Figure 7.

Figure 7: Australia's Food and Grocery Net Trade Balance
($ million Free-On-Board, 2004-2010)

Source: ABS Customs Data, International Merchandise Trade

Total industry imports expressed as a percentage of domestic industry turnover has grown from 19.9 per cent in 2005 to 22.9 per cent in 2009 (see Figure 8). The product categories which have been historically most exposed to imports include processed fruit and vegetables, processed seafood, and pharmaceuticals.

Figure 8: Growth in Imports of Food and Grocery Items
(2002-2009)



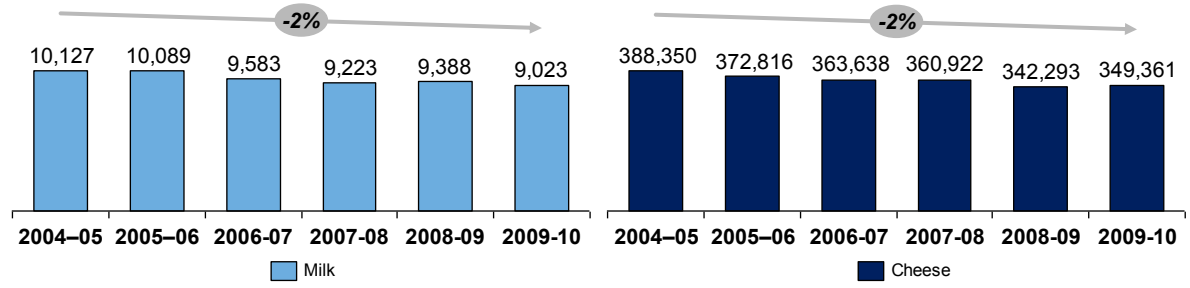
Source: ABS Customs Data, International Merchandise Trade, ABS Catalogue Number 8159.0, 7503.0

Continued strong growth in imports is expected in 2010 through 2015 as the full impact of the Australian dollar appreciation to parity against the US dollar is felt.

Food and grocery manufacturers have responded to these pressures over the last five years by rationalising supply and focusing on productivity gains to cut costs and improve profitability. Supply rationalisation has occurred through a combination of mergers between industry players, site consolidation and for some product categories offshoring of manufacturing production to lower cost countries (if AQIS and supply chain issues allow).

For example, the dairy industry has experienced significant consolidation in the last five years and as a result milk production in Australia has declined from 10.1 billion litres of production in 2005 to 9.0 billion litres in 2010 (refer Figure 9). Cheese production has also declined over this period.

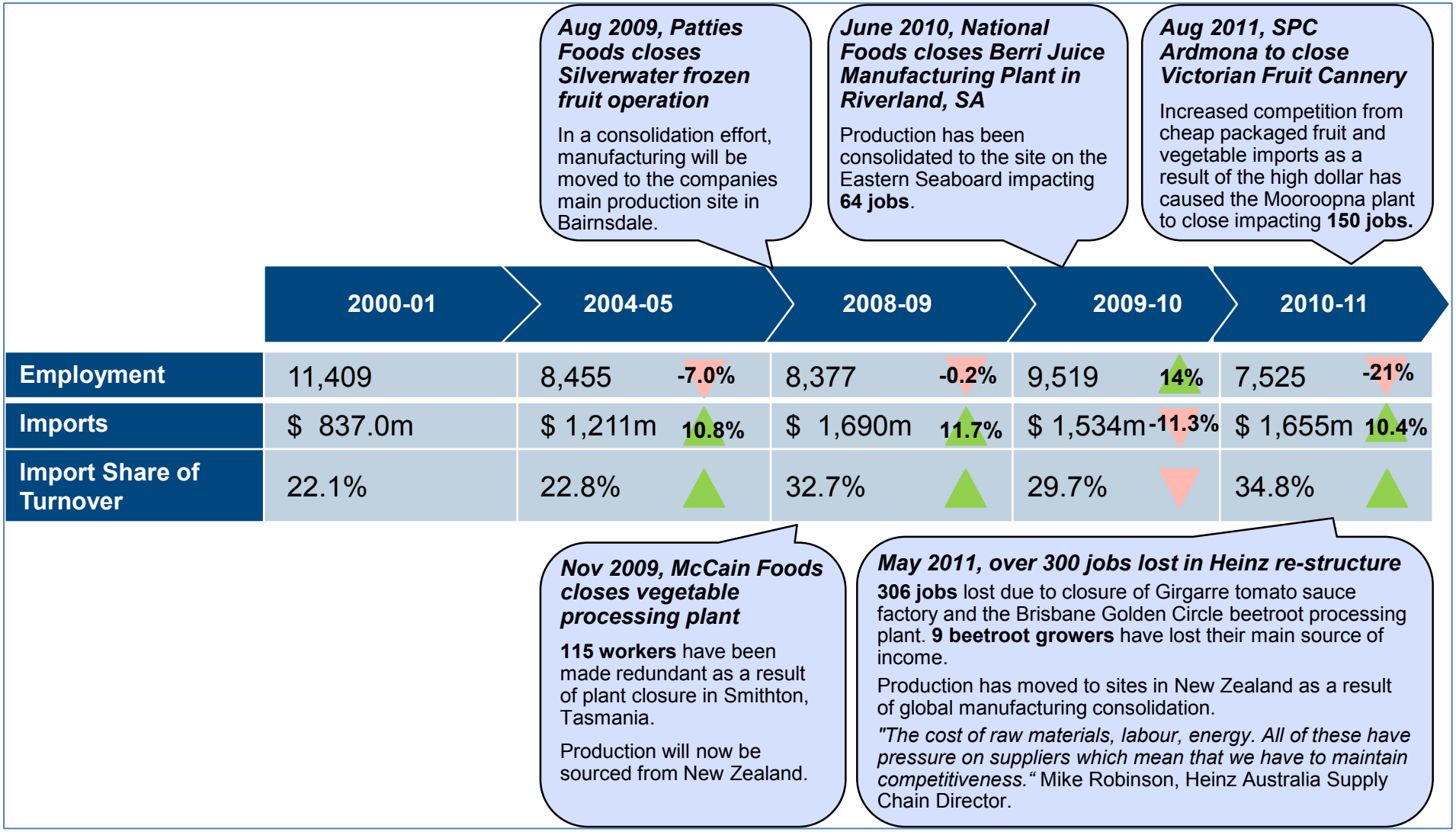
Figure 9: Volume of Dairy Production in Australia
(2005-2009, million litres of milk and tonnes of cheese)



Source: Dairy Australia

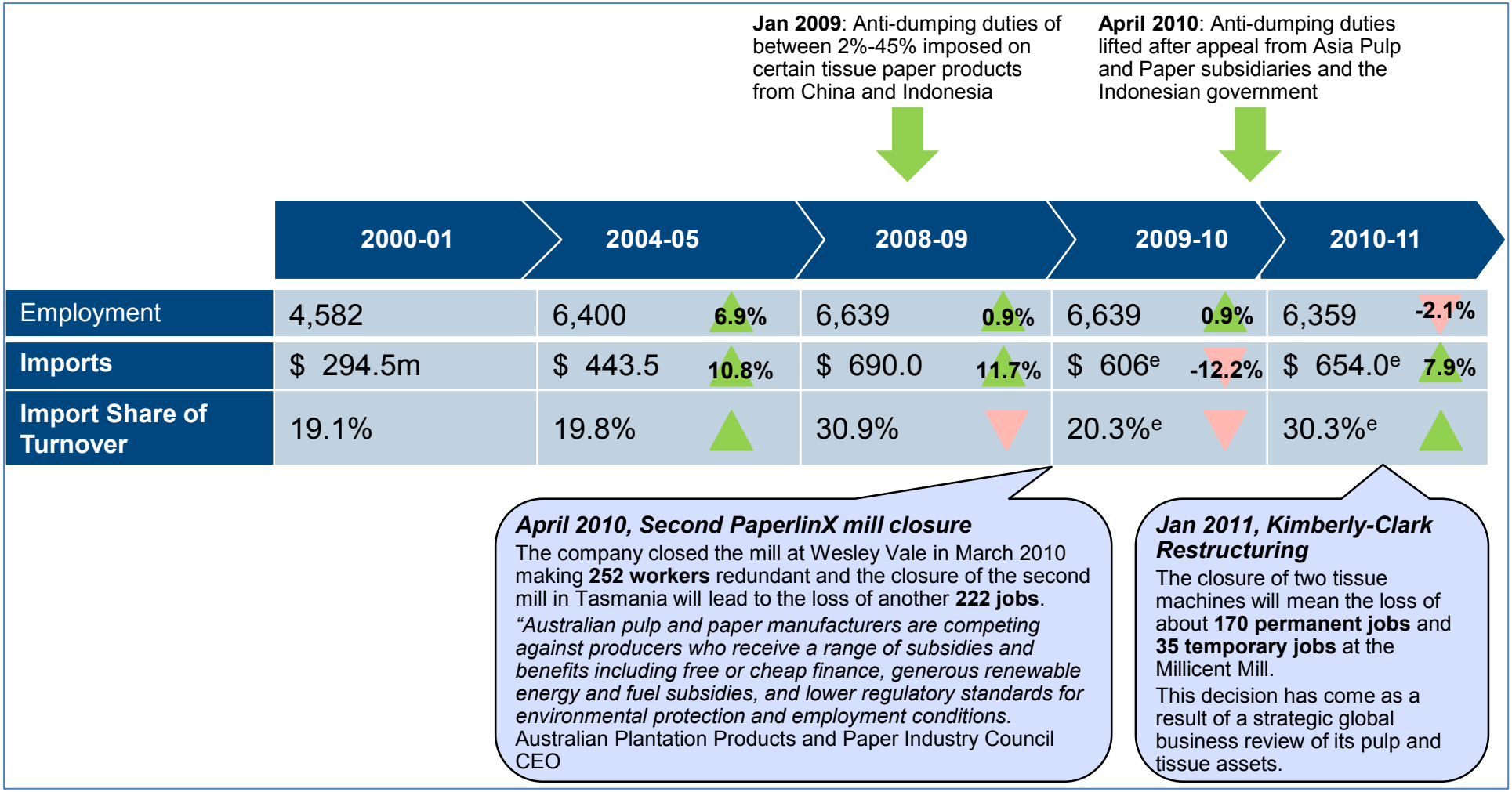
The following case studies (see Figure 10 and Figure 11) on the processed fruit and vegetable industry and sanitary paper industry highlight how manufacturers have responded to these pressures through a combination of consolidation and offshoring of manufacturing production.

Figure 10: Fruit and Vegetable Manufacturing in Australia



Source: Company media releases

Figure 11: Sanitary Paper Product Manufacturing in Australia[7]

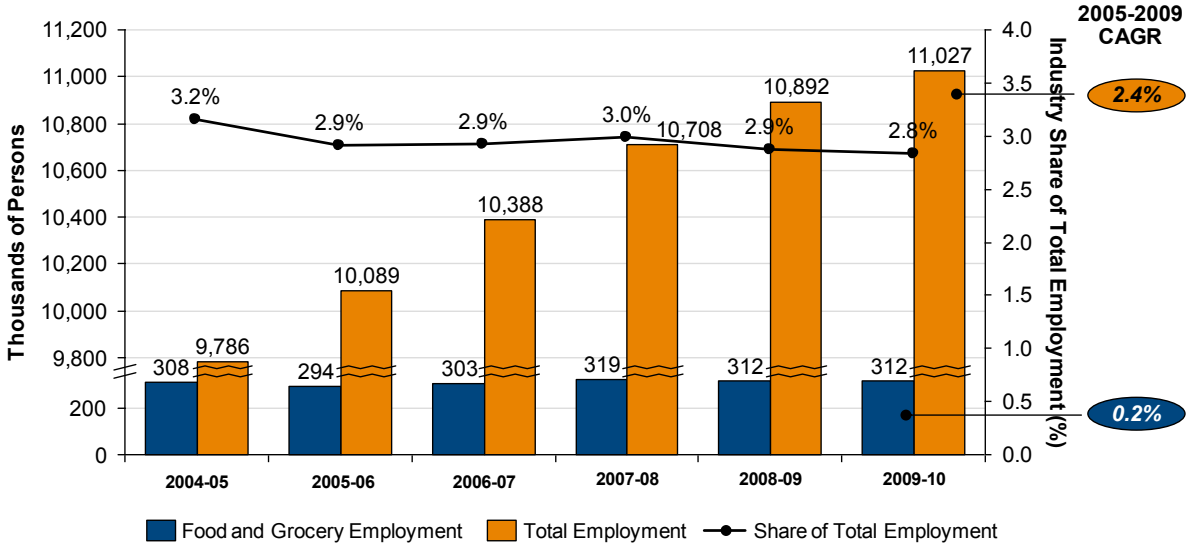


Source: Australian Manufacturing Workers' Union, Company media releases

[7] e = Estimate

As a consequence of the industry's challenges with growth and competitiveness, industry employment has declined as a share of the total Australian workforce. Since 2005, industry employment has grown minimally at 0.2 per cent per annum compared to economy wide job growth of 2.4 per cent per annum. As a result of this growth disparity, the industry's share of total employment has declined by over 10 per cent from 3.2 per cent in 2005 to 2.8 per cent in 2010.

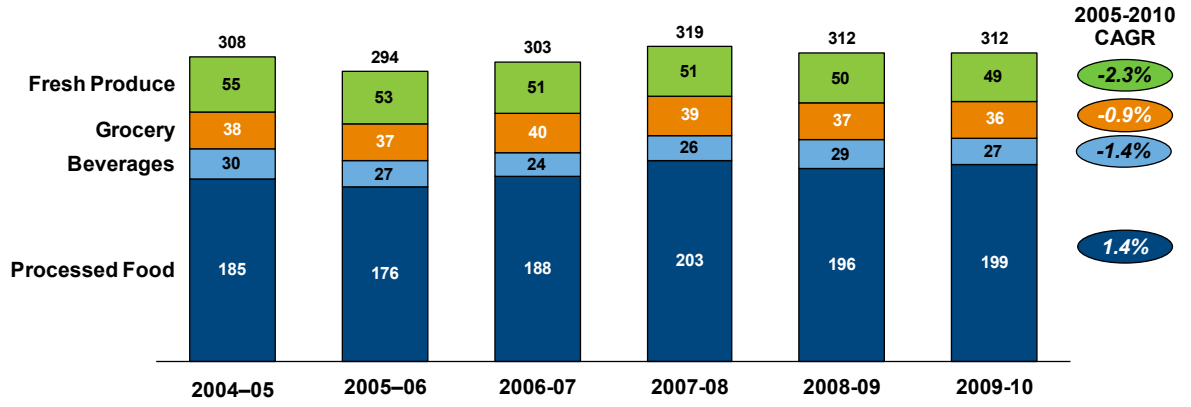
Figure 12: Food and Grocery Industry Employment Compared to Overall Employment in Australia
(Thousands of persons, 2005-2010)



Source: ABS Catalogue Number 6291.0, IBIS World Industry Reports, ABS Catalogue Number 6291.0.55.001 - Labour Force, Australia, Detailed, July 2011

Within some sub-sectors, the employment picture is more negative. Employment in fresh produce, grocery and beverage manufacturing has declined while employment in processed food manufacturing has grown slightly. Since 2005, fresh produce employment has declined at 2.3 per cent per annum, grocery sector employment has declined at 0.9 per cent per annum and beverage sector employment has declined at 1.4 per cent per annum as seen in Figure 13.

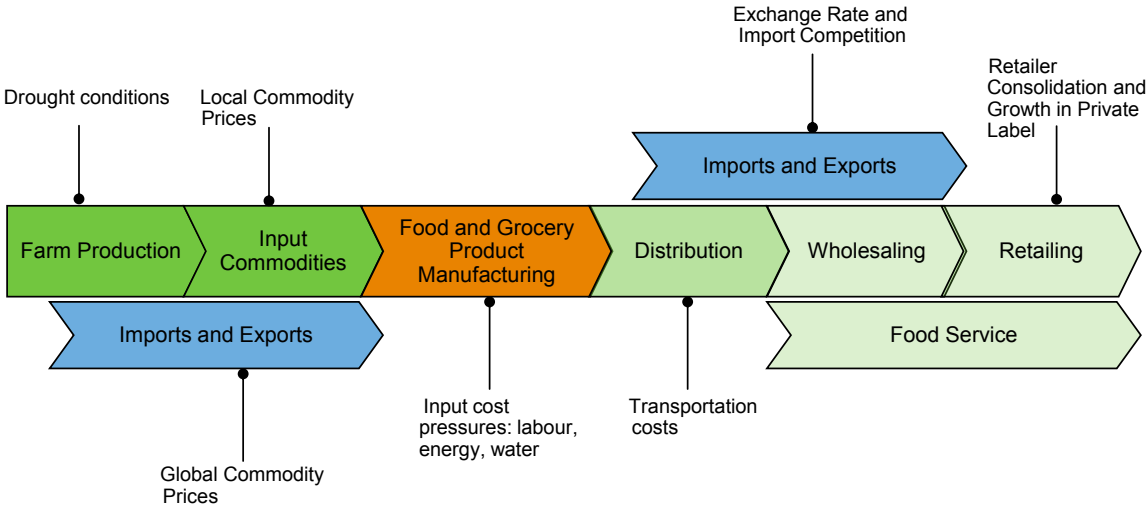
Figure 13: Industry Employment by Sub-Sector
(Thousands of persons, 2005-2010)



Source: ABS Catalogue Number 6291.0, IBIS World Industry Reports

2.2 Key Pressure Points and Challenges

The competitiveness and sustainability of the industry is under pressure from a combination of forces and challenges right across the value chain[8].



2.2.1 Changing Retail Landscape

The structure and dynamics of the retail market has increasingly created significant challenges for the Australian food and grocery manufacturing industry. The Australian retail market is amongst the most concentrated in the world. Consequently, Coles and Woolworths, as the market leaders, have significant influence when dealing with suppliers and in controlling access to the consumer. A combination of major retailers' private label strategies, intense price discounting in certain core product categories and competition for shelf space have placed pressure on food and grocery manufacturers' margins.

Australia Retail Market Structure and Concentration

Major supermarkets are the preferred channel of choice for Australian consumers accounting for 50 to 70 per cent of total food and grocery industry sales across most product categories.

Table 1: Major Supermarket Chains' Share of Total Food and Grocery Sales

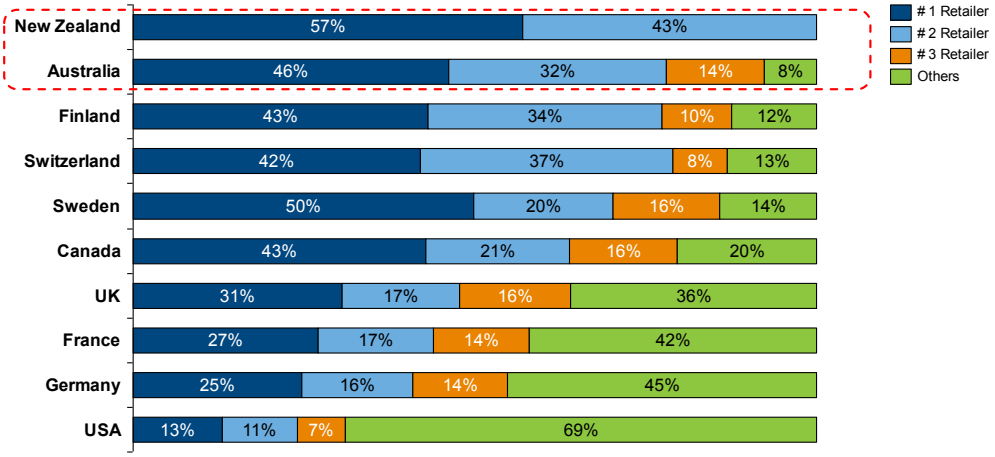
Category	Major supermarket chains' share of sales (approx)
Packaged groceries	**70**%
Fruit and vegetables	**50**%
Fresh meat	**50**%
Bakery products	**50**%
Dairy products	**50–60**%
Deli products	**50–60**%
Eggs	**50**%

Source: Australian Competition and Consumer Commission, Inquiry into the competitiveness of retail prices for standard groceries, July 2008

[8] The pressures along the supply chain have been numbered based on their level of significance.

The top three supermarket retailers in Australia comprise ~92 per cent[9] of total supermarket sales, which places it in the top two most concentrated food retail markets in the world. Only New Zealand, which is a relatively small market (population 4.3 million) and often a ‗satellite' of Australian based Retail Operations, is materially more concentrated than Australia.

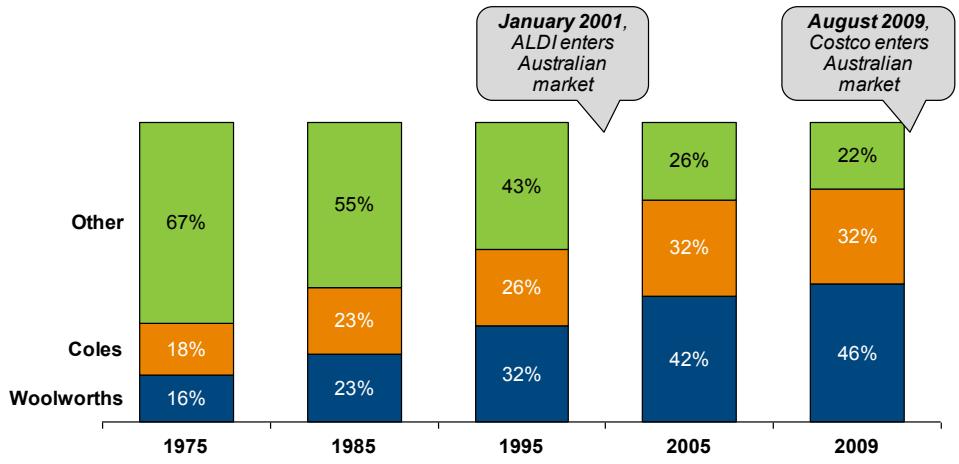
Figure 14: Market Share of Top Three Supermarket Retailers by Country
(Per cent of total market sales; various years 2009-2011)



Source: Coriolis Research, USDA Foreign Agricultural Service, Retail Food Sector Annual Report France, UK, Finland, Sweden, BMO Capital, Canadian Grocers 2011, The Food and Beverage Industry in Germany, Germany Trade and Invest 2010-11, Planet Retail

Within the supermarket channel, Coles and Woolworths have ~78 per cent share of the market, up from about 47.5 per cent in 1995. IGA is the third largest player and currently has a 14.4 per cent share of the supermarket channel. Coles and Woolworths have continued to gain market share despite the entry of new players such as ALDI (launched in Australia in 2001) and Costco (launched in 2009).

Figure 15: Market Share of the Major Supermarket Channel[10]



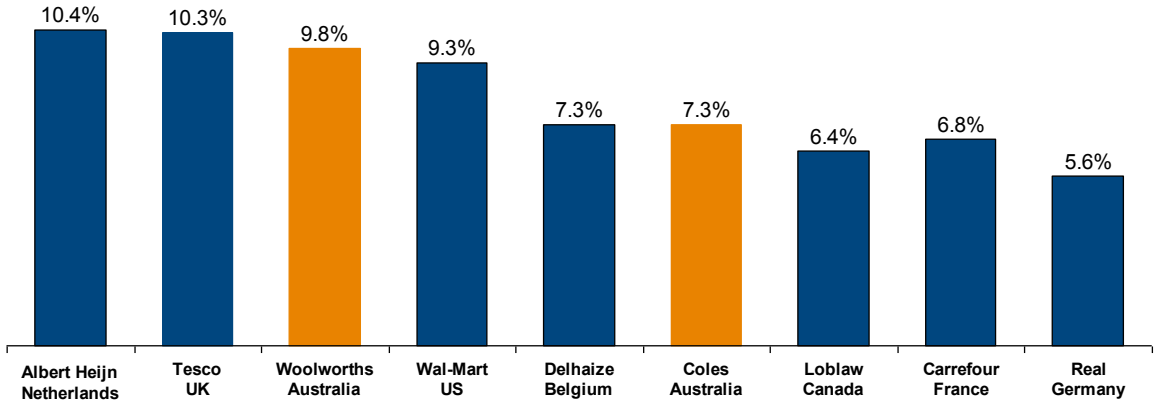
Source: Planet Retail

The high level of market concentration is partly reflected in Coles and Woolworths financial performance relative to comparable international retailers. Coles and Woolworths are within the top 30 food and grocery retailers in the world by revenue and are also amongst the most profitable (see Figure 16). In 2009, Woolworths Australia's Earnings before Interest, Taxes, Depreciation,

[9] Australian market share data relates to 2009
[10] Other includes IGA, ALDI, Foodworks, Franklins, SPAR

Amortization and Rent (EBITDAR) margin was higher than Wal-Mart's, and within the sample set only Albert Heijn in the Netherlands and Tesco in the UK generated higher levels of profitability.

Figure 16: Comparison of EBITDAR margins for Grocery Retailers[11]
(EBITDAR margin, FY2009)



Source: Citi Investment Research

Over the last five years, the market leaders in the retail sector have consolidated their supplier base to one to two preferred suppliers in many categories (in addition to their own private label or owned brands). This has enabled them to set commercial terms, more tightly integrate with suppliers and restructure their supply chain. The strength of Coles and Woolworth's market position gives them a superior negotiating position and anecdotally many food and grocery manufacturers (particularly in more commodity type categories) now see themselves largely as price ‗takers'.

These suppliers in commodity type product categories, such as milk, and/or products without a strong brand are most exposed as their connection and perceived differentiation with the consumer is weaker. Across surveyed companies, manufacturers of commodity style products reported limited success in passing on increases in raw material input costs which have increased significantly over the last few years (see section 2.2.4 for more detail). In comparison, manufacturers of iconic branded products indicated that the major retailers were willing to adjust wholesale prices to reflect significant increases in raw material commodity inputs.

However, some multi-national companies who manufacture globally-branded products have commented in interviews that the major retailers have used the threat of ‗parallel' imports to push back on wholesale prices. This is more evident and successful in categories where the consumer may have no perceived affinity (from a taste perspective) with the locally manufactured product.

[11] Coles and Woolworths reflects Food & Liquor segment only.

Parallel Imports

Parallel importing, or the grey market, refers to the market that arises as a result of companies, (either manufacturers or distributors) setting different price points for their products in different markets. Parallel importers ordinarily purchase branded products from one country at price P1, which is cheaper than the price for the same branded product in another country, P2. They then sell the branded product in the second market at a price between P1 and P2.

Parallel importing can give consumers access to more goods, enhance competition (putting downward pressure on prices) and also offer a potentially cheaper supply chain for retailers.

There are however risks associated with parallel imports including differences in specifications of products across countries, which may led to brand deterioration as a result of variation in taste and consumer satisfaction. Additionally, parallel imports can be shipped two or three times before landing in Australia as is the case with alcohol. This may also have the impact of compromising the quality of the product.

During interviews, other perceived risks and challenges cited by local suppliers are that as part of preferred supplier arrangements, they are expected to share their New Product Development ideas 12 months out from launch yet are often competing in the category with the retailers' private label and owned brands.

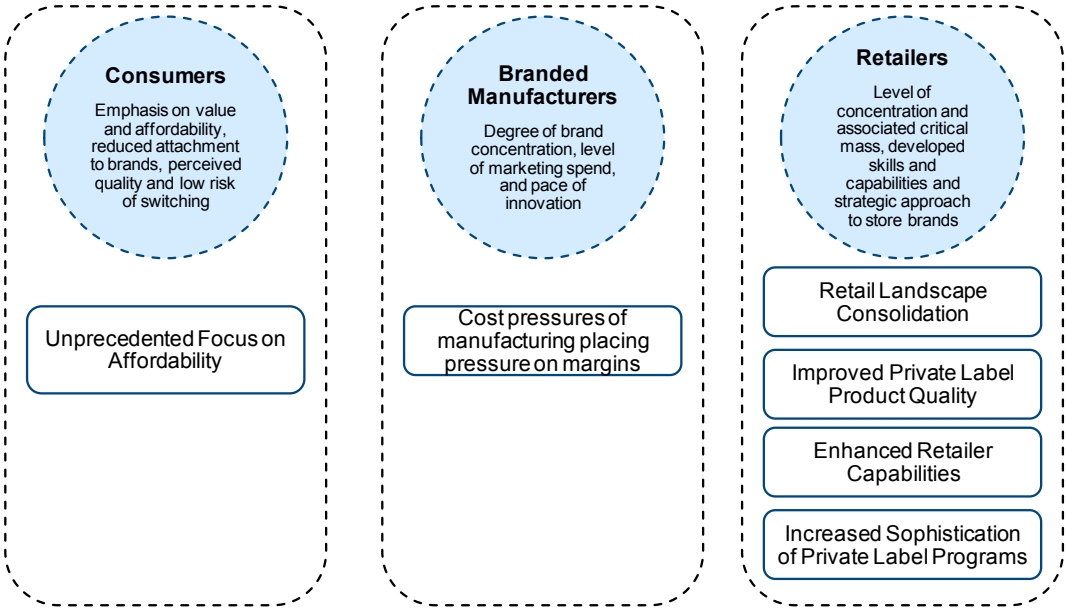
In addition, the reconfiguration of retailers' distribution models from a 'direct to store' to 'direct to warehouse' distribution model, has weakened supplier ability to distribute to other customers in an economic way.

The major retailers are also focused on growing revenue by substituting for the 'eat out' and 'take home' markets with a convenience offer, taking share from other channels and growing market share of the supermarket channel. Their core supermarket value proposition focuses on providing consumers with superior value through price/affordability and convenience through 'ready to eat' products and an extensive, growing store network.

Private label, price discounting and new store formats with a greater proportion of space allocated to fresh and convenience foods are therefore critical aspects of their strategies.

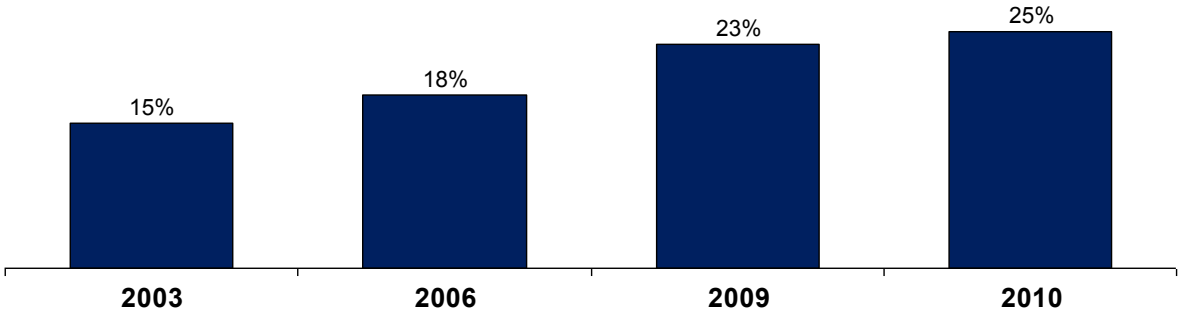
Private Label Growth

A confluence of factors is creating near-perfect conditions for accelerated private label growth.



Private label share of total supermarket sales in Australia has increased steadily from ~15 per cent in 2003 to ~25 per cent in 2010.

Figure 17: Private Label Share of Total Supermarket Sales in Australia[12]

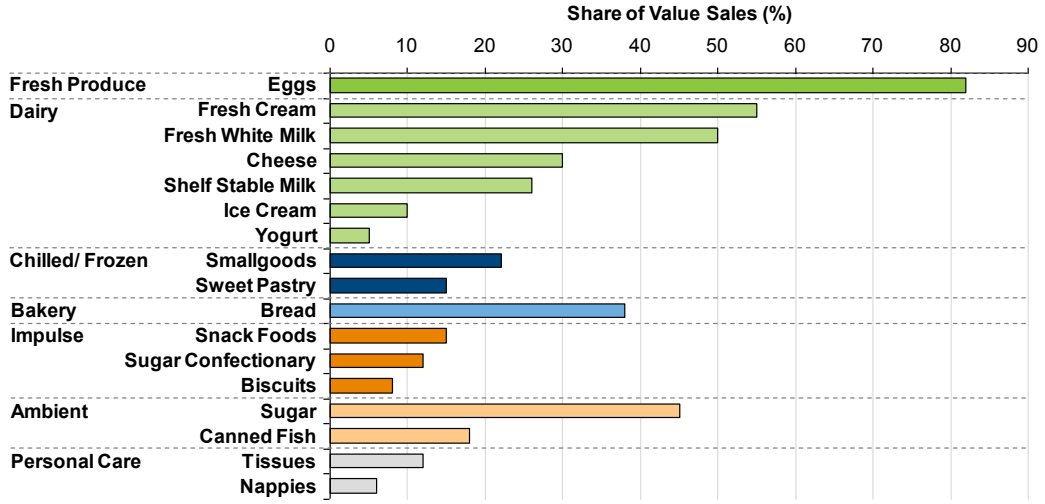


Source: AC Nielsen, Retail World

[12] Includes ALDI

Private label share is much higher for commodity and fresh/perishable products such as eggs, fresh milk, sugar and bread than for categories with a stronger brand proposition. These products have less opportunity to differentiate with the consumer and these trends are consistent with the level of private label development seen in offshore markets.

Figure 18: Private Label Share by Product Category
(Various years, 2007-2009)



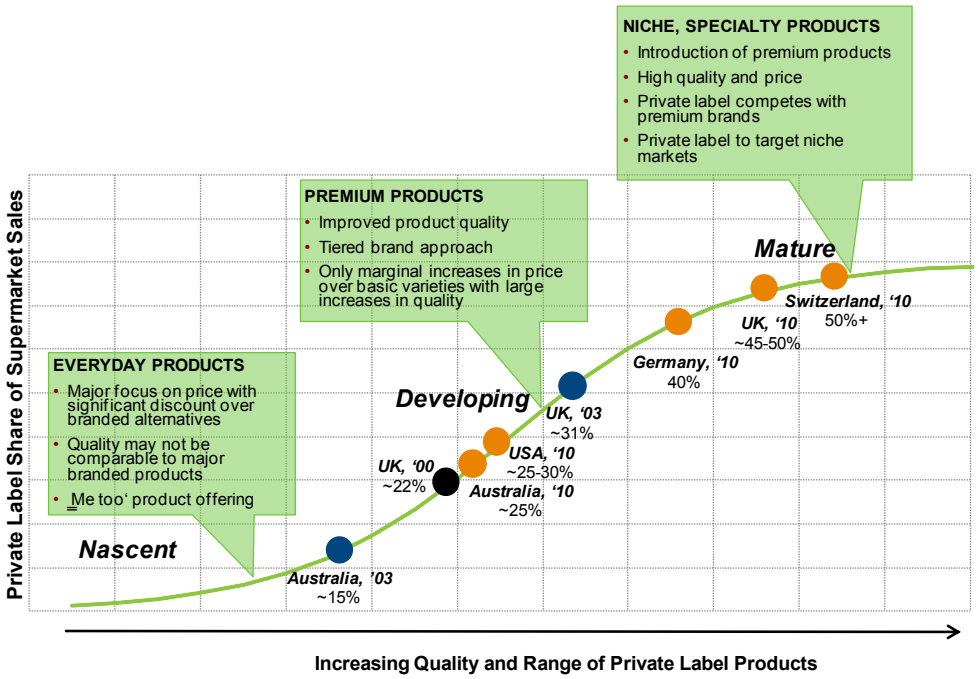
Source: Retail World, Planet Retail, A.C. Nielsen, Dairy Australia, Company Interviews

Despite the growth in private label over the last five years, the Australian market is still underdeveloped when compared with Europe.

Private Label Insights from Offshore Markets

As Figure 19 shows, Australia is in the ‗developing' stage of market development for private label food and grocery products. Given that the UK, a relevant lead market, was at similar levels of private label penetration to Australia 10 years ago, it would be reasonable to assume that Australia could reach comparable private label penetration rates in the next 10 years.

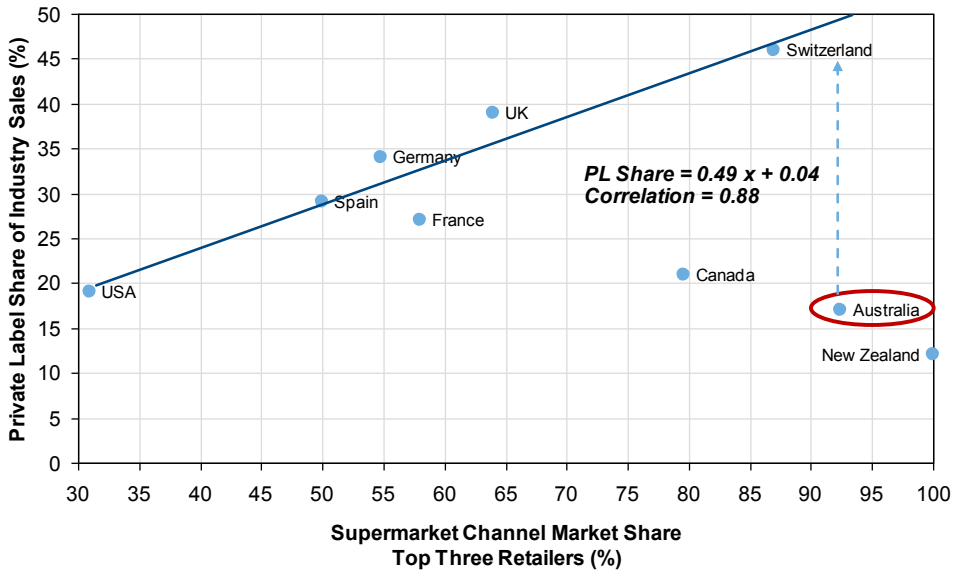
Figure 19: Private Label Market Maturity



Source: USDA Foreign Agricultural Service, UK Food Retail Report 2010, Harvard Business Review, Private Label Strategy, How to meet store brand challenges 2006, Interbrand Research

Private label penetration is strongly correlated with market concentration (see Figure 20). Using this relationship, it is reasonable to assume that the end state level of penetration for Australia could be higher than what has been experienced in the UK (given the relative retail concentration). This would clearly be dependent on similar levels of product quality & innovation and the specific Australian consumer shopping attitudes adapting at similar rates.

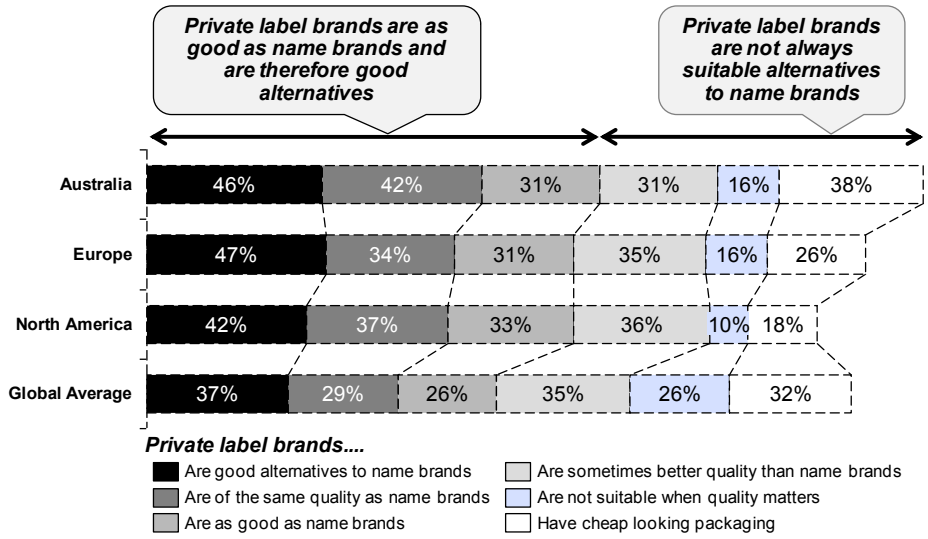
Figure 20: Relationship between Private Label Penetration and Market Concentration
(Various years, 2009-2011)



Source: Planet Retail, USDA Foreign Agricultural Service, Germany Trade and Invest, Canadian Grocers

Recent research suggests that Australian consumer attitudes are also supportive of high levels of private label adoption. Australian consumers perceive private label brands more favourably than consumers in North America and Europe. According to a 2010 Nielsen Global Survey, 46 per cent of Australians believe private label brands are good alternatives to name brands and 42 per cent believe they are of the same quality. This implies that private label growth and penetration could ultimately be higher than what has been observed in North America and many parts of Europe.

Figure 21: Global Perception of Private Label Brand Quality
(Percentage of respondents)

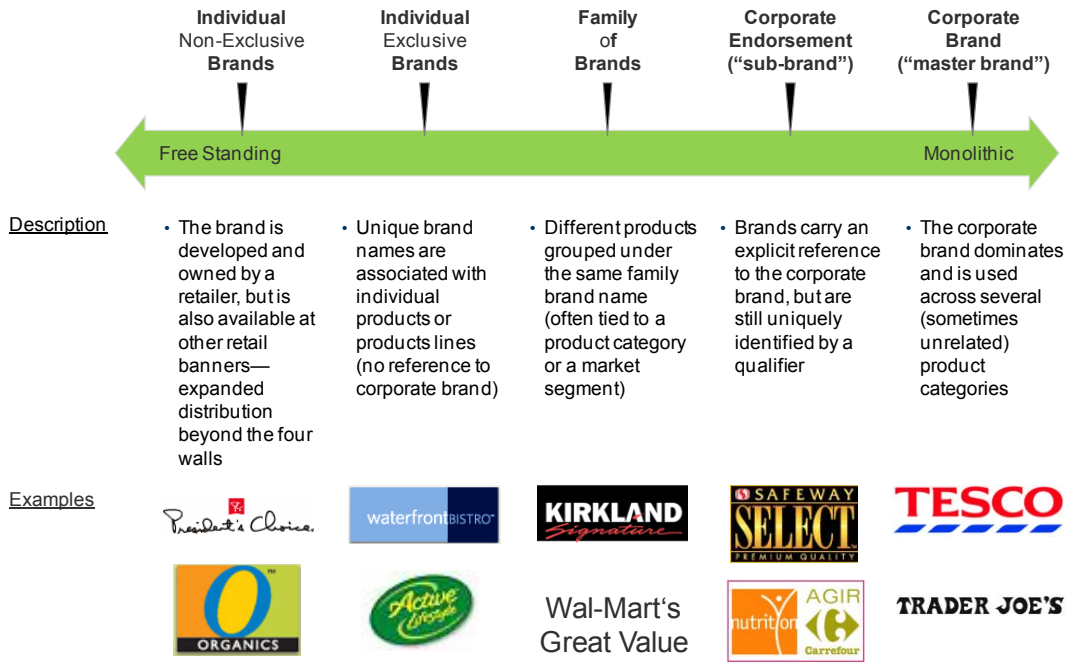


Source: The Nielsen Company, Global Online Survey, Q3 2010

As private label brands become more sophisticated, they will take up more shelf space, creating greater competition amongst branded players for access to the consumer.

Private label brands in offshore markets are increasingly behaving as standalone brands, competing on dimensions other than ~~"v~~alue" and becoming an integral part of a retailer's portfolio strategy.

Figure 22: Private Label Brand Evolution in Offshore Markets



Retailers such as Tesco have based their private label strategy on in-depth shopper insight using their own stores as a testing ground for creating customer segmentation and a sophisticated tiered brand approach. Tesco now offers a full spectrum of tiered private label products across the basic value segments to luxury and speciality segments such as organic products. Australian retailers are now starting to adopt a similar tiered strategy in their private label range development (for example the MACRO organics brand introduced by Woolworths).

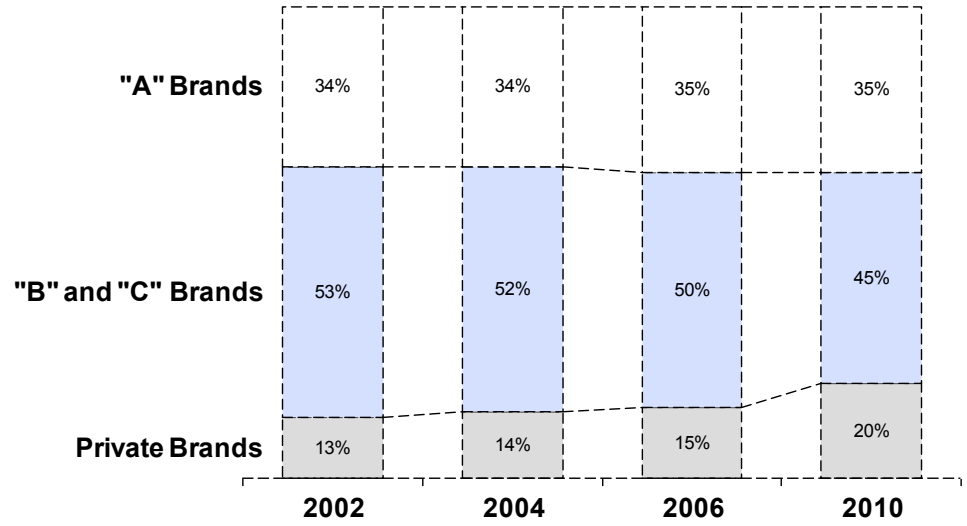
Figure 23: Tesco's Branded Private Label Strategy

In the more mature private label markets, branded manufacturers (particularly the second tier) are being 'boxed in' by retailer private brands with both higher end products and value products.

Shelf space available to branded manufacturers has also reduced, and across many categories, all manufacturers but the top one or two branded players are being forced off shelves or having their product sold at severely discounted prices. This trend is illustrated in Figure 24 which shows that private label brands have expanded market share at the expense of second tier "B and C" brands[13].

[13] "A" brands are the top three selling brands per segment; "B" and "C" brands represent the remainder of national brands.

Figure 24: Market Share Gains of Private Brands
(U.S. market example)



Source: A.C. Nielsen, Datamonitor, Planet Retail

The implication for Australian food and grocery manufacturers is that they will find it increasingly difficult to maintain their share of shelf space unless they have an ‗iconic' category brand and create greater brand equity with consumers.

Therefore, it will be critical that Australian food and grocery manufacturers invest in their brands and new product development to create consumer demand for their product. Given the retail market concentration in Australia and the growth potential for private label, maintaining a share of shelf can only become more challenging for Australian food and grocery manufacturers.

Price Discounting Strategies

Woolworths and Coles clear push for greater penetration of their private label portfolios, along with the vigorous competition between the two, has led to intense pricing strategies in a bid to win market share.

Private label staples such as bread and milk are being priced at record low levels. This pricing is intended to drive traffic in-store, but there has been speculation that this does not necessarily translate into lower pricing across the broader basket of food and grocery products consumers purchase.

In early 2011 Coles reduced the price of fresh white milk across pack sizes to an average of $1 per litre. Woolworths and other retailers have largely matched these discounts. Dairy Australia estimates that this move has taken approximately $85 million in annual equivalent terms from the retail sales value of milk products[14]. While the margins of some branded suppliers have been impacted as a result of this pricing strategy, there is speculation that the impact on the major supermarket chains is smaller. Some food and grocery manufacturers believe that retailers have off-set margin loss in fresh white milk by growing volume share and therefore revenue in other categories.

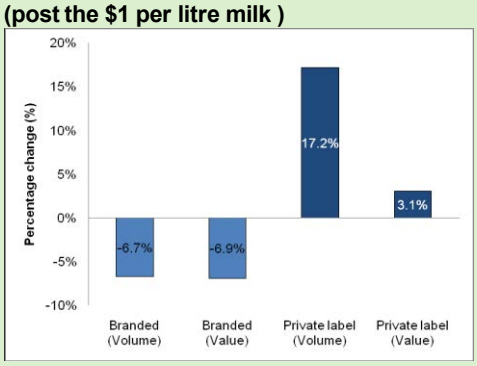
[14] Dairy Australia, Situation and Outlook 2011

Figure 25: Impact of Supermarket Milk Pricing

Case Study: Future of Fresh White Milk in Australia

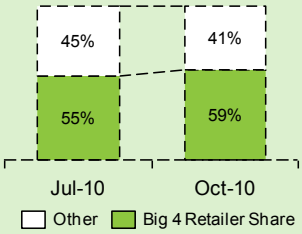
The recent supermarket milk ‗price-wars' have called into question the sustainability of the fresh white milk industry.

Shift in Grocery Volume and Value from Branded to Private Label Fresh White Milk (post the $1 per litre milk)



The recent price drops have caused a transfer of volume from higher margin branded products into private label and from the non-grocery channel to grocery as was seen in the UK market when similar pricing was introduced.

Channel Shift from Non-Grocery to Grocery in the UK



Capital Intensity of Dairy Industry and Key Cost Components

The unsustainably low price of fresh white milk does not reflect the capital intensive nature of the dairy industry, from the farm to the consumer.

Approximate dairy farm investment (Tas)	
Plant machinery and equipment	$400,000
Livestock	$600,000
Land and improvements	$3.0 million
Investment Return	2.2%

Cost Structure of Fresh White Milk	
Cost Component	**Contribution**
Raw Milk Supply	~54%
Distribution	2nd largest cost
Processing	3rd largest cost
Ave margin (EBIT)	Negative Forecast

Fresh White Milk Sales Channels		
Supermarkets	65% of sales	75,000 outlets
Non-Grocery	35% of sales	

According to Lion, the current market structure sees neither farmers or processors making good returns and any further dilution of the value pool places pressure on the entire supply chain.

Source: Lion (formerly National Foods) Submission to the Senate Economics References Committee, September 2011

Since the pricing was introduced in January 2011, the wider price gap between private label and branded milk has resulted in a lift in sales of lower-priced products, at the expense of brands, thereby weakening the overall wholesale returns to processors.

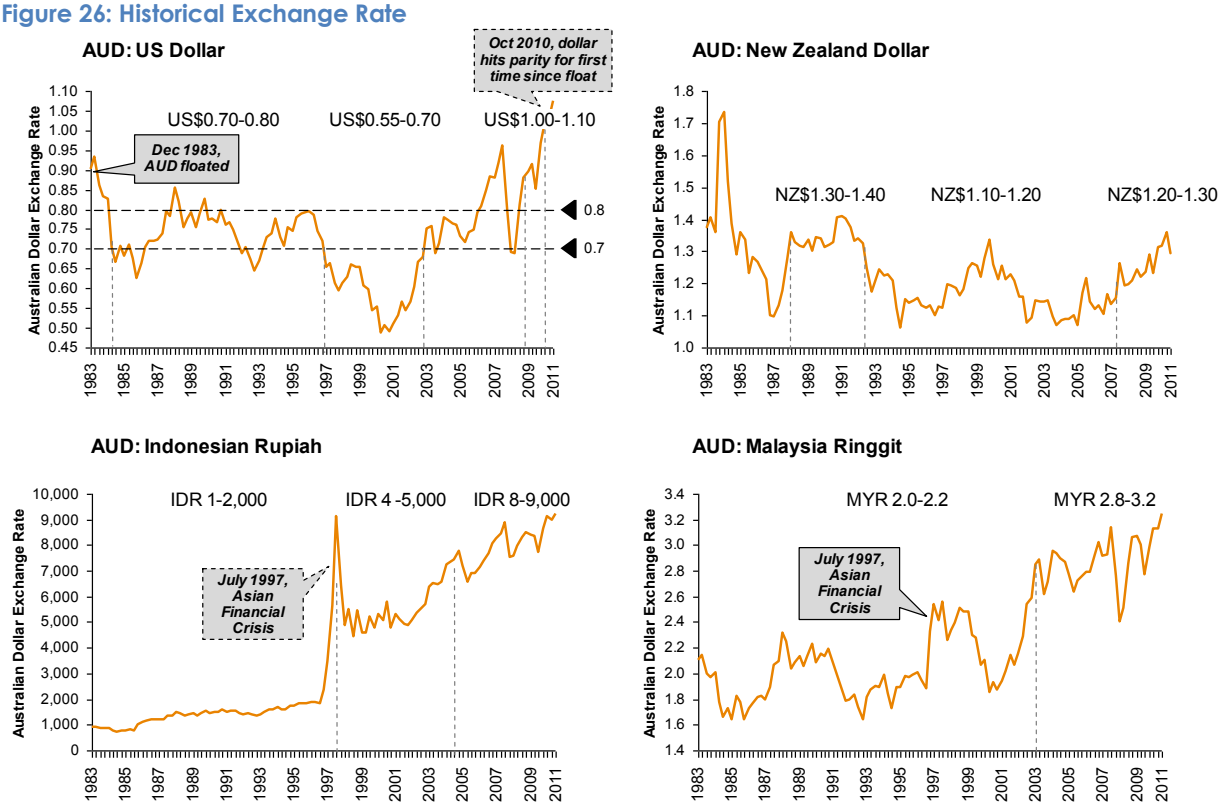
The shift in sales has not only occurred from branded milk to private label, but also from the non-grocery channel to grocery – with a corresponding decline in white milk returns for processors, distributors, franchisees and small retail outlets.

2.2.2 Rising Exchange Rates and Import Competition

The unprecedented high of the Australian dollar against the currencies of its major food and grocery trading partners has created a universal pressure across the sector, making many domestically produced products significantly more expensive on shelf than imported substitutes. Interviewed companies have indicated that in some categories, such as frozen confectionery, ice cream and sanitary paper products, domestically produced product is 40 per cent more expensive on shelf than imported substitutes.

The current exchange rate between the Australian dollar and the US dollar at between $1.00 and $1.10 is well above the long term average cross rate of $0.70 and $0.80 observed since the dollar was floated in December 1983. The Australian dollar has also steadily appreciated against the Malaysian Ringgit and the Indonesian Rupiah and has recently made some gains on the New Zealand dollar.

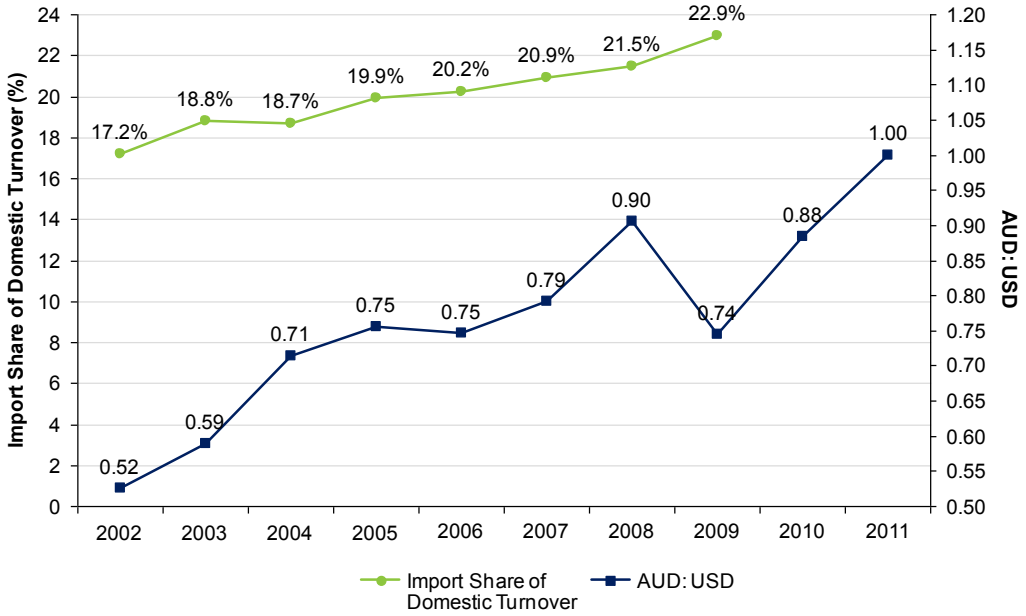
Figure 26: Historical Exchange Rate



Source: Reserve Bank of Australia

The impact of the high Australian dollar is that imported food and grocery items are cheaper and more competitive leading to strong import growth over the last five years. In 2009, the value of total industry imports was $25 billion, equivalent to 22.9 per cent of domestic industry turnover, compared to 17.2 per cent of domestic industry turnover ($18 billion) in 2002. The recent currency appreciation has yet to fully wash through in terms of displacing domestic production with imports. As a result we expect that industry imports will continue to increase at a faster rate than historically observed.

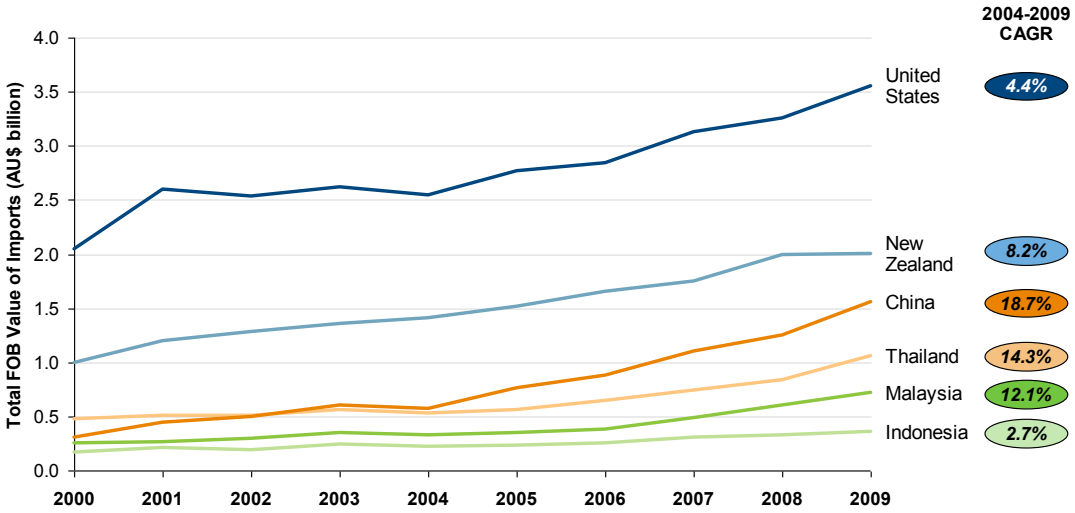
Figure 27: Industry Import Growth[15]
(2002-2010)



Source: ABS, Catalogue Number 8159.0, Customs Data and Reserve Bank of Australia

China, Thailand, Malaysia and New Zealand have recently been the fastest growing food and grocery exporters to Australia. Imports from these countries have grown at rates between 8 and 18 per cent per annum between 2004 and 2009.

Figure 28: Total Food and Grocery Imports by Country[16]
(A $billion, Free-On-Board value)



Source: Australian Bureau of Statistics, Customs Data

2.2.3 Rising Manufacturing Input Costs

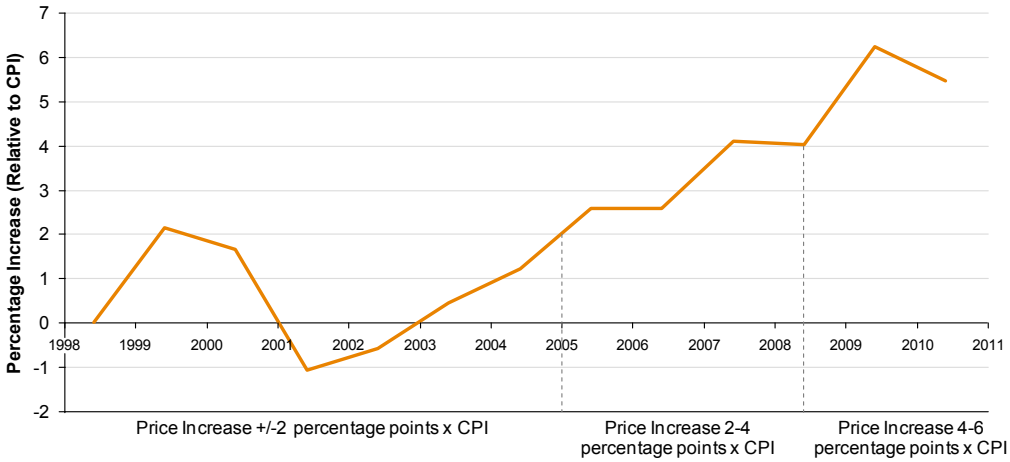
Labour is a key manufacturing cost component for many food and grocery products, comprising between 12 to 22 per cent of total costs across various categories. These costs have increased over

[15] Although import data is available for 2009-10, domestic industry turnover data is only available up to 2009
[16] 2010 import data has been excluded from this chart as it was an anomaly year; during the Global Financial Crisis imports across most categories fell for the first time in ten years as consumers stopped spending

the last 5 years and are measured through changes in the average hourly wage rate in the Australian manufacturing industry.

Since 2008, the overall hourly wage rate of manufacturing workers has increased at a rate of between 4 and 6 per cent more than general inflation. This data includes all manufacturing within Australia, including metal product manufacturing and mineral product manufacturing which may be inflating the overall wage price index. Interviews with food and grocery manufacturing companies indicate that the manufacturing wage rate increases in this industry have been more in the range of 3 per cent to 5 per cent per annum.

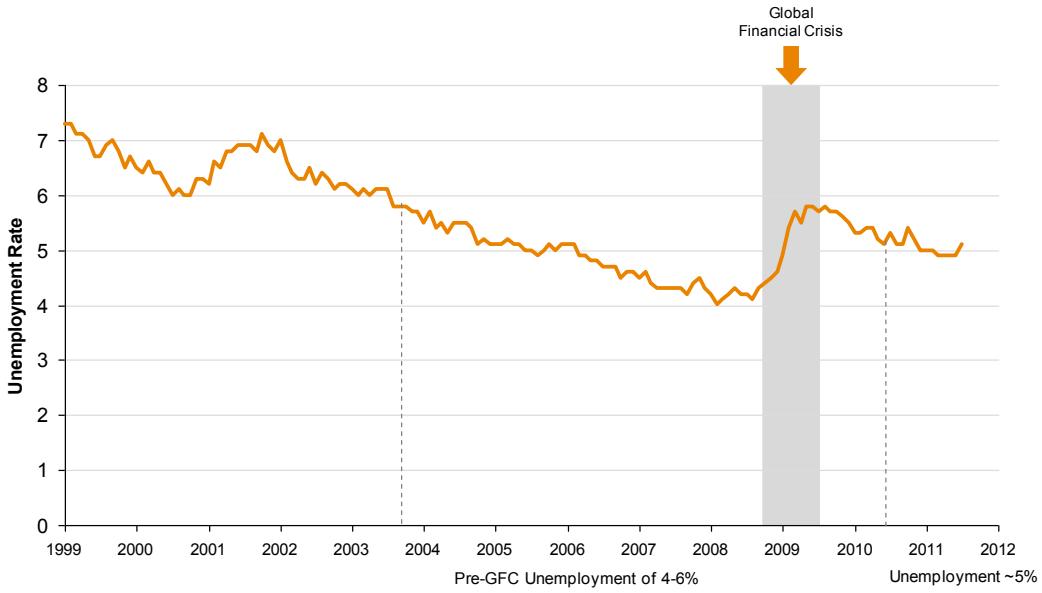
Figure 29: Manufacturing Wage Price Index Relative to Overall CPI
(Per cent differential)



Source: Australian Bureau of Statistics, Catalogue number 6401.0 and 6345.0

One of the key drivers of increasing labour costs is the long term improvement in Australia's economic fundamentals. This trend has resumed since the Global Financial Crisis ('GFC') in 2008-2009. The unemployment level in Australia as of June 2011 was 5.0 per cent, the lowest since before the GFC as is seen in Figure 30.

Figure 30: Unemployment Rate in Australia

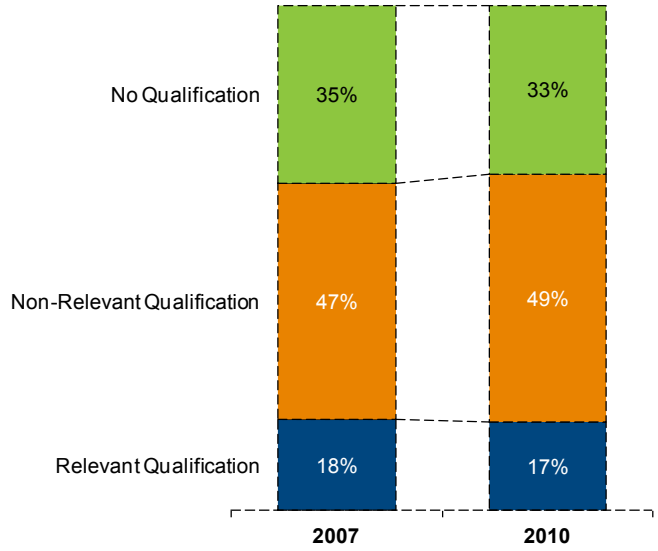


Source: Reserve Bank of Australia, Employment and Workforce Statistics

Food and grocery manufacturers have also had to deal with a skills shortage. As Figure 31 shows, since 2007 there has been a decline in the availability of skilled workers with relevant technical and

industry related qualifications[17], which may have contributed to observed wage increases. Interviews with industry players better highlight the criticality of skills shortages, particularly technical skills including New Product Development.

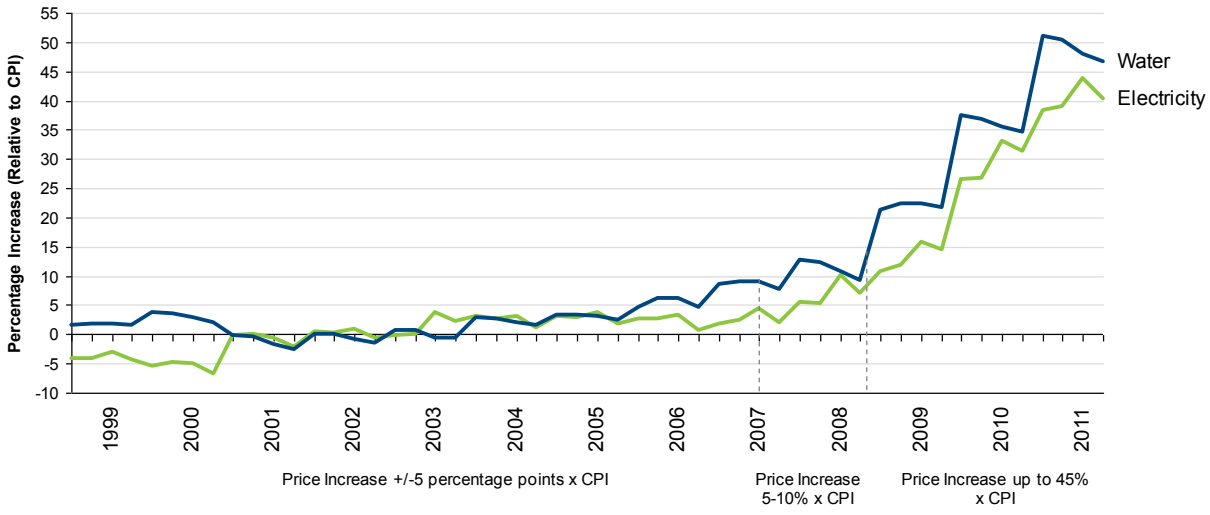
Figure 31: Workforce Participants by Qualification[18]



Source: ABS Catalogue Number 6306.0 - Employee Earnings and Hours, Australia, May 2010 and 2006

In addition to increases in labour costs, Australian manufacturers have had to absorb record high electricity and water price increases over the last three years. Since 2008, the price of utilities has increased at rates between 10 to 45 per cent more than general inflation as a result of growing demands, ageing underlying assets and historic under investment.

Figure 32: Electricity and Water Price Index Relative to Overall CPI
(Per cent differential)



Source: Australian Bureau of Statistics, Catalogue Number 6401.0, Energy Users Association of Australia (EUAA): Australia's Rising Electricity Prices and Declining Productivity

Historically, one of the relative cost advantages of manufacturing in Australia has been the low tariff for electricity compared to South East Asian manufacturing locations. If energy and water prices in

[17] A relevant qualification is defined as a post-high school qualification in engineering and other technologies, agriculture and food sciences and food services
[18] ibid

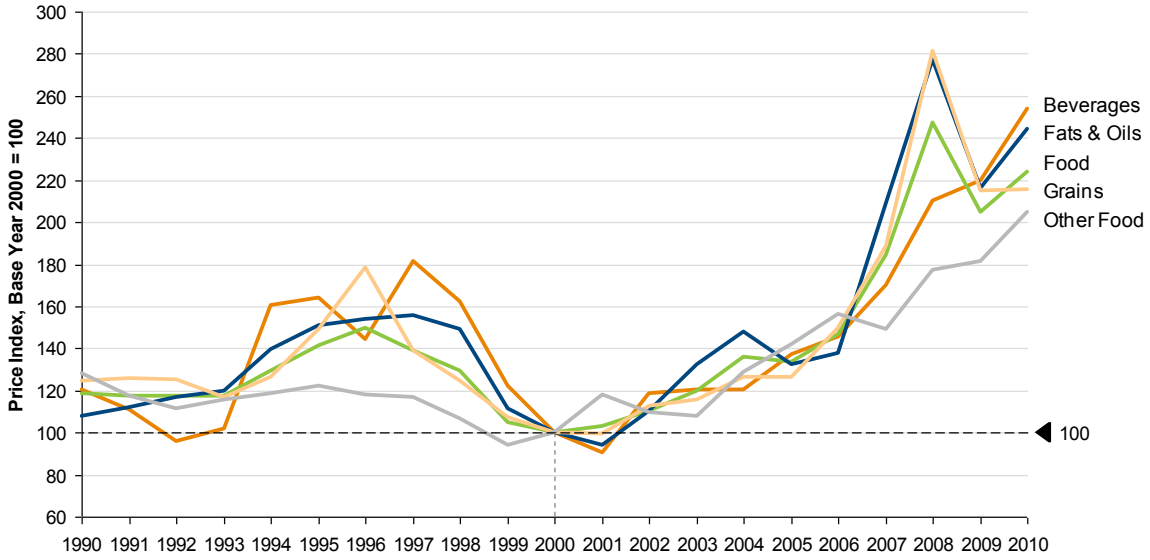
Australia continue to rise at or above recent rates of increase, these increases will continue to erode any relative cost advantage.

2.2.4 Rising Commodity Costs

Raw material products, including those which are locally produced and sourced, have significantly increased in cost over the last five years. Although these cost increases have contributed to margin pressure, they have not necessarily impacted the relative cost competitiveness of Australian manufacturers.

Prices for globally sourced commodities have increased materially as a result of global demand and supply dynamics as consumers in emerging economies are consuming more food in line with discretionary income increases. The World Bank's global food price index indicates that on average the price of food and beverage items in 2010 was about 12 per cent higher than levels a year ago.

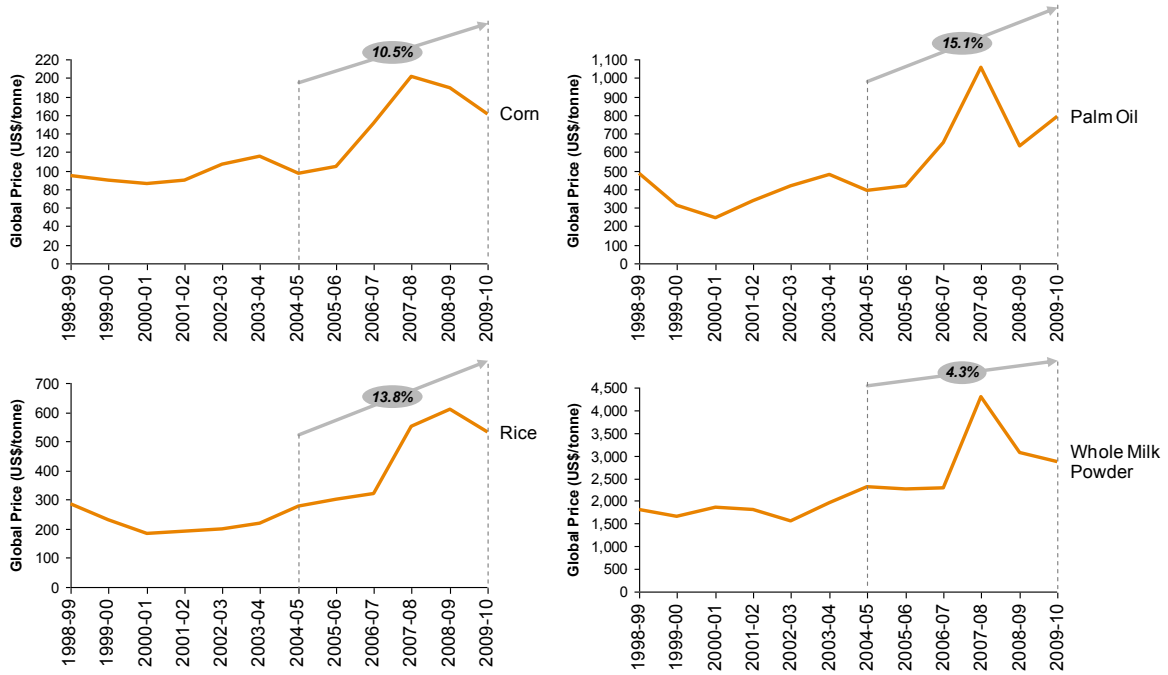
Figure 33: Global Food and Beverage Price Index (Base Year, 2000 = 100)



Source: World Bank Commodity Price Data (Pink Sheet)

Some inputs, such as palm oil, rice and corn have hit record high levels within the last two years as can be seen in Figure 34.

Figure 34: Globally Sourced Commodity Prices



Source: ABARE, Australian Commodity Statistics 2010

These price increases impact offshore manufacturers as well and, although they are a source of margin pressure, they do not always impact the relative cost competitiveness of Australian manufacturing. In fact, the high Australian dollar makes globally sourced commodities relatively cheaper for Australian manufacturers.

In many cases, significant increases in input costs are not able to be fully passed through to retail price increases due to the relative position of the brand with the major supermarket chains. Interview feedback indicated that the risk of soft commodity volatility is smaller with number one brands in a category. However, it is becoming increasingly important for all food and grocery manufacturers to manage this risk and effectively hedge against it.

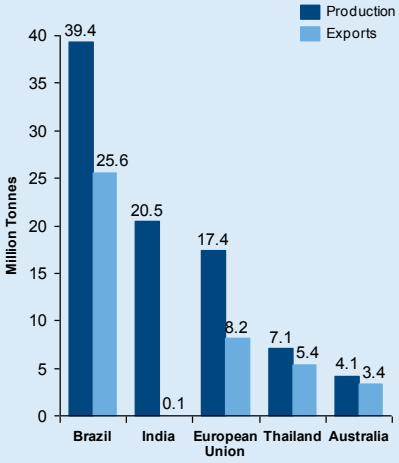
The pass through of international prices to domestic prices is commodity specific and depends on multiple factors that are country-specific, such as the degree of integration of domestic and international markets, transport conditions, and national policies such as taxation rates. In some instances, offshore manufacturers are able to source locally raw materials at lower prices due to protectionism in their markets in the form of subsidies to domestic producers and tariffs on foreign imports.

For example, most South East Asian countries have high levels of protection in their domestic sugar industry. Thailand, the world's second largest exporter of sugar, has a highly regulated and government controlled sugar market. The Thai Office of the Cane and Sugar Board regulates sugar prices and the distribution of revenue while providing growers with subsidies to offset rising costs. The Thai market is protected from imports by high tariffs on ‗in- quota' and ‗out- of- quota' sugar and as a result the government can set the domestic price above the global price for sugar. Despite this, today, the local wholesale price of sugar in Thailand is lower than in Australia due to the current strength of the Australian dollar.

Case Study: International Sugar Markets

A number of the major international sugar markets are heavily controlled by government quotas on production and government set pricing. This creates a disconnect between the observed global sugar price on the soft commodity markets and the average retail and wholesale selling price for sugar in these particular markets.

Global Production and Exports of Sugar, 2010



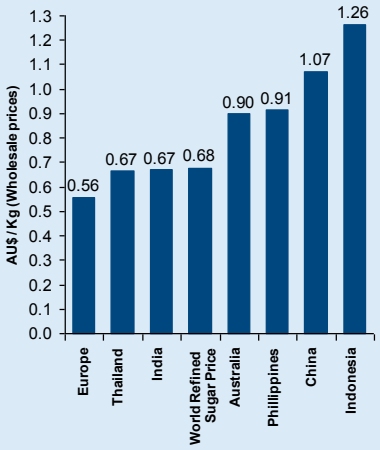
Most of India's sugar is consumed domestically, while a high proportion of Australia and Thailand sugar is exported .

Protectionism of Sugar Industries

Thailand	
Local Production	Govt. controlled and funded (subsidised loans)
Local Price	Govt. set price controls
Import Tariff on ASEAN Imports	Free under the Asian Free Trade Agreement, effective January 2010
Import Tariff on WTO Members (incl Aus)	65% tariff in quota 94% tariff out of quota
Australia	
Tariff on Thai Imports	39% in quota (2011) Free in quota (2020) 85% tariff out of quota[1] Tariff and quota free access from 2020

1. WTO rate (85%) + 10% Margin of Preference

Sugar Pricing in Global Markets *(2011)*



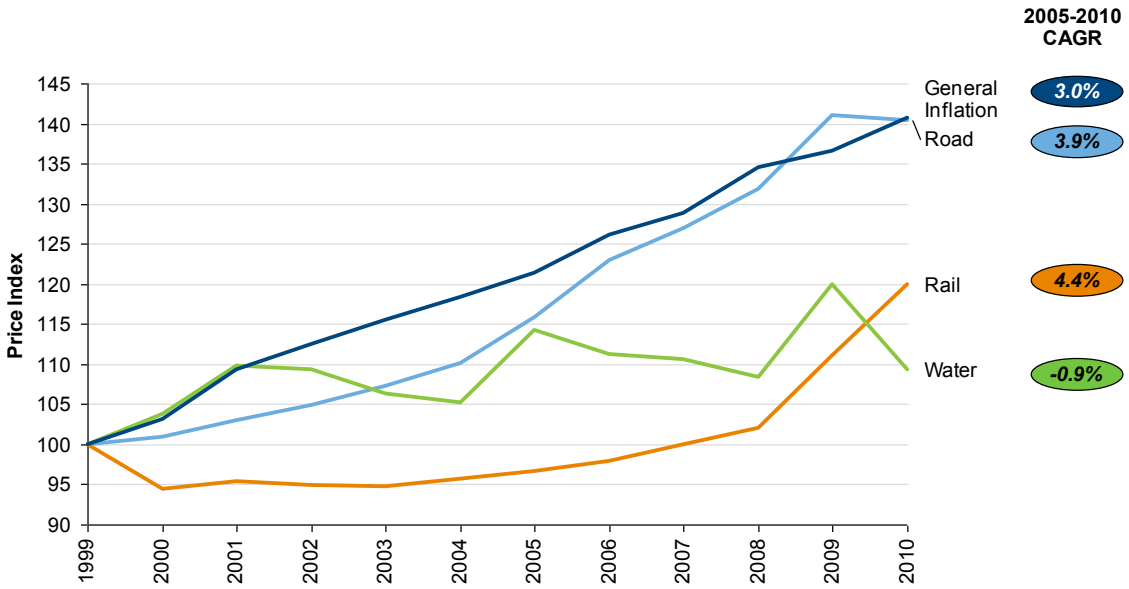
Using average FY11 Australian dollar exchange rates

Source: World Trade Organisation, Agricultural Trade Agreements, USDA Foreign Agricultural Service (GAIN), Sugar Annual 2010

2.2.5 Increasing Transport Costs

Transport costs, particularly road freight, have increased broadly in line with general inflation in Australia over the last 10 years. While these costs are increasing they are not viewed as a key driver of the industry's cost competitiveness particularly since locally manufactured food and grocery items do not incur the sea freight charges that imported goods do.

Figure 35: Producer Price Index for Freight Costs in Australia



Source: Australian Department of Infrastructure and Transport, Australian Infrastructure Statistics Yearbook 2011

2.2.6 Summary of Key Pressures on the Industry

In summary, when all factors are considered, the most significant threats to the future competitiveness of the Australian food and grocery manufacturing sector are in order of importance:

1. The retail market structure and dynamics
2. The ongoing strength of the Australian dollar compared to key trading currencies
3. Labour scarcity pressures
4. Increases in energy costs.

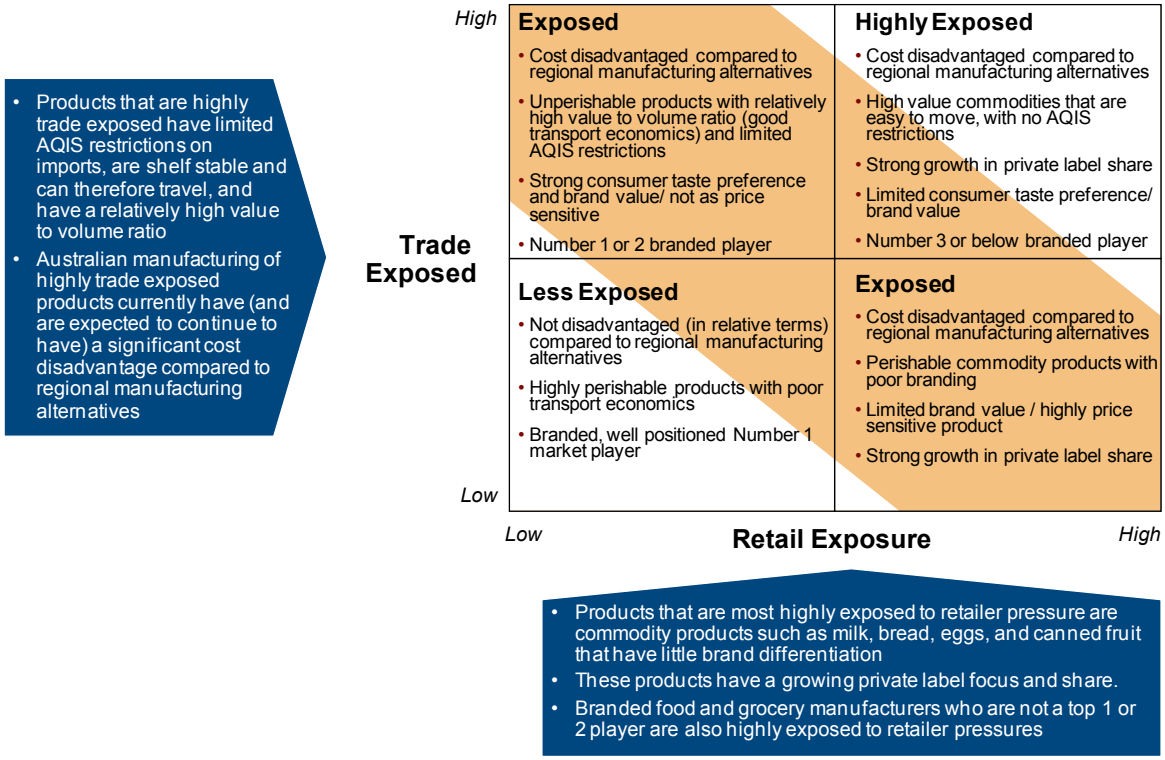
Commodity prices and volatility are expected to create continued margin pressure, but are not a key driver of relative cost competitiveness since these cost pressures also impact off-shore manufacturers.

Of the critical pressures listed above, the relative importance will vary by product category. For example, commodity type products such as fresh milk will be highly impacted by retailer pressures as they try to increase private label share, but are relatively protected from exchange rate pressures as AQIS restrictions, product perishability and transport economics limit import competition.

2.3 Impact of Key Pressures on Food and Grocery Manufacturers in Australia

The impact of these pressures varies across the Australian food and grocery manufacturing sector. Those sub-sectors and product categories which are most impacted are highly trade exposed and are under intense pressure from retailers as illustrated in Figure 36 below.

Figure 36: Framework to Measure Relative Exposure of Product Categories and Food and Grocery Manufacturers



Trade exposed categories are defined as those which:

- The cost of manufacturing the product in Australia is significantly higher than manufacturing in regional locations
- AQIS protection and rules around importation allow products of this nature into Australia
- The product is relatively shelf-stable rather than perishable and can therefore travel
- The supply chain is relatively long allowing offshore manufacturing
- The transport economics are not prohibitive, that is the product has a relatively high value relative to its weight and transportation costs.

Products that are highly exposed to retailer pressure are:

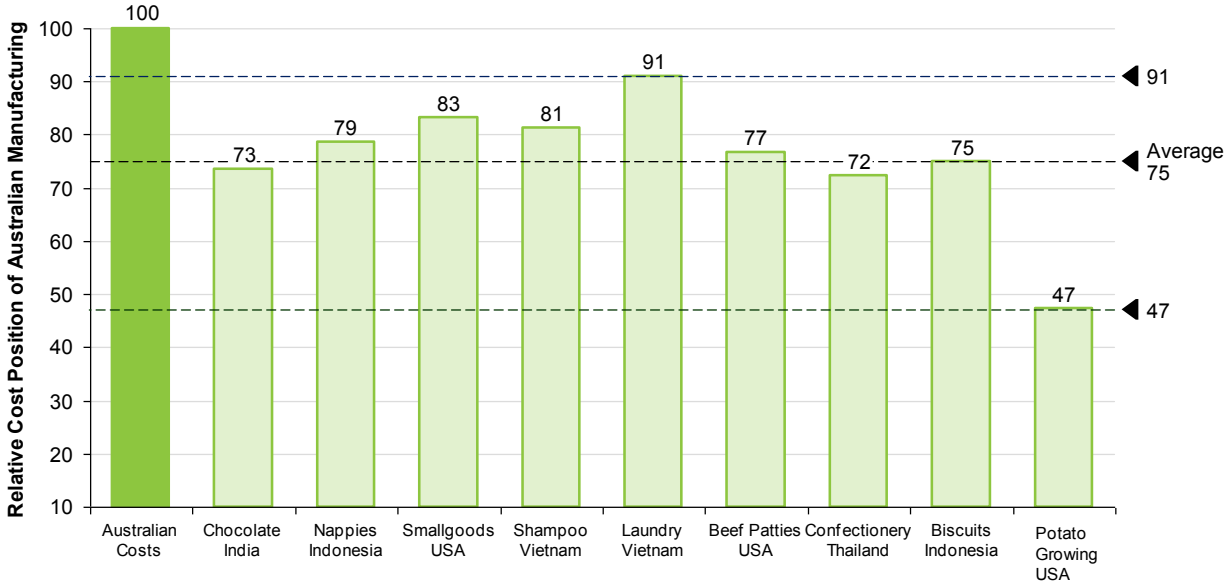
- Commodities such as bread, milk, eggs and canned fruit
- A priority for retailer‘s private label or owned brands, for example milk
- Major players who do not have an iconic brand or patent that creates differentiation with consumers and pull-through.

2.4 Relative Cost Position of Australian Manufacturers Compared with Offshore Alternatives

A sub-set of product categories were selected for cost benchmarking after considering their level of trade and retailer exposure. The selection was made to ensure that the analysis provides a breadth of coverage across food and the non-food grocery sector.

Today the relative cost position of Australian food and grocery manufacturers is on average 25 per cent higher than lowest cost regional alternatives as shown in Figure 37. Of the processed food and grocery products benchmarked, confectionery, chocolate and biscuits have the largest cost disadvantage in Australia today compared to regional manufacturing alternatives.

Figure 37: Australian Relative Cost Position by Product
(FY2011)



Source: A.T. Kearney Benchmarking Model

Since AQIS restrictions prohibit importation of beef patties into Australia, this product example compares the landed price of Australian beef patties into the main export market of Japan versus the landed price of American beef patties into Japan. As Figure 37 shows, Australian produced beef patties are considered to be approximately 23 per cent more expensive than an equivalent American produced product.

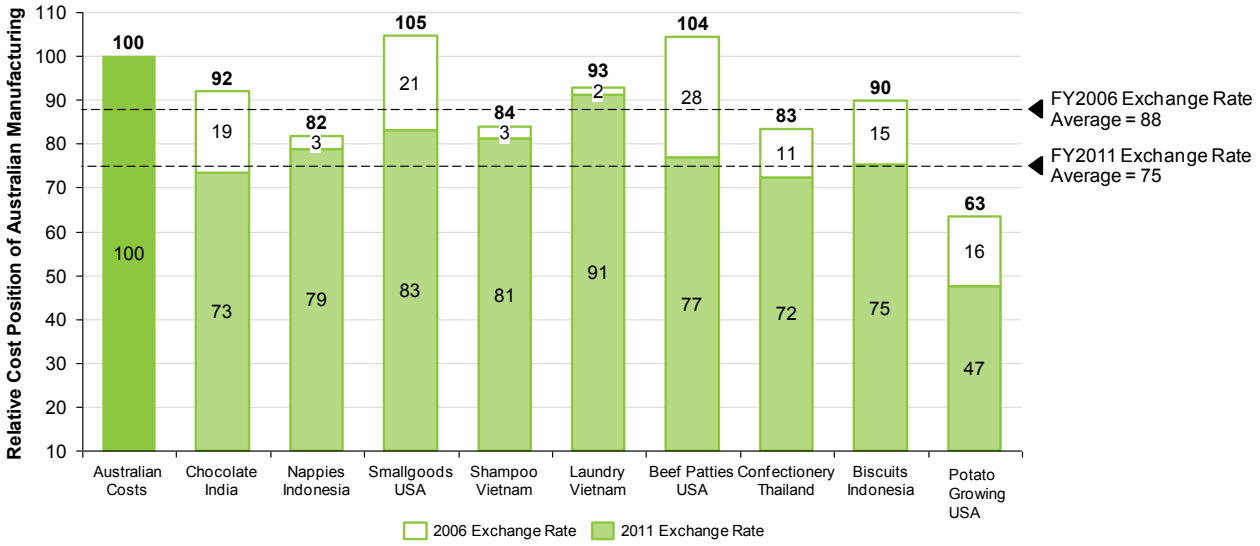
The cost of growing potatoes has been used as a proxy to compare the relative cost disadvantage of processed potato products in Australia with regional alternatives. This analysis is based on the differential in the farm gate cost of the potato in Australia compared with the United States. The major drivers of the differential in this case are labour costs, equipment utilisation costs, the cost of water and irrigation and the cost of transporting the potato from the farm gate to the factory gate. The labour and equipment utilisation cost differentials are a result of the relatively small scale of the Australian farming industry when compared to the US. These costs are significantly higher in Australia compared to the United States under the current exchange rate scenario.

Across all product categories, one of the major driving factors of cost disadvantage for Australian manufacturers today is the strength of the Australian dollar compared with the currencies of regional manufacturing alternatives. The currency exchange rates underlying the following analysis drives the

comparative Australian dollar values of all cost components and therefore is a fundamental underpinning assumption in the analysis[19].

If we assume that the exchange rate was at FY2006[20] levels, the relative cost position of Australian manufacturing is on average 12 per cent higher than the lowest cost regional alternative. This represents a reduction in the average relative cost disadvantage by 13 percentage points compared with today's exchange rate environment.

Figure 38: Relative Cost Position of Australian Manufacturing
(Exchange rates at FY2006 and FY2011)



Source: A.T. Kearney Benchmarking Model

The following examples illustrate how benchmarking was undertaken and how key drivers of cost were adjusted across countries.

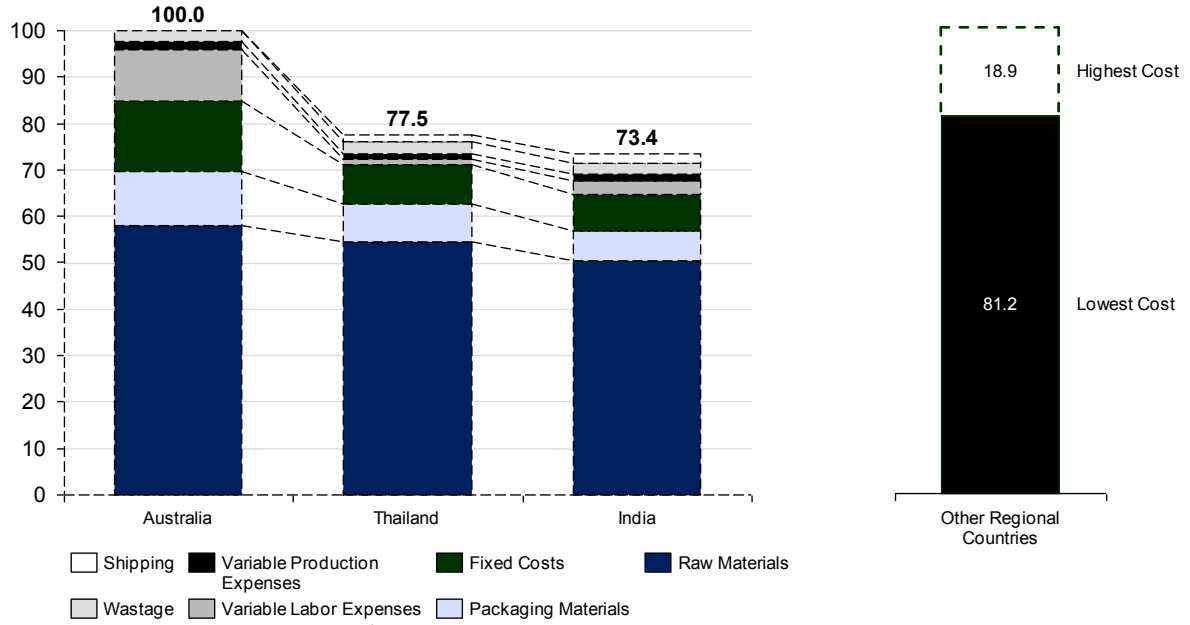
[19] The exchange rate assumptions used in this analysis were the average values for financial year ending June-2011 and are: USD: 1.0, CNY: 6.6, INR: 45.2, THB: 30.6, NZD: 1.3, MYR: 3.1, IDR: 8,828, VD: 19,976
[20] FY06 exchange rates are USD: 0.75, NZD: IDR: 1.12, 7,182 and THB: 28.30

2.4.1.1 Chocolate Manufacturing

The cost of manufacturing chocolate confectionery was benchmarked for Australian manufacturing in 2011 by identifying the key cost components and the relative contribution of these components to total cost of goods sold. The major drivers of cost in chocolate manufacturing are:

1. Materials (ingredients and packaging materials): ~70 per cent
2. Fixed costs: ~15 per cent
3. Variable labour expenses: ~11 per cent.

Figure 39: Relative Cost Comparisons for Chocolate Manufacturing, Australia and Regional Alternatives
(Indexed to Australian costs, FY2011)



Source: A.T. Kearney Benchmarking Model

India has the largest relative cost advantage and the overall cost per tonne of chocolate is ~28 per cent cheaper than in Australia. This advantage is driven by three key factors:

1. Lower overall variable and fixed labour costs, despite the lower level of labour productivity, as wage differences more than offset the productivity gap
2. Relatively lower price for locally sourced sugar and milk used in chocolate manufacturing
3. Relatively lower price for packaging materials.

Thailand is the next most competitive location with total manufacturing cost ~23 per cent lower than in Australia. The lower costs in Thailand are being driven by lower prices on ingredients, particularly sugar, which is cheaper on the Thai market than in neighbouring South East Asian nations.

2.4.1.2 Nappy Manufacturing

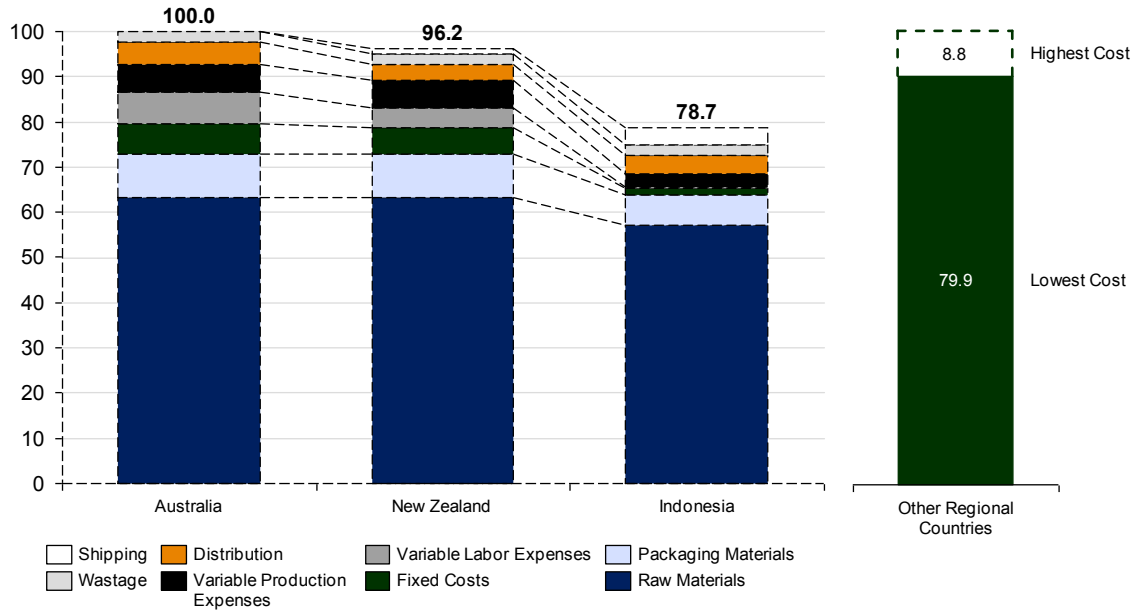
The major drivers of cost in nappy manufacturing are:

1. Raw materials (ingredients and packaging materials): ~73 per cent
2. Fixed costs: ~7 per cent
3. Variable labour expenses: ~7 per cent.

Variable production expenses such as repairs, maintenance and utilities contribute the remaining amount to cost of goods sold. Wastage is generally low and in many cases waste is recycled and re-used.

The raw materials that go into nappy manufacturing are paper pulp and super absorbent polymer, both of which are globally sourced. Large Australian manufacturers of sanitary paper products source these materials through contracts with local or offshore suppliers at similar prices to manufacturers in other locations. Therefore the cost of raw materials is not significantly different across the region. However there are differences in the environmental regulations around paper pulp in Asian countries such as Indonesia compared to Australia and this causes some deviation in the price of inputs[21]. However, the differences are not material enough for raw material costs to act as a major differentiator of cost.

Figure 40: Relative Cost Comparisons for Nappy Manufacturing, Australia and Regional Alternatives
(Indexed to Australian costs, 2010)



Source: A.T. Kearney Benchmarking Model

Indonesia has the largest cost advantage over Australia for nappy manufacturing, with the landed cost position coming in at ~21 per cent lower. This is mainly being driven by:

1. Low labour costs as wage rate differentials are much larger than productivity differences
2. Lower fixed costs in the form of lower labour overheads, lower levels of depreciation (assuming a less capital intensive set up), cheaper insurance and lower rental costs.

Freight on transporting nappies from an offshore location to Australia is significant (as a proportion of total costs). This is due to the relatively low value to weight ratio of nappies.

[21] In the cost benchmarking model, the average cost of pulp in Indonesia is modelled as being approximately 25 per cent lower than the equivalent in Australia

2.4.1.3 Smallgoods Manufacturing

The major cost drivers for smallgoods manufacturing are:

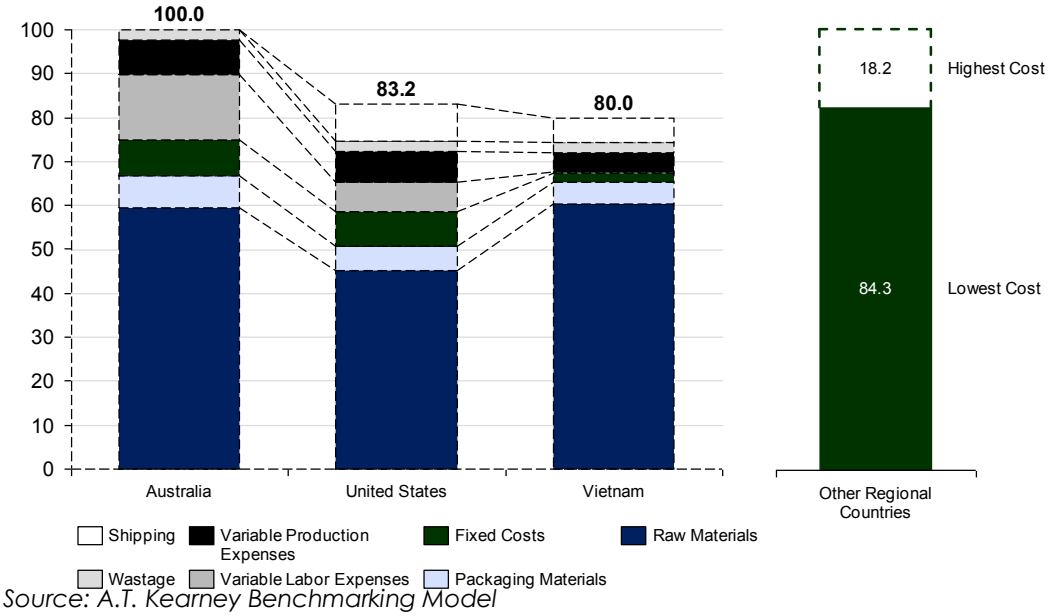
1. Raw material costs: 68 per cent
2. Variable labour: 15 per cent.

Manufacturing smallgoods is a relatively labour intensive process, with direct labour comprising 14.8 per cent and indirect labour contributing to 4.3 per cent of total costs of goods sold.

This cost structure will vary based on the type of smallgoods being manufactured. For example a much higher proportion of the cost of manufacturing bacon is driven by the cost of the raw material inputs, whereas a product like salami has a much higher labour content in the cost structure.

The raw material for smallgoods manufacturing is primarily pig meat which is generally sourced from a combination of imported and domestic sources. In Australia, a growing proportion of pig meat for food processing is globally sourced, particularly from Canada and Denmark. The breakdown between locally and globally sourced pig meat is assumed to be 30 per cent locally sourced and 70 per cent globally sourced. The differential in raw material costs between countries is primarily driven by locally sourced meat and packaging costs. Imported meat prices will differ slightly by country due to the transportation costs involved in moving pig meat to the manufacturing location.

Figure 41: Relative Cost Comparisons for Smallgoods Manufacturing, Australia and Regional Alternatives
(Indexed to Australian costs, 2010)



Source: A.T. Kearney Benchmarking Model

The two most competitive alternatives to Australia for smallgoods manufacturing are the United States and Vietnam.

The cost advantages of the US are driven by:

1. Local pig meat is significantly cheaper in the US than in Australia, and given the closer position of the US market to Canadian exports the cost of imported meat is also cheaper than in Australia[22]
2. Manufacturing wages for direct labour in the US are lower on average by 53 per cent when compared with Australia at the current exchange rate.

[22] Shipping cost of bringing imported pig meat to the manufacturing site is embedded in the raw material price paid.

The cost advantage of Vietnamese manufacturing is driven primarily by the cost of labour which is much lower than both in Australia and in US. Given the labour intensity of smallgoods production, this lower labour cost is a significant driver of cost advantage.

Amongst the other regional alternatives, Thailand is the most competitive with a cost advantage of approximately 16 per cent over Australia.

It should also be noted that there are AQIS restrictions on the importation of ‗bone-in' meat products, however these are more relevant to products such as ham on the bone than smallgoods. AQIS also has strict regulations around the facilities in which pigs are slaughtered and the imported meat is prepared, the temperature and time for which the imported meat is cooked and which part of the animal the meat is derived from. As such, there are a number of regulatory issues that importers of smallgoods need to comply with which may restrict imports in this category to a certain extent.

2.4.1.4 Biscuit Manufacturing

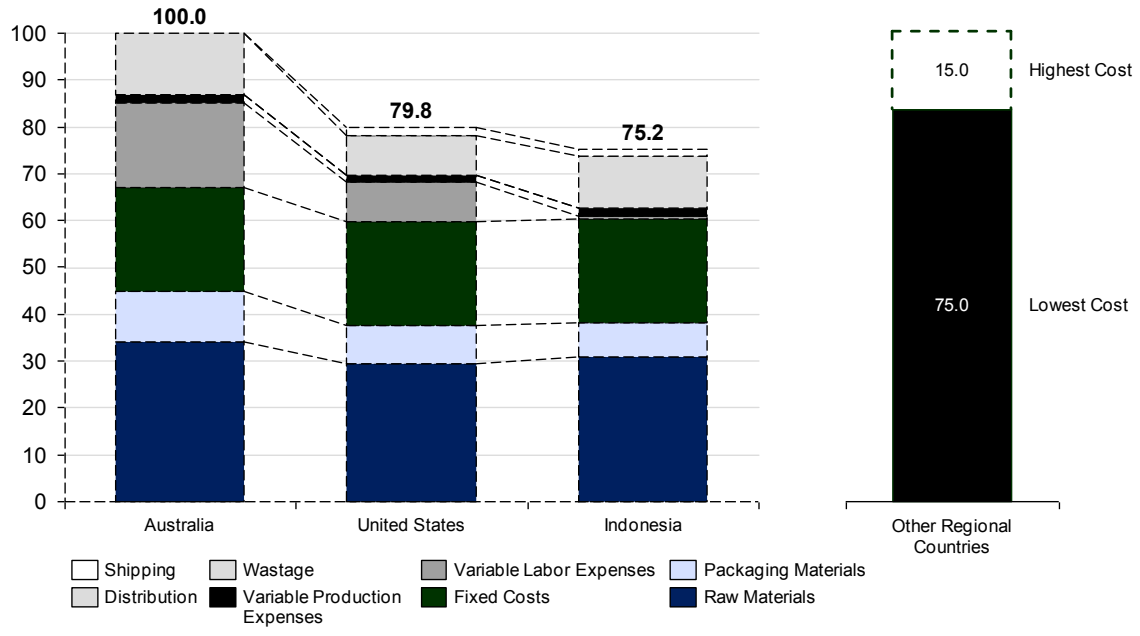
The major cost drivers for biscuit manufacturing are:

1. Raw material costs (ingredients and packaging): ~45 per cent
2. Variable labour expenses: ~18 per cent.

Indonesia and India have the largest relative cost advantage with the overall cost per tonne of biscuits. Both countries are ~25 per cent cheaper than the equivalent in Australia. This advantage is driven by three key factors:

1. Relatively lower price for locally sourced sugar and wheat used in biscuit manufacturing
2. Relatively lower price for biscuit packaging materials
3. Lower overall variable and fixed labour costs despite the lower level of labour productivity as wage differences offset the productivity gap.

Figure 42: Relative Cost Comparisons for Biscuit Manufacturing, Australia and Regional Alternatives
(Indexed to Australian costs, 2010)



Source: A.T. Kearney Benchmarking Model

3 Outlook for Industry Competitiveness

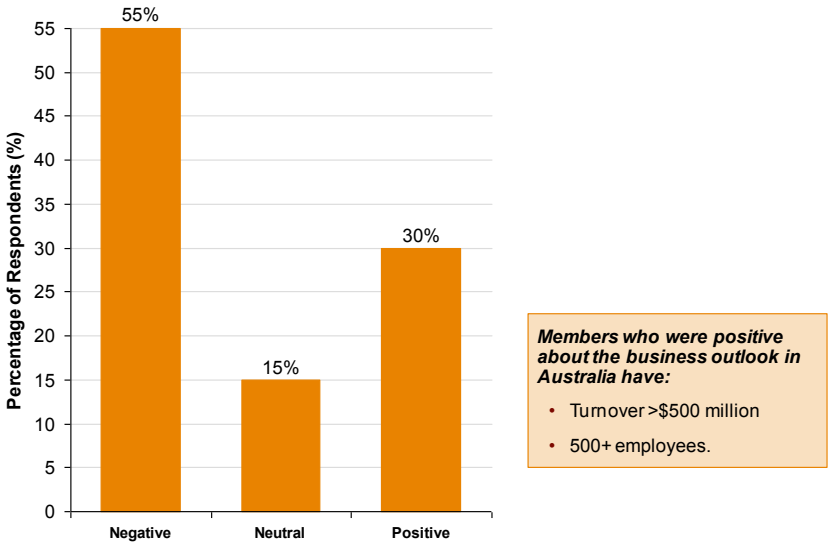
3.1 Outlook for Key Pressures and Challenges Facing the Industry

Under a ‗business as usual' scenario, the key pressures facing the industry are expected to continue unabated over the coming decade. Of the various pressures on the industry, the concentrated retail sector is expected to be the most significant challenge to contend with.

A combination of ongoing, intense pricing strategies by the major supermarket chains, a continued push for greater private label penetration and diminishing access to the consumer is likely to place significant pressure on manufacturer's margins, particularly for those players who are not the number one brand within a product category. In addition, the exchange rate and manufacturing wage and energy price increases are expected to compound the expected impact on wholesale margins.

Given the outlook for industry, it is no surprise that 55 per cent of surveyed food and grocery manufacturers are negative about the future (see Figure 43). Of the respondents that are negative about the outlook, the majority are small to medium sized national food and grocery manufacturers.

Figure 43: Business Outlook with Respect to Investing in Australian Manufacturing



Source: A.T. Kearney CAPEX and R&D Survey, 2011

3.1.1 The Retail Environment

The retail environment is expected to remain as challenging, if not more challenging, for food and grocery manufacturers in Australia over the coming decade. The retail market is expected to remain highly concentrated and potentially become more concentrated. As a result, the major retail supermarkets are expected to maintain and potentially increase their profit margins in the coming years, while there will be continued margin pressure on food and grocery manufacturers. The recent entry of Costco and ALDI is not expected to provide much relief in the form of diluting retail market concentration given their current levels of penetration and ability to expand.

The prospect of new players, such as Tesco, entering the Australian retail market is unlikely given the small population size, low rates of growth due to market maturity and the high barriers to entry. One barrier is access to a distribution network across Australia; the distribution network for most food manufacturers in Australia today no longer exists outside of the major retailers central distribution hubs. Other major barriers to entry include the cost of land, the limited availability of prime real estate locations and planning and zoning issues.

Barriers to Entry and Expansion in Grocery Retailing

The ACCC inquiry report into the competitiveness of the Australian Grocery Retailing environment considered a number of barriers to entry faced by new entrants to grocery retailing and by smaller players wanting to expand.

Access to Suitable Sites: Submissions to the inquiry raised concerns that the access to suitable sites was a significant barrier to establishment of independent supermarkets in the local area. These barriers prevent smaller players from competing more effectively with the major supermarket chains.

- Shopping centre landlords' prefer to lease sites to the major supermarket chains over independent supermarkets. Additionally, the number of supermarkets within centres is generally determined by the size of the centre and the mix of large anchor tenants and smaller specialty shops. ALDI is an exception and has been able to gain access to leases in a number of shopping centres as landlords consider ALDI to be a beneficial addition to their tenant mix. However ALDI's business model, which concentrates on limited lines in stores of around 1000m2 makes it less difficult for ALDI to obtain sites than larger full service supermarkets.

- The market dominance of the major supermarket chains affords them a stronger bargaining position in negotiating access to high quality retail sites which are sometimes charged to them at a lower comparative rent. Major supermarket chains sometimes restrict landlords from introducing a second, or third, supermarket over a certain size into a centre for a specific period of time.

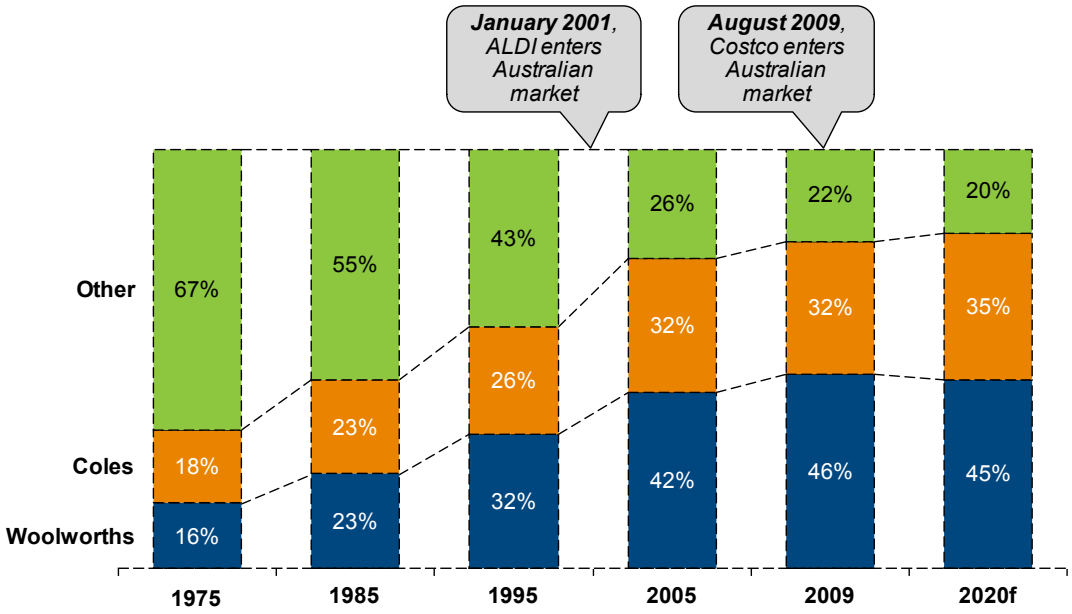
Planning and Zoning Issues: State planning regimes can act as a barrier to new supermarkets being established in local areas. The purpose of planning regulation in the retail market is to release land at a rate at which to achieve ‗orderly' or ‗desirable' development and maintain the existing character and structure of communities.

- Planning agencies do not currently take into account the impact on competition when considering new proposals for development.
- Planning laws also allow the incumbent operators to delay the operations of new developments by raising objections. This creates additional restrictions on competition in retail markets.
- The ACCC has recommended that consideration of planning decisions should have specific regard to competition issues, particularly where it would facilitate the entry of a supermarket not currently trading in the area.

Source: Report of the ACCC inquiry into the competitiveness of retail prices of standard groceries, Australian Productivity Commission, Performance Benchmarking of Australian Business Regulation: Planning, Zoning and Development Assessments

Coles and Woolworths are expected to maintain or increase their market share position from 78 per cent of total supermarket sales today to 80 to 85 per cent of total sales in 2020 (see Figure 44). ALDI and Costco's planned store growth is not expected to materially dilute Woolworths and Coles market position.

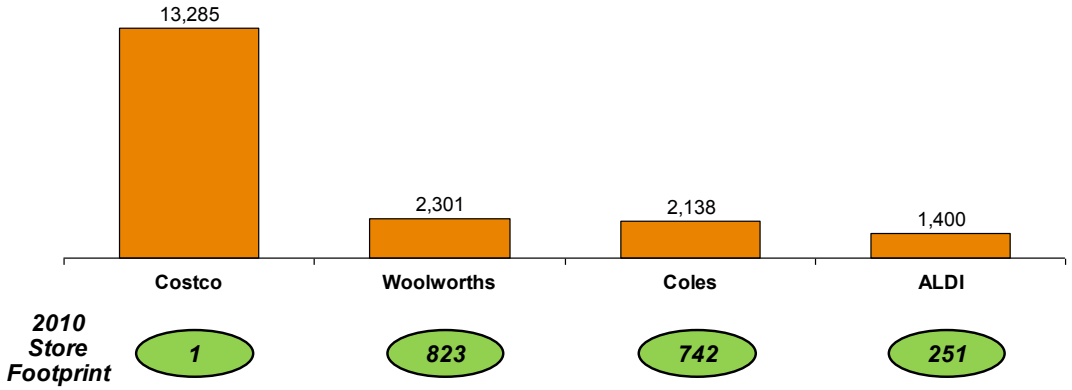
Figure 44: Forecast Grocery Retail Market Share



Source: Retail World, A.T. Kearney forecast

Even if ALDI achieves its planned store growth targets, it is only expected to absorb 0.7 per cent of the industry's growth each year. ALDI's historical pace of store growth in Australia has been about 25 to 35 stores per annum. Analyst forecasts predict that this number could ramp up to 40 to 50 stores each year to reach more than 650 stores by 2020. Given ALDI's average store size and implied revenue per store is smaller than the major retailers, an increase in store openings to 40 to 50 per year, only translates into a 0.7 per cent share of supermarket sales growth.

Figure 45: Average Store Size for Australian Supermarkets
(2010)



Source: Citi Investment Research

Analysts are predicting, based on management plans, that Costco will have a much slower expansion of about one store per annum due to the difficulty in obtaining suitable sites of the appropriate size for its mega store format. Given this, Costco is not expected to represent a significant threat to Coles and Woolworths.

The entry of Costco and ALDI, who tend to compete on price more than brand and innovation, is unlikely to provide manufacturers with a better route to market. In fact, these new entrants are expected to further drive the price sensitivity of consumers.

Coles and Woolworths are expected to continue to compete vigorously in the coming years. A key part of this ‗battle' will be driving a greater share of foot traffic in-store. The major retailers are expected to extend the use of pricing loss leaders to a wider range of categories (beyond bread and milk) to win this battle. This will inevitably place further margin pressure on food and grocery manufacturers as the major retailers look to maintain their own margins.

Coles and Woolworths strategic supplier model is expected to remain in place over the coming decade, with increasing focus on information sharing, co-operation and reducing costs to deliver on their proposition of value through price. Coles and Woolworths are expected to continue with their strategy of one to two branded offerings across most categories in addition to their own private label brands and owned brands.

Major retailers are also expected to continue ‗parallel' importing of global brands where they believe the consumer does not perceive value or have affinity with a locally produced formulation. This will continue to put pricing pressure on local food and grocery suppliers.

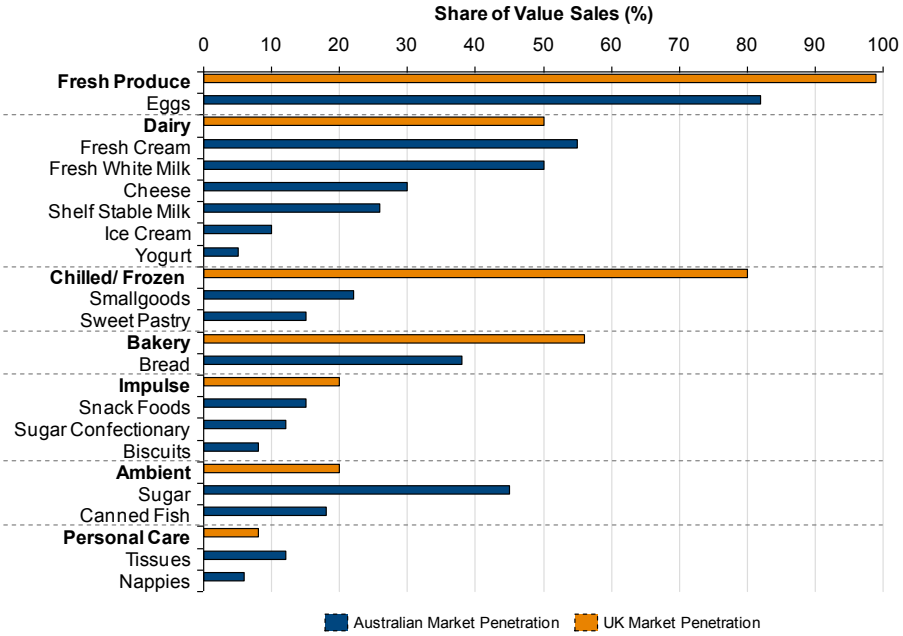
3.1.1.1 Growth of Private Label

Over the next 10 years, the Australian market for private label food and grocery products is expected to mature. By 2020, private label could potentially reach 40 to 50 per cent of total supermarket sales and have expanded into a fully tiered brand strategy which includes premium brands such as organics.

A 40 to 50 per cent private label penetration rate in 2020 is consistent with current and expected market concentration and the rate of adoption in other lead markets such as the UK. If we assume that current levels of market concentration are maintained and apply the statistical relationship outlined in Figure 20 (page 19), this would imply an end state penetration for private label of 49 to 50 per cent. In the UK it has taken approximately ten years for private label to grow from levels observed in Australia today to a penetration rate of 45 to 50 per cent.

Similar to what has occurred in other markets, future private label penetration rates are expected to be highest in fresh produce, food service, ready meals and fresh/frozen grocery categories where penetration levels of greater than 50 per cent have been achieved as can be seen in Figure 46.

Figure 46: Private Label Penetration: Australia vs. UK Market

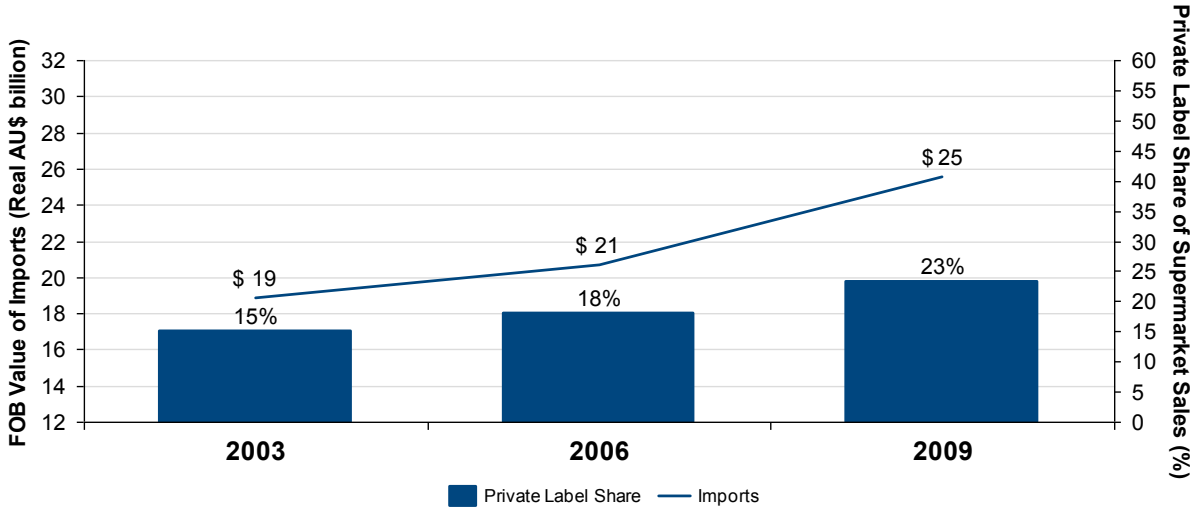


Source: AC Nielsen, Retail World, Dairy Australia, Company Interviews, A.T. Kearney Primary Research, A.T. Kearney Consumer Industry and Retail Practice

In order to maintain their higher gross margin on private label products retailers are expected to source these items, where possible, direct from offshore manufacturers. Furthermore, as spare capacity in the local food and grocery manufacturing industry diminishes and margins decrease, some Australian manufacturers are expected to exit or choose not to enter this part of the market, since private label manufacturing economics typically only make sense as an option to utilise spare capacity.

Historically there has been a correlation between private label share of supermarket sales and import value as shown in Figure 47. Given this relationship, it is reasonable to assume that future private label growth will be predominately sourced from offshore manufacturers.

Figure 47: Imports to Private Label Share Correlation
(2003-2009)



Source: Retail World, AC Nielsen, ABS Customs Data

Over the next 10 years major retailers' control of their supply chain is expected to further increase. Similar to what has occurred in the UK, it is likely that Coles and Woolworths will look to form closer relationships with processors and also farmers with the intent of achieving greater efficiencies, quality and collaboration on innovative product offerings. For categories of strategic importance, where the processor supplier base is still fragmented, the major retailers could make strategic acquisitions as part of a broader push to drive the category through consolidation of the supplier base. True vertical integration is less likely to occur on a widespread basis given the economics in terms of capital investment and its inevitable distraction from retailers' core competency of understanding the consumer.

Strategic acquisitions are consistent with recent market events in meat and dairy. For example in April 2011, Coles put in an unsuccessful bid for the Colac-based lamb processor CRF. CRF had a long standing supply contract with the supermarket chain.

3.1.1.2 Supplier Consolidation and Changing Store Format

As food and grocery retailers change store formats to provide a greater variety of fresh produce and ready-to-eat convenience food, packaged food and grocery manufacturers will be competing for a smaller amount of shelf space. Unless the manufacturer is a number one or two player in a category, they will struggle to gain access to the consumer and are likely to come under intense pressure to rationalise their product range or consolidate with other manufacturers.

3.1.2 The Exchange Rate

Through to 2013 the Australian dollar is expected to remain high against the currencies of the major food and grocery trading nations. Looking forward beyond 2013 however, there is much debate and a divergence of views on whether the Australian dollar will return to the long term average cross rate with the US dollar of $0.75 to 0.80 or remain at the current levels of parity.

Given the lack of consensus, we have assumed that under a business as usual' scenario, the Australian dollar will hold at the levels observed today from 2013 to 2020. This assumption has been detailed in Table 2 below.

Table 2: Exchange Rate Assumptions

Exchange Rate Assumptions	
	FY2011-2020
US Dollar	1.0
Thai Baht	30.6
Indonesia Rupiah	8,828
Indian Ruppee	45.2
Malaysia Ringgit	3.1
Vietnamese Dong	19,976
Chinese Yuan	6.6

Source: Reserve Bank of Australia, FY11 Exchange Rates

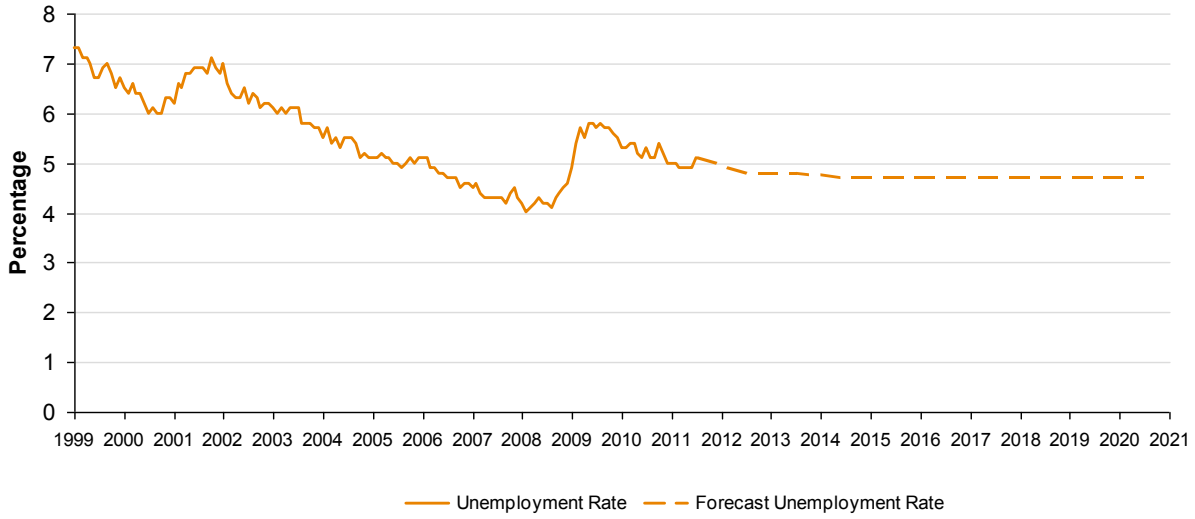
This assumption is consistent with corporate business planning norms. Companies considering capital investment decisions today for the next three to five years would assume in their business cases that the Australian dollar remains at current levels of parity with the US dollar and then perform sensitivity analysis on this assumption.

3.1.3 The Manufacturing Labour Rate

Another pressure that will continue to impact Australian manufacturers is the year-on-year increases in nominal wage rates. Ongoing labour scarcity is expected to continue due to a combination of low

unemployment (~5.0 per cent of the total workforce as seen in Figure 48) and an ongoing skills shortage in filling technical roles. This is expected to result in forecasted wage rate increases of ~3.6% per annum to 2020.

Figure 48: Forecast Unemployment Rate
(2009-2020)



Source: Reserve Bank of Australia, International Monetary Fund, World Economic Outlook Database, April 2011

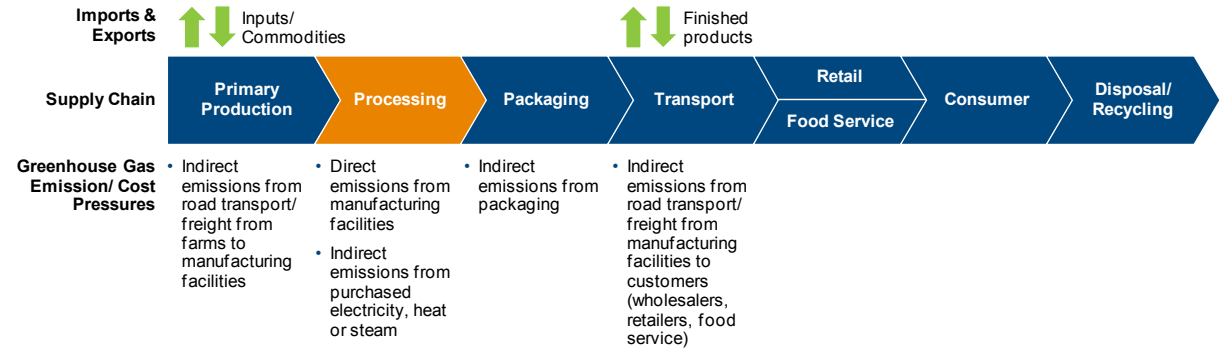
3.1.4 Energy Prices and Impact of the Carbon Pricing Mechanism

The proposed Clean Energy Plan, including the new Carbon Pricing Mechanism, announced by the Federal Government on 10 July 2011 sets out legislation in Australia for the introduction of a carbon price:

- From 1 July 2012, the fixed carbon price will start at A$23 per tonne of carbon dioxide equivalent (CO_2-e) for three years (growing at 2.5 per cent real growth per year) before moving to an emissions trading scheme in 2015.
- From 1 July 2015 onwards, the price will be set by the market and the number of permits issued by the Government each year will be capped.

To fully understand the impact of the Clean Energy Act on the operating costs of food and grocery manufacturers, it is necessary to assess the supply chain and understand the key inputs/ drivers of emissions and cost increases. The below figure illustrates the supply chain for a typical food/grocery company.

Figure 49: Processed Food and Beverage Supply Chain and Expected Emission Pressures



Source: A.T. Kearney

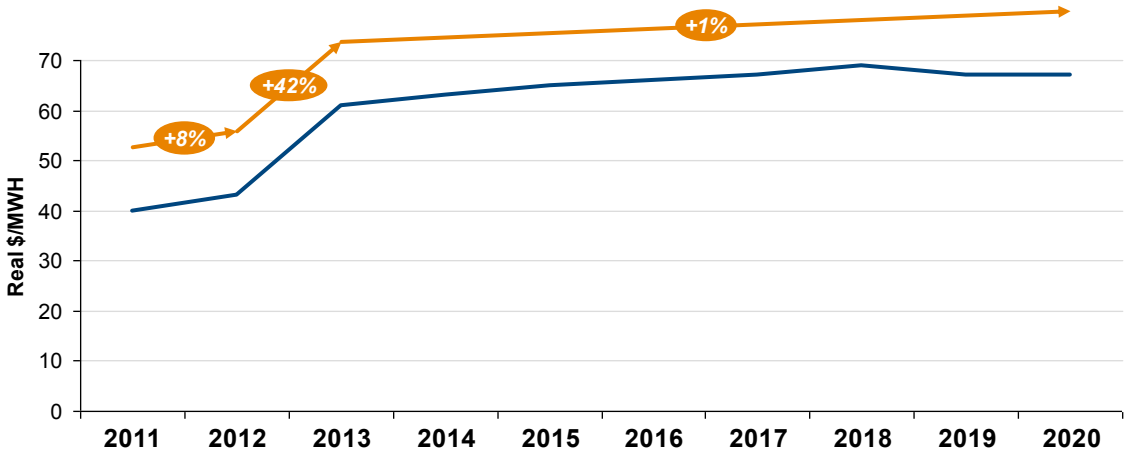
For the majority of Australian food and grocery manufacturers, the inputs that are likely to be most impacted by the proposed scheme (and therefore drive cost increases) are:

Electricity: Although the food and grocery sector is a small consumer of electricity relative to other sectors in the economy, indirect emissions from the consumption of purchased electricity accounts for the majority of total emissions within the industry. Over the last three years, manufacturers have had to absorb record high electricity and water price increases.

Interviews with food and grocery manufacturers suggest that the increasing price of electricity is the biggest concern resulting from the proposed scheme. Companies believe that electricity suppliers will pass through 100 per cent of emission costs.

As a result, electricity prices are forecast to increase in real terms by 8 per cent between 2011 to 2012 and 42 per cent between 2012 and 2013 (equivalent to a 10 to 40 per cent increase in nominal terms), in part due to the introduction of the carbon tax. From 2013, more moderate real price increases of 1 per cent per annum (equivalent to a 1 to 5 per cent increase in nominal terms) are forecast through to the end of the decade. These assumptions are in line with the core policy scenario of the Australian Treasury's modelling of the average wholesale energy prices under a carbon tax.

Figure 50: Average Wholesale Electricity Price Under Core Policy
(2011-2020, AU Real $ per MWH)



Source: Australian Government Treasury Modelling, Core Policy Scenario; EIU Inflation Forecast

Freight: Distribution and logistics is particularly concerning for manufacturers with remote facilities or plants. Company interviews indicate a potential 2 to 5 per cent price increase in road transport as a direct implication of the carbon tax.

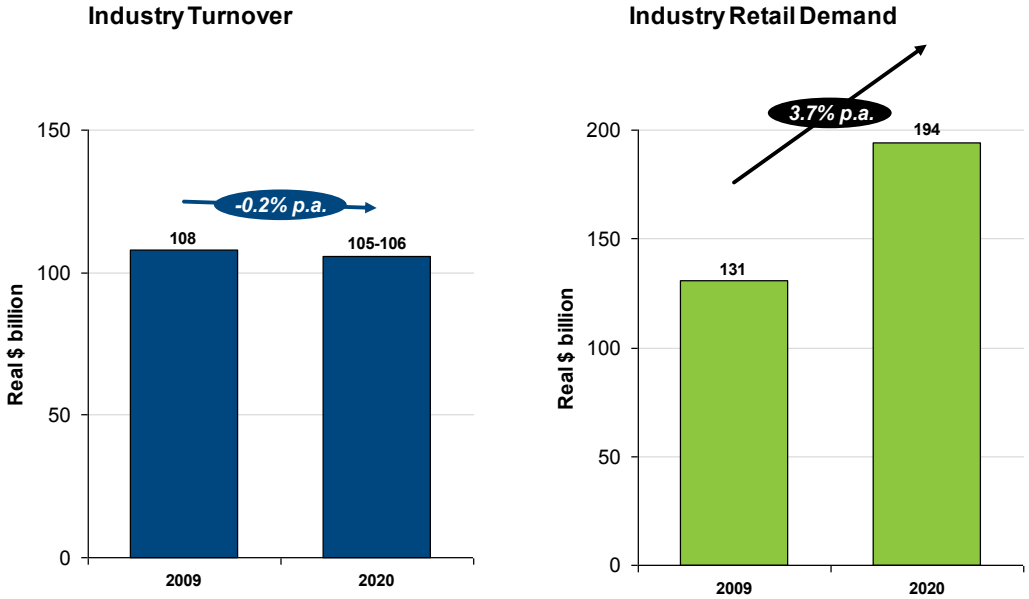
Packaging: Packaging will have a small indirect impact on food and grocery manufacturers. Although some forms of packaging, including paper cardboard, carton board, and glass container, may be eligible for EITE assistance, company interviews indicate a potential 1 to 5 per cent price increase in packaging materials in the first few years of the scheme. Once the EITE assistance is removed after 2014-15, the impact could be far greater.

3.2 Impact of Key Pressures on Future Industry Competitiveness

3.2.1 Outlook for Industry Size and Growth

Given the outlook for the various pressures on the industry, real industry turnover is expected to decline at about 0.2 per cent per annum over the next decade from $108 billion in 2009 to between $105 and $106 billion in 2020. This decline is predicted despite growth in the real retail demand for food and grocery products of 3.7 per cent per annum, in line with population and per capita income growth, from $130 billion in 2009 to approximately $190 billion in 2020.

Figure 51: Outlook for Food and Grocery Manufacturing Industry Turnover and Retail Demand
(2009-2020, A $ billion)

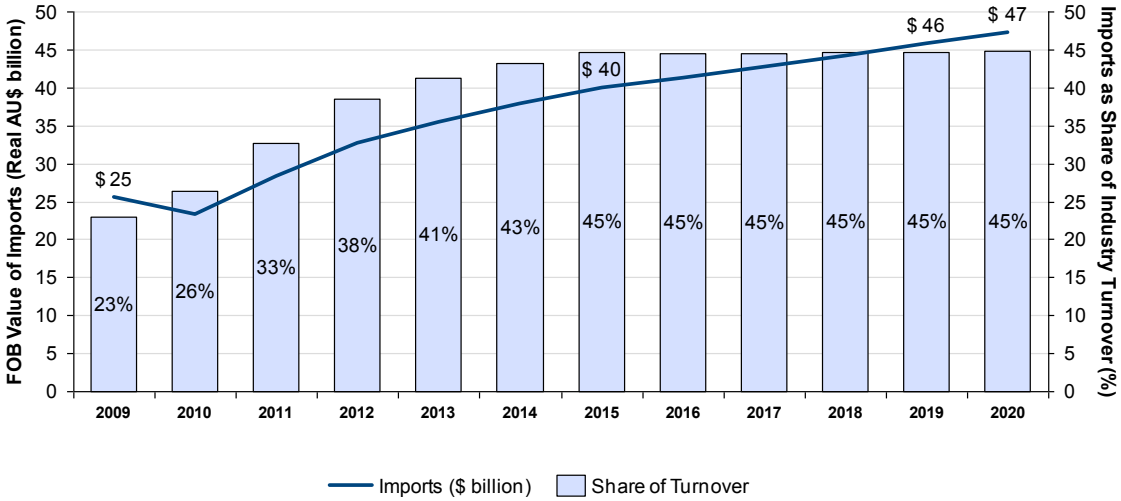


Source: ABS Catalogue 8159.0, 8122.0, ABS Catalogue 8501.0: Retail Turnover by Sub-Group, A.T. Kearney Industry Model

The gap between growth in manufacturing industry turnover and retail demand is expected to be increasingly filled with imports of food and grocery products which are expected to grow in real terms from ~$25 billion in 2009 to ~$47 billion in 2020.

This represents a growth in imports as a share of total industry turnover from 22.9 per cent in 2009 to 44.8 per cent in 2020.

Figure 52: Forecast Growth in Industry Imports[23]
(2009-2020, real A $billion (FY2009 dollars) FOB value, percentage share of total industry turnover)



Source: ABS Customs Data, A.T. Kearney Industry Model

Strong growth in industry imports is being driven by two key factors: retailer private label strategies, and the impact of the recent appreciation of the Australian dollar which has created a structural cost disadvantage for many Australian manufacturers. Looking forward, the ongoing strength of the Australian dollar is expected to create an incentive for manufacturers to offshore manufacturing production.

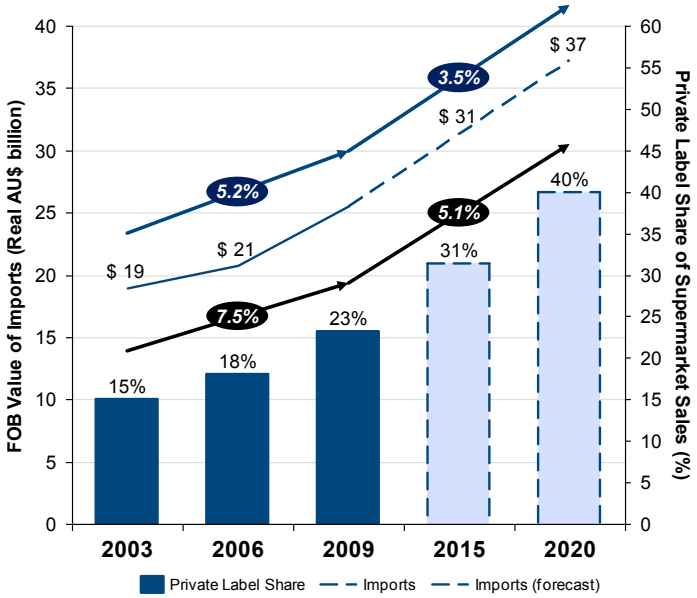
3.2.1.1 Private Label Growth

Private label sales are forecast to reach 40 per cent of total supermarket sales by 2020. Food and grocery manufacturers in Australia are increasingly choosing to exit their private label manufacturing contracts due to the lack of capacity in production and negligible margin on this product. In order to maintain the larger gross margin on private label goods and to achieve the targeted basket penetration levels, Australian food and grocery retailers will likely source a high proportion of this growth directly from offshore manufacturers who have a lower total cost base than their Australian counterparts. As a result, private label growth is likely to directly contribute to growth in food and grocery industry imports.

[23] FOB import value is actual data up to 2010 whereas import share data (calculated as a percentage of total industry turnover) is actual only up to 2009

Using the historical correlation between private label and import growth as an indicator, 70 per cent of private label product is assumed to be sourced directly from offshore rather than from local Australian manufacturers. Therefore, a 5.0 per cent per annum growth in private label share leads to an average growth rate of ~3.5 per cent per annum in industry imports.

Figure 53: Import Growth Attributable to Private Label Share Growth
(2003-2020)



Import Share correlation with Private Label	
2003-2009 CAGR Private Label Share	7.5% p.a.
2003-2009 CAGR Real Imports ($ million)	5.2% p.a.
Imports to Private Label Share correlation	~0.7% increase in imports per 1.0% increase in private label share
2009-2020f Growth in Private Label Share	5.1% p.a.
2009-2020f Growth in Real Imports attributable to Private Label Growth	3.5% p.a.

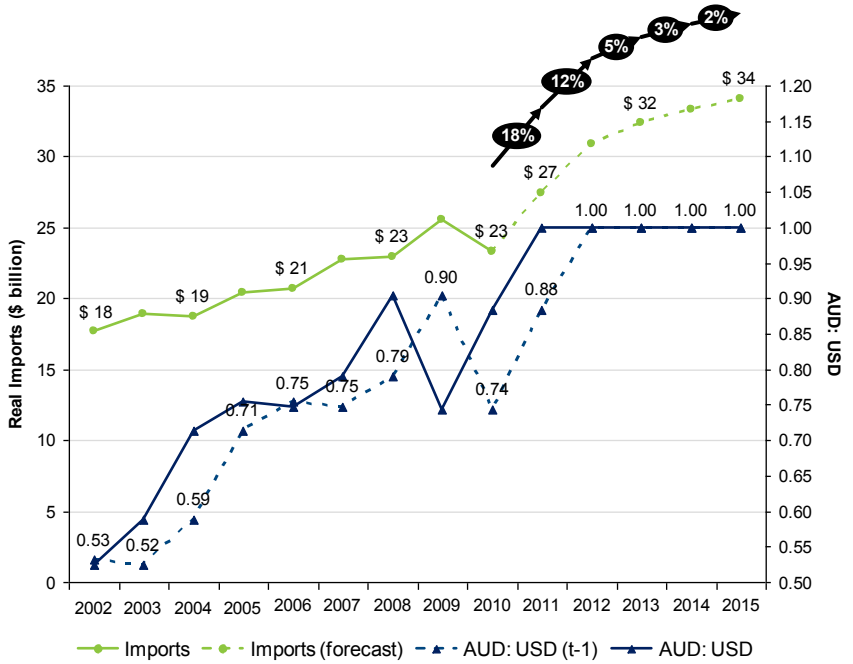
Source: AC Nielsen, Retail World (for actual data until 2010), A.T. Kearney Industry Model

3.2.1.2 Australian Dollar Exchange Rate

The recent appreciation of the Australian dollar in the period between 2009 and 2011 is expected to lead to strong import growth in the period between 2011 and 2015. Import growth is highly correlated to changes in the exchange rate with a lag of one time period, since changes in the exchange rate impact the cost position of Australian manufacturers relative to regional competitors.

From 2012 to 2015, continued import growth of 2 to 5 per cent per annum is forecast despite holding the exchange rate constant at 1.0 US dollar. This lag effect on growth assumes that it will take five years for imports to reach their new equilibrium level with the long term exchange rate, as food and grocery manufactures make difficult decisions on whether to offshore their manufacturing capacity to improve their cost competitiveness.

Figure 54: Import Growth Attributable to Exchange Rate

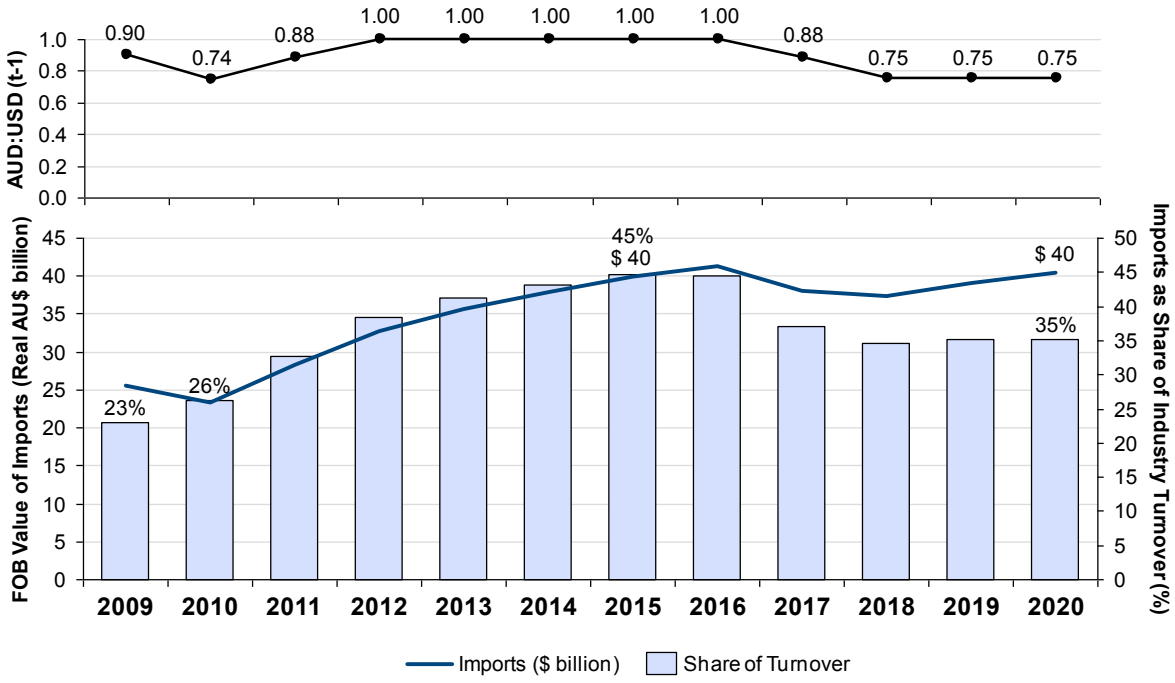


Source: Reserve Bank of Australia, Exchange Rate Data, ABS Customs Data, A.T. Kearney Industry Model

3.2.1.3 Exchange Rate Sensitivity

The outlook for industry size is sensitive to the exchange rate outlook. If the exchange rate was to return to a long-term average of $0.75 after 2015, then the level of imports would ‗steady' at about $40 billion by 2020.

Figure 55: Exchange Rate Sensitivity of Forecast Import Growth



Source: A.T. Kearney Industry Model

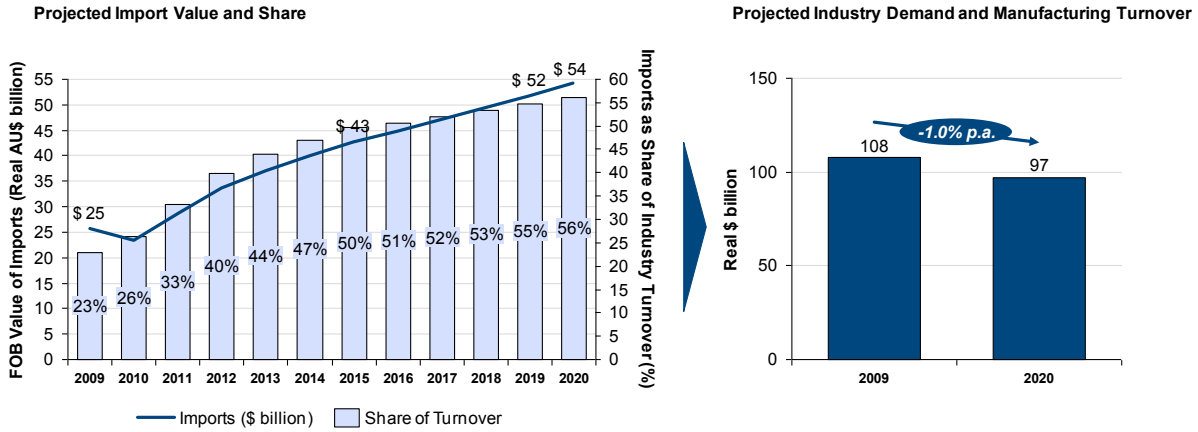
If this were to happen, real industry turnover in 2020 could be 6 to 8 per cent greater than the predicted industry turnover under the exchange rate assumptions detailed in section 3.1.2.

3.2.1.4 *Downside Risks to Industry Outlook*

Similarly, there are several other downside risks that have not been factored into the outlook for industry size. For example, significant investment is occurring in Asia to build new mega plants focused on serving their respective domestic economies. However, as those economies mature, there is potential that spare capacity could be used to supply directly to Australian retailers.

Similarly, if private label were to reach 50 per cent by 2020, real industry turnover could be 5 to 10 per cent lower than what has been forecast.

Figure 56: Projected Industry Turnover under Aggressive Private Label Growth Scenario



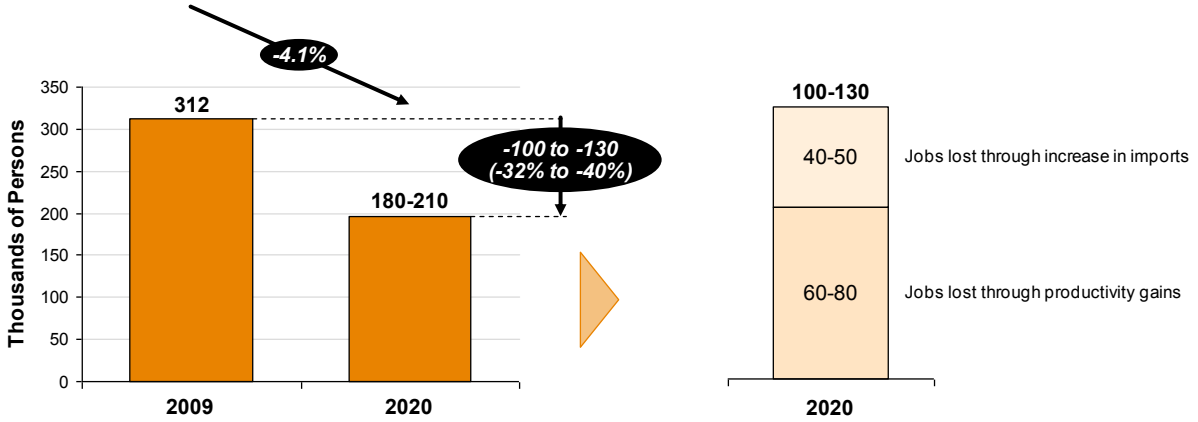
Source: A.T. Kearney Industry Model

3.2.2 Outlook for Industry Employment

Forecast growth in imports means that a greater proportion of total food and grocery production is manufactured offshore than locally in Australia. This combined with ongoing improvements in labour productivity will result in the loss of an estimated 100,000 to 130,000 industry jobs by 2020.

Total employment in food and grocery manufacturing is expected to drop from ~312,000 jobs in 2009 to ~180,000 to 210,000 jobs in 2020, a net loss of ~32 to 40 per cent of current employment over this period.

Figure 57: Outlook for Industry Employment
(2009-2020, thousands of persons)



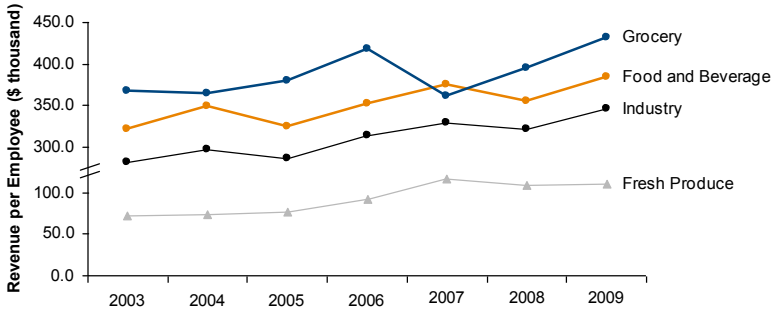
Source: A.T. Kearney Industry Model

Of the 100,000 to 130,000 jobs lost, 60,000 to 80,000 jobs are attributed to ongoing productivity gains associated with consolidation and automation and the remaining 40,000 to 50,000 are attributed to

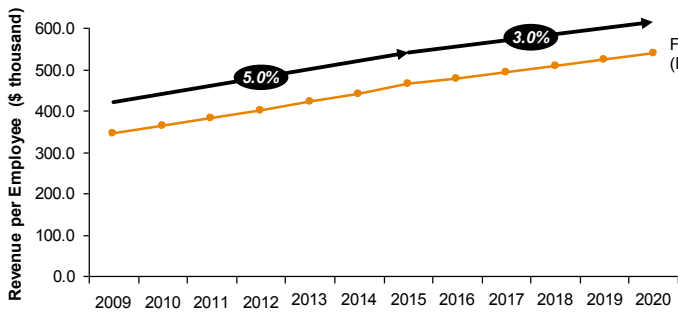
direct substitution to imports. Job losses are expected to come principally from players competing in the most exposed product categories (see section 2.3).

The intense pressures on the industry will require food and grocery manufacturers to drive improvements in labour productivity in order to cut costs and maintain profitability. As such, the forecasted improvement in labour productivity is expected to continue in line with historical trends as shown in Figure 58.

Figure 58: Actual and Forecasted Improvement in Labour Productivity
(2003-2009, 2009-2020f)



Labour Productivity Growth, 2005-2009	
Grocery Productivity Growth	3.3% p.a.
Food and Beverage Productivity Growth	4.4% p.a.
Fresh Produce Productivity Growth	9.5% p.a.
Industry Productivity Growth	***4.9% p.a.***



Projected Increase in Productivity of Labour	
Industry Productivity Growth Forecast Growing at historical levels due to the increased pressures and after 2015 growing at a slower rate	***~5% p.a. to 2015 and then ~3% p.a. to 2020***

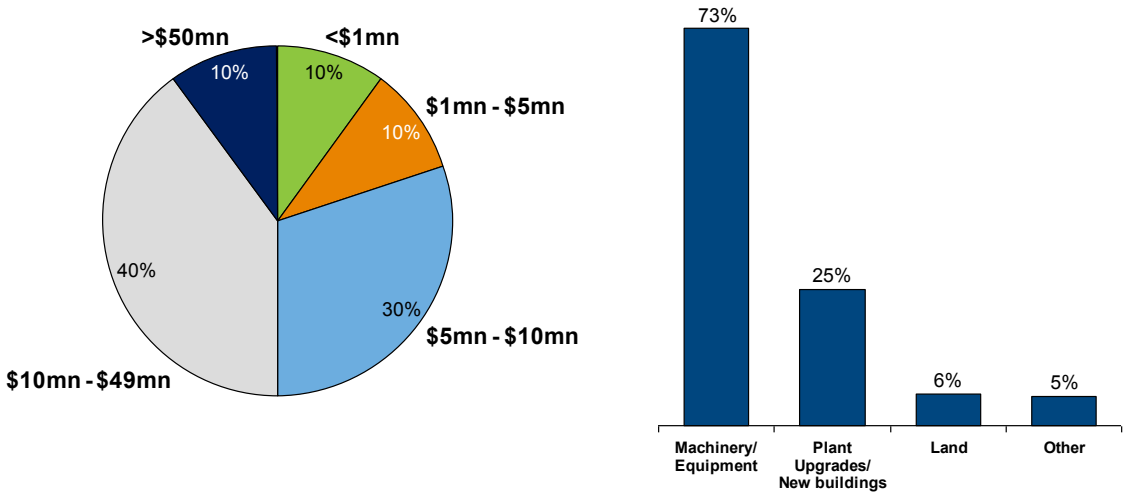
Source: ABS Catalogue 8159.0, ABS Labour Force Detailed

3.2.3 Outlook for Capital Investment and Implications

The food and grocery manufacturing industry faces a significant investment challenge. It is highly uncertain if the industry will have the capital or will to make the scale of investment required over the next decade to maintain a vibrant competitive sector.

Over the last five years, the principal focus has been getting ‗more out of existing assets' rather than upgrade or renewal of plants. In 2011, ~60 per cent of surveyed companies invested $10 million or less in capital with over 70 per cent of this expenditure going towards machinery and equipment rather than plant upgrades. Two thirds of surveyed companies also responded that today's capital investment is higher than what it was five years ago.

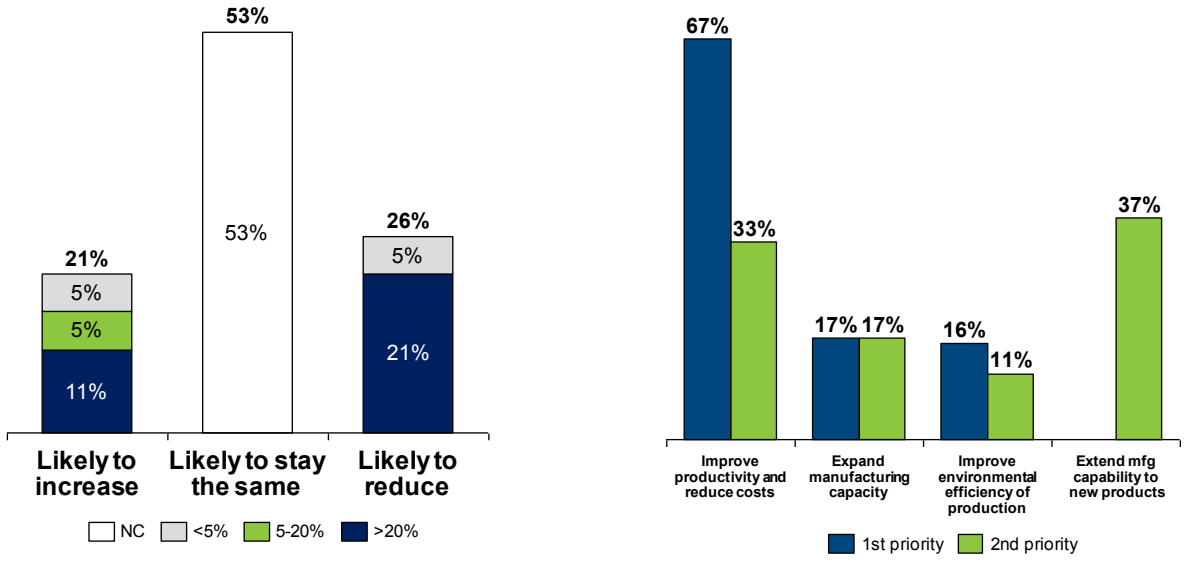
Figure 59: Size and Purpose of Capital Investment in Australia
(2011)



Source: A.T. Kearney CAPEX and R&D Survey, 2011

Some companies have commented in interviews that their Australian manufacturing sites are now ageing and will require significant investment to renew and upgrade. Despite this, only 21 per cent of surveyed companies indicated that capital expenditure was likely to increase over the next five years; companies indicated their first preference for use of these additional funds will be a continued focus on productivity and reducing costs. Twenty six per cent of surveyed companies indicated that capital expenditure was likely to reduce in future.

Figure 60: Outlook for CAPEX and Key Drivers of CAPEX Spending
(2012-2016; five year outlook)



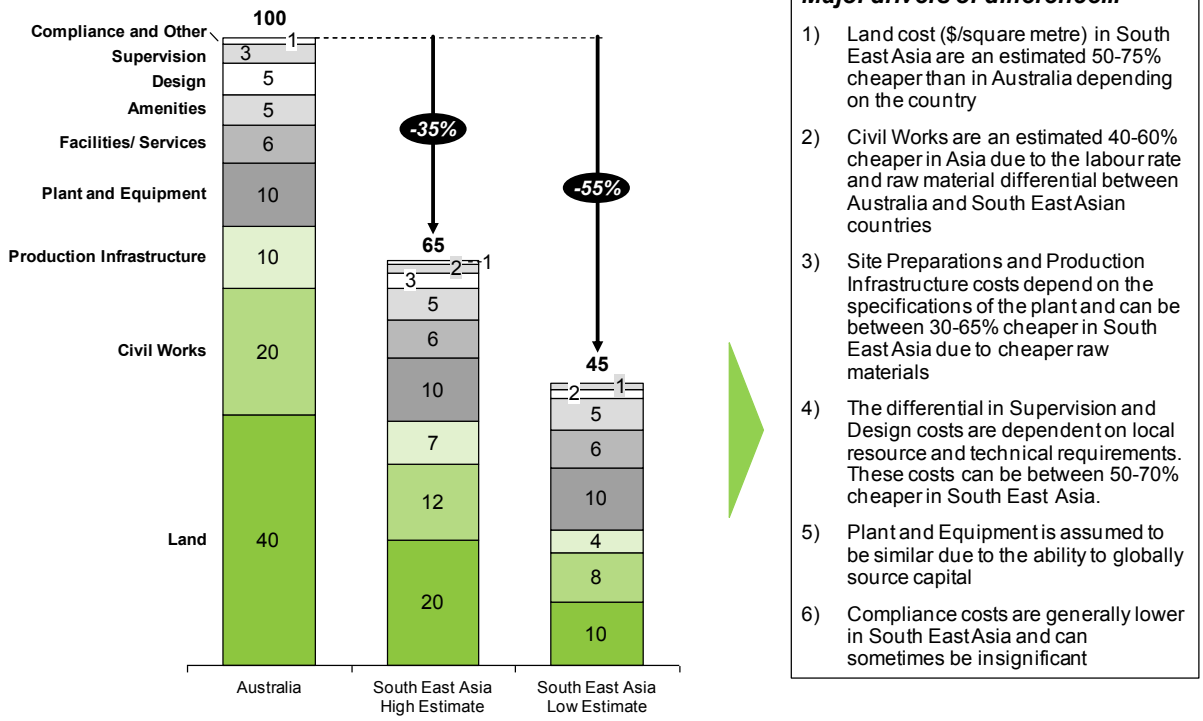
Source: A.T. Kearney CAPEX and R&D Survey, 2011

With the forecast strong Australian dollar over the next five years, capital investment in machinery equipment sourced from offshore provides a more favourable rate of return. Despite this, Australian manufacturing is still at a relative disadvantage compared to South East Asia when it comes to the cost of capital. There is scope for Government to make the investment and tax environment more favourable in Australia to ease some of the burden on local manufacturers.

Another relative disadvantage of manufacturing in Australia is that the cost of setting up a greenfield plant is significantly cheaper in Asia. The total cost of constructing a plant in South East Asia can be up to 55 per cent cheaper than in Australia under a low cost scenario.

The illustrative example in Figure 61 compares the main cost components in setting up a 'like-for-like' plant in Australia versus South East Asia.

Figure 61: Capital Cost Comparison Australia v South East Asia
(Illustrative example, Australian cost indexed to 100)



Given the large capital cost differential between Australia and Asia, creating a more favourable investment environment (through investment allowances and/or tax breaks) in Australia can be an impactful way in which Government can ease some of the pressures on food and grocery manufacturers.

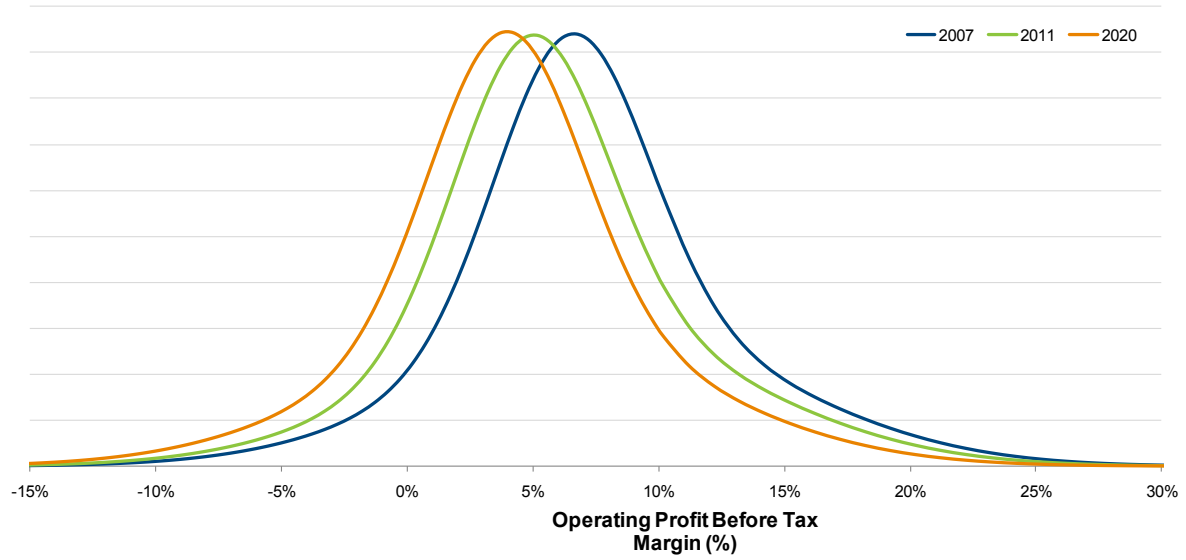
For companies considering future investment in a major plant upgrade, it is highly likely that some will choose to offshore, part or all, of their current manufacturing capacity. Where feasible, offshoring would enable manufacturers in trade exposed categories to respond to the ongoing challenges presented by the retail environment and the structural cost disadvantage created by a strong Australian dollar. Such offshoring is consistent with recent trends in the industry (refer to section 2.2.6, Figure 10 and Figure 11 for examples).

Interviews with multi-national food and grocery manufacturers have also consistently indicated that Australia is a less attractive investment option than other regional alternatives. They have commented that Australia is both higher risk (due to the challenging retail environment and other pressures) and lower growth relative to other investment alternatives in Asia. Should these multi-nationals invest in

building capacity in Asian emerging markets at the expense of Australia, there is likely to be a flow on effect as spare capacity could be deployed to manufacture for the Australian market.

For small to mid-sized industry players, the outlook is even more challenging. Even in a best case scenario that current estimated average industry operating profit margins of 5.3 per cent are maintained, it is highly unlikely that the smaller players (with less scale) are generating sufficient returns to have the balance sheet strength required to make the scale of investment required. Given that average industry operating profit before tax has declined from 7.1 per cent in 2007 to an estimated 5.3 per cent in 2011 it would be reasonable to assume, under a business as usual scenario that further erosion of industry profit margins will occur. Smaller players in trade exposed commodity product categories are most vulnerable to these margin pressures.

Figure 62: Industry Profitability Distribution (Illustrative)
(2007-2020)



Source: ABS Catalogue Number 8159.0, 2006-07, A.T. Kearney Industry Model

Should food and grocery manufacturers be unable or unwilling to make the scale of investment required to renew their manufacturing assets, the long term prognosis for the industry and Australian jobs is bleak.

3.2.4 Outlook for Research and Development and Implications

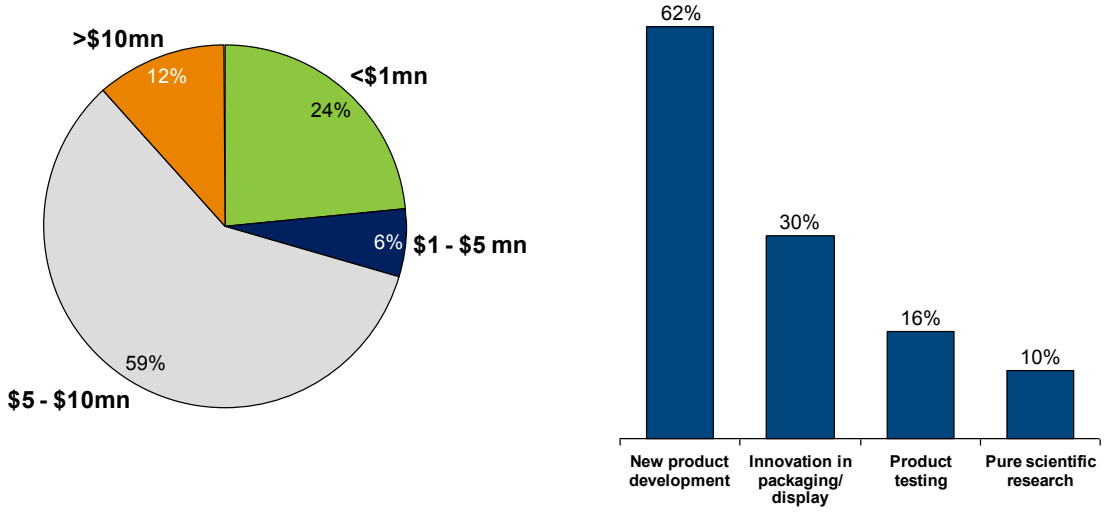
It is highly uncertain whether the industry will be in sufficient financial health to make the investments required to protect its future competitiveness.

Innovation and new product development are critical to maintaining a leading position and brand within a product category. Without these, players are highly exposed to the power of retailers and import competition.

Today, the industry as a whole is under investing in Research and Development (R&D). In 2011, only 12 per cent of surveyed companies invested $10 million or more in R&D, with 30 per cent of companies investing $5 million or less and nearly one quarter of respondents investing less than $1 million.

Respondents cited new product development, at 62 per cent, as the largest use of R&D funds. Only 10 per cent of manufacturers in the survey are spending R&D funds on pure scientific research.

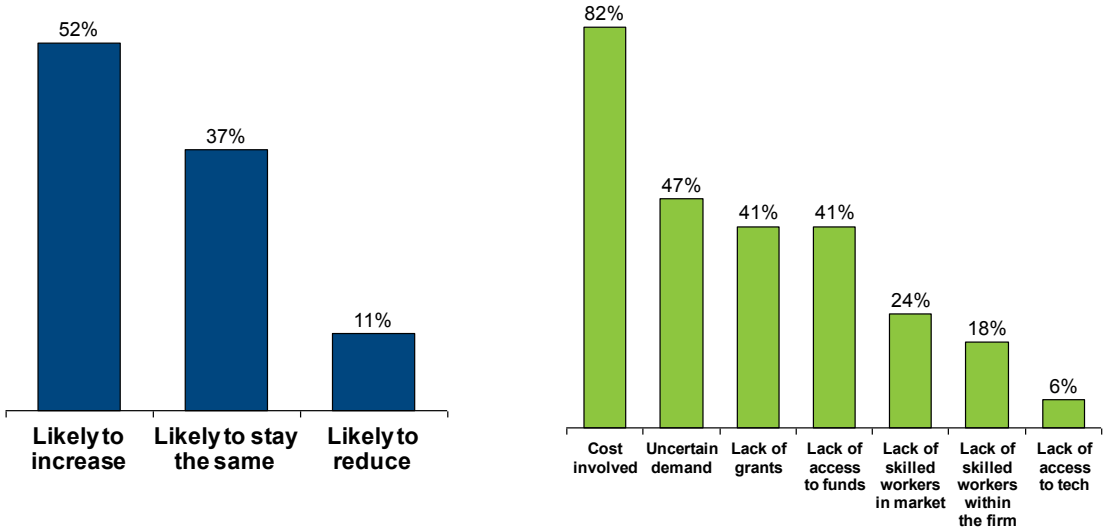
Figure 63: Size of R&D Investment in Australia and Average Distribution of Investments by Type



Source: A.T. Kearney CAPEX and R&D Survey, 2011

Half of all respondents indicated that they plan to increase R&D spending. However, surveyed food and grocery manufacturers have cited a number of barriers to future investment in R&D, of which the ‗cost involved' was the number one barrier with over 80 per cent of respondents citing this as the main barrier to R&D spending in Australia. 40 per cent of companies referenced the lack of favourable grants and access to funds as a barrier to investment and nearly one quarter sited the lack of skilled workers in the employment market.

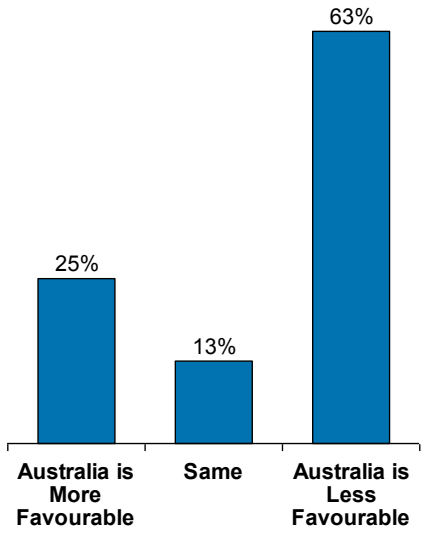
Figure 64: Outlook for R&D and Perceived Barriers to R&D Investment in Australia over Next Five Years



Source: A.T. Kearney CAPEX and R&D Survey, 2011

Additionally, 63 per cent of surveyed food and grocery manufacturers perceive Australia to be less favourable for R&D activities than regional alternatives.

Figure 65: Perceived Favourability of the Australian Environment for Research and Development Spending Compared to Regional Alternatives



Source: A.T. Kearney CAPEX and R&D Survey, 2011

Given the margin pressures on food and grocery manufacturers, it is highly uncertain whether smaller players will have the financial resources to invest in new product development.

Longer term, food manufacturers' negotiating power with the major retailers will deteriorate further if they are unable to invest sufficiently to maintain their brand and new product innovation as a non-price source of value for consumers. It is critical that industry works with Government to address some of the barriers to investment such as R&D grants and access to funding.

3.2.5 Outlook by Product Category and Implications

Within the industry, certain product categories and players are better positioned than others to weather the ongoing challenges facing the industry.

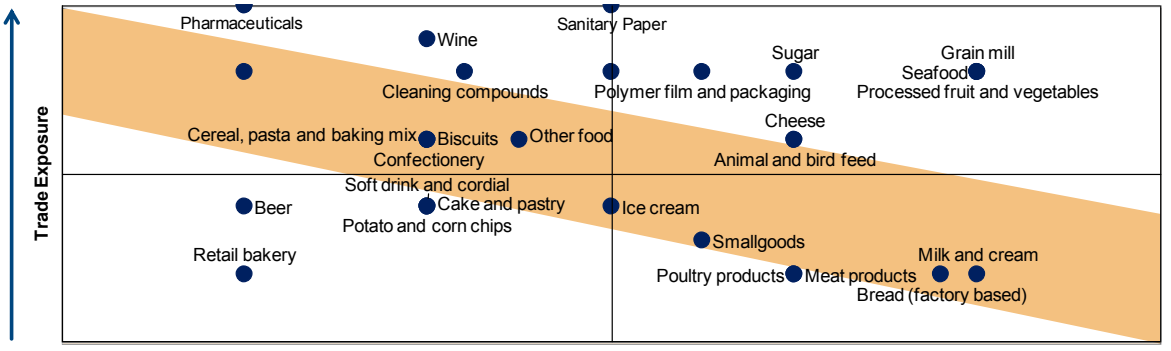
As previously discussed in section 2.3, the product categories and players who are most exposed are those that are both highly trade exposed and exposed to pressures from the retail sector.

Based on these factors, we have characterised the industry along a spectrum of risk:

- *Highly exposed*: processed fruit and vegetable products, seafood processing, animal and bird feed, grain mill products, sanitary paper products, sugar, cleaning and personal care products, wine, and cheese
- *Exposed:* smallgoods, ice cream, bread, milk and cream, cereal, pasta and baking mix, confectionery, and biscuits
- *Less exposed*: beer, soft drink and cordial, meat products, poultry products and leading brands in confectionery, biscuit manufacturing, cake and pastry.

The most highly exposed product categories are most at risk for future offshoring of production and consolidation.

Figure 66: Relative Risk Position of Product Categories and Food and Grocery Manufacturers



Less Exposed	Exposed	Highly Exposed
• Beer	• Smallgoods	• Processed fruit and vegetable
• Potato and corn chips	• Bread (factory based)	• Seafood processing
• Cake and pastry leading brands	• Milk and cream	• Animal and bird feed
• Confectionery, biscuits leading brands	• Cereal, pasta and baking mix	• Grain mill products
• Soft drink and cordial	• Ice Cream	• Polymer film and packaging
• Meat products	• Confectionery	• Other Dairy (Cheese)
• Poultry products	• Biscuits	• Sanitary paper products
		• Cleaning compounds
		• Sugar
		• Wine

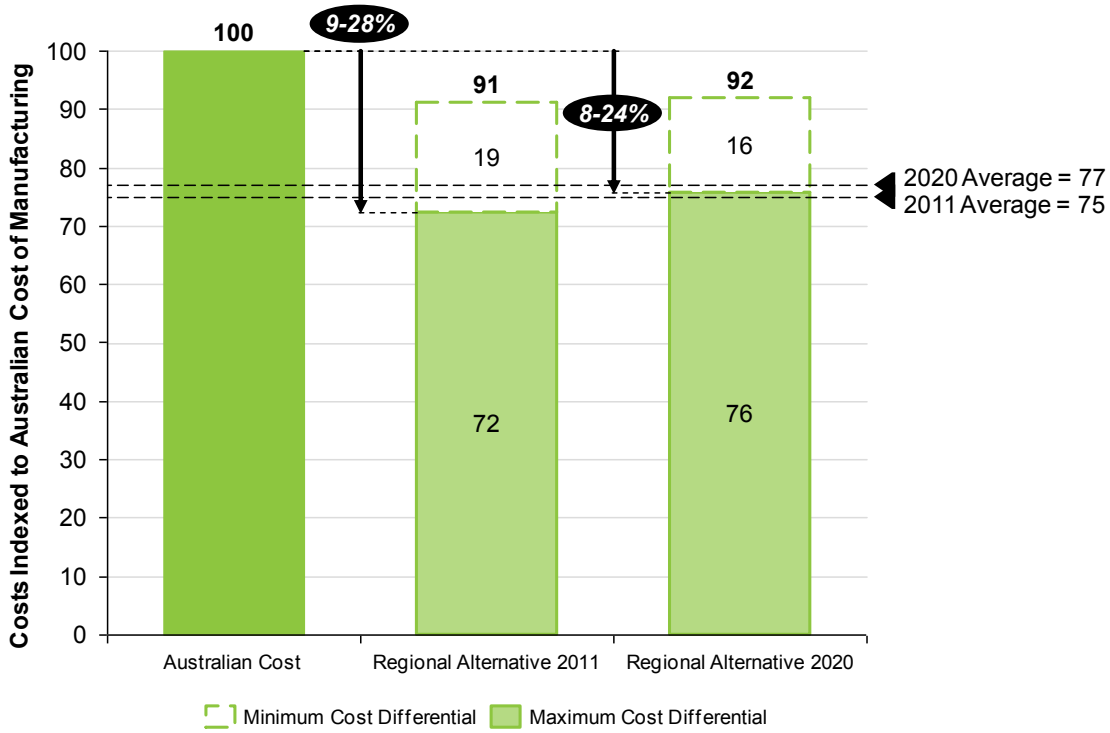
Source: A.T. Kearney Industry Model, Company Interviews

3.2.6 Outlook for Future Cost Position and Implications

For food and grocery manufacturers in highly trade exposed product categories, their future cost position relative to regional competitors is critical. If the landed cost position is significantly lower than the cost structure of manufacturing on shore in Australia, this is likely to lead to substitution to imports and job losses in this particular sub-sector.

A.T. Kearney's analysis of the future cost competitiveness of Australian manufacturers reveals that food and grocery manufacturers will continue to be cost disadvantaged, with an average differential of 23 per cent in the landed cost position in 2020. While a slight improvement in the relative cost position of Australian manufacturers is forecast, mainly due to faster labour cost growth in Asia, Australian manufacturers will nonetheless remain at a significant cost disadvantage to their regional competitors.

Figure 67: Overall Cost Competitiveness of Australian Manufacturing[24]
(2011 and 2020)

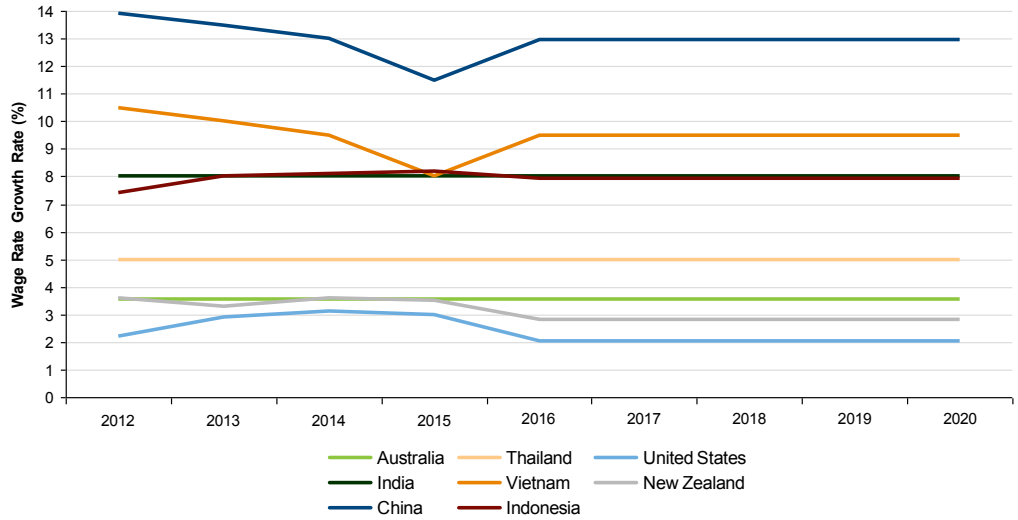


Source: A.T. Kearney Benchmarking Model

[24] Excludes the potato category which was as outlier in the data set

Manufacturing wages in Asian countries are expected to grow at a faster rate than those in Australia, New Zealand and the United States over the next decade. Additionally, Australian manufacturers are expected to continue to link labour cost increases to productivity gains to mitigate this disadvantage.

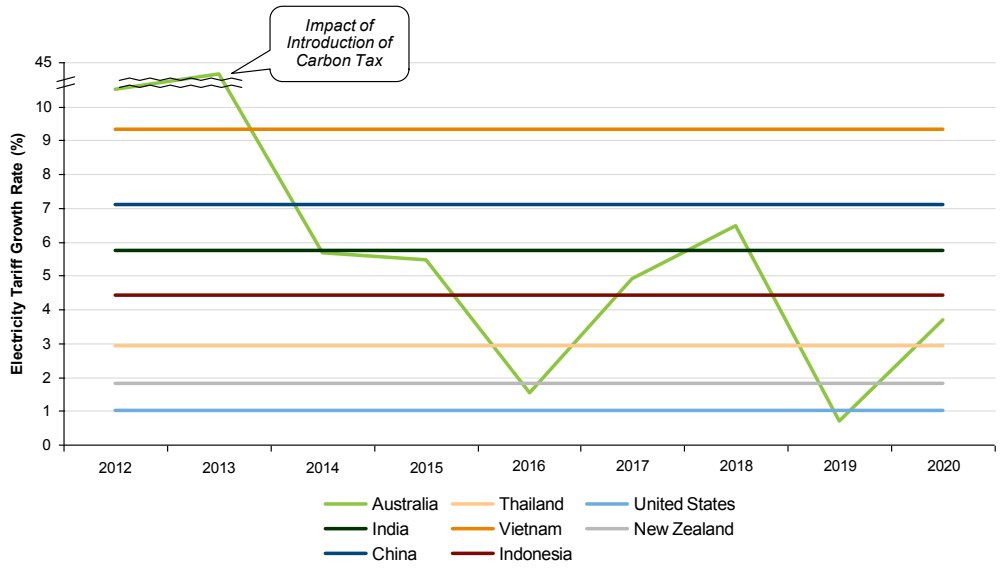
Figure 68: Nominal Manufacturing Wage Rate Growth
(2011-2020)



Source: Economist Intelligence Unit Forecast

This slight improvement in labour costs will however be offset by higher energy price increases in Australia. Energy prices in Australia are expected to grow at a faster rate on average over the period 2012-2020 than in Asian countries. This is partly due to the introduction of the carbon tax in 2012.

Figure 69: Nominal Increase in Electricity Tariff
(2012-2020)

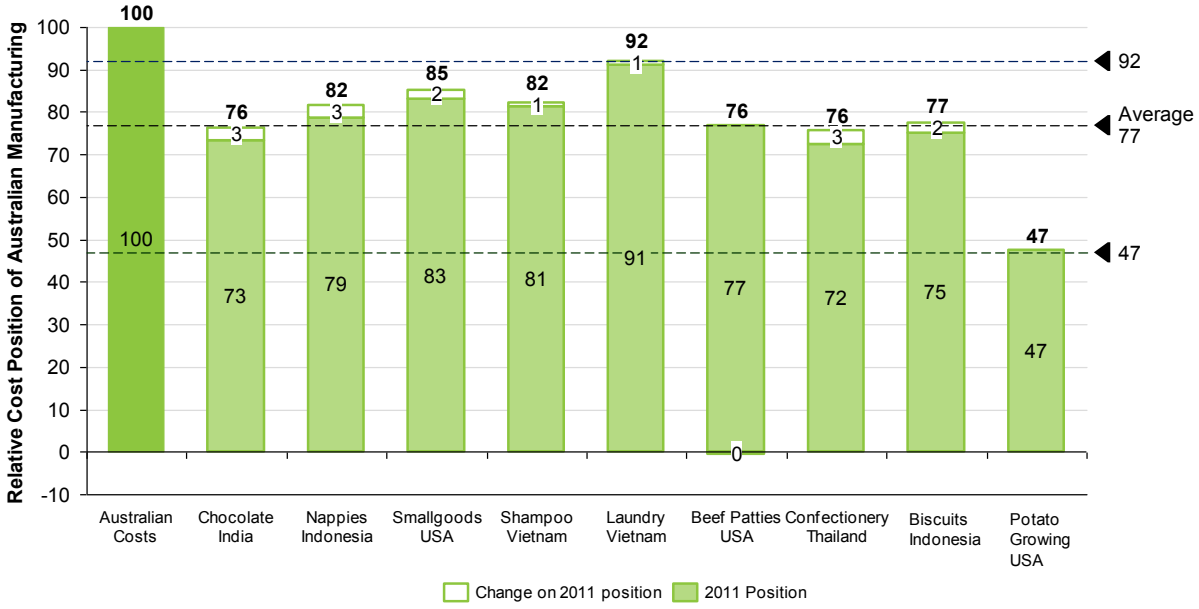


Source: Economist Intelligence Unit Forecast, Australian Treasury Forecasts

Despite these variations in the growth rate of key manufacturing costs, the relative cost position of Australian manufacturing across all food and grocery product categories in 2020 is predicted to change marginally on today's position.

In order to compete effectively in the future there needs to be a change to „business as usual" in the form of significant gains in labour productivity, innovation and more effective negotiation with raw material and packaging suppliers.

Figure 70: Overall Cost Position of Australian Manufacturing compared to Lowest Cost Offshore Alternatives
(2020)



Source: A.T. Kearney Benchmarking Model

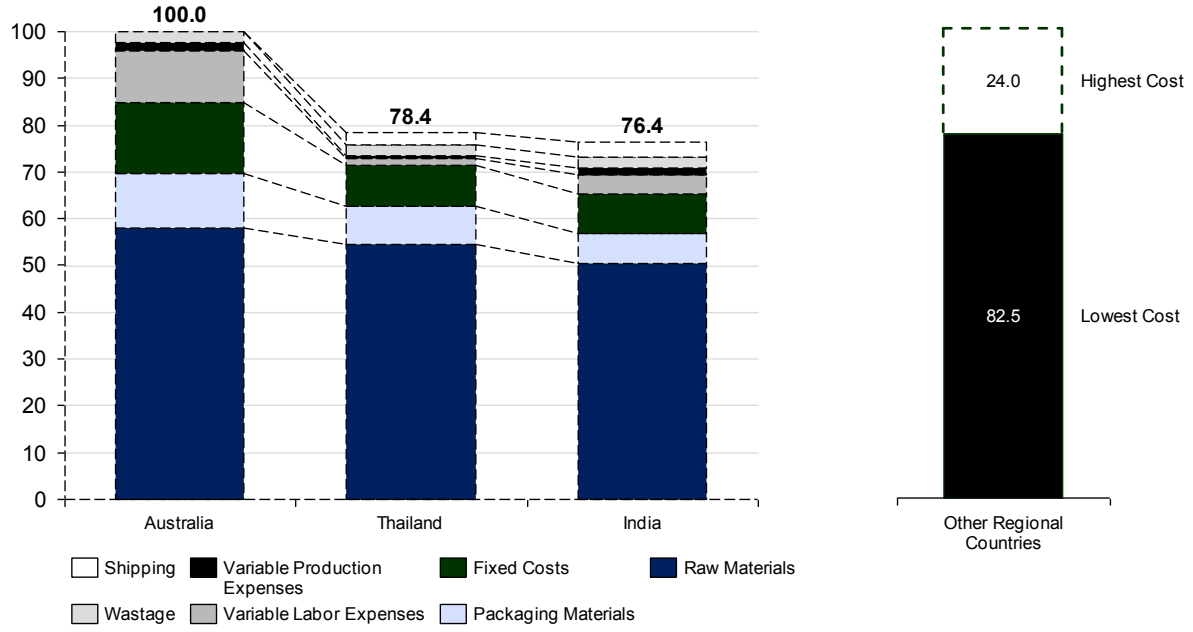
The following section of the report illustrates for selected product categories how the future cost position of Australian manufacturers relative to offshore manufacturers was estimated.

3.2.6.1 Chocolate Manufacturing

In 2020, India is expected to remain the most cost competitive offshore location to manufacture chocolate compared with Australia. The relative cost advantage of India is expected to reduce from 27 percentage points to ~24 percentage points. This will be driven by two key factors:

1. Shipping costs will increase from about 2 per cent of total cost to 3.3 per cent of total cost as a result of increased freight rates. This will occur as a result of ongoing growth in world trade and demand for shipping as well as increases in the cost of fuel.
2. Variable and fixed labour rates in India are expected to grow at a faster rate than in Australia. Additionally, it has been assumed that the comparative productivity in India will remain lower than in Australia. This will have a combined result of shrinking the gap in labour cost differential between the two locations.

Figure 71: Relative Cost Comparisons for Chocolate Manufacturing, Australia and Regional Alternatives
(Indexed to Australian costs, 2020)

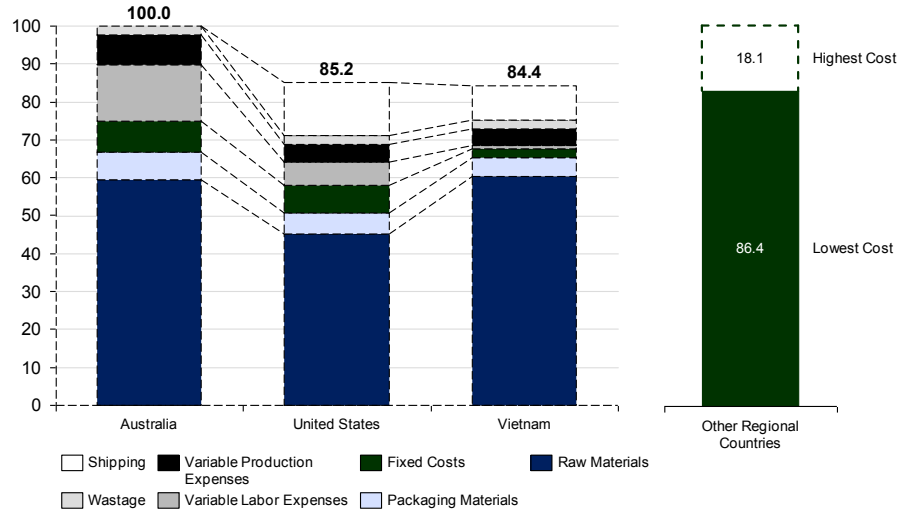


Source: A.T. Kearney Benchmarking Model

3.2.6.2 Smallgoods Manufacturing

In 2020, the United States is expected to remain one of the most cost competitive offshore locations to manufacture smallgoods compared with Australia. The relative cost advantage of the United States is expected to reduce from 17 percentage points to ~15 percentage points. This will be driven by the cost of shipping which is predicted to increase from 8 per cent of total costs to 14 per cent.

Figure 72: Relative Cost Comparisons for Smallgoods Manufacturing, Australia and Regional Alternatives
(Indexed to Australian costs, 2020)

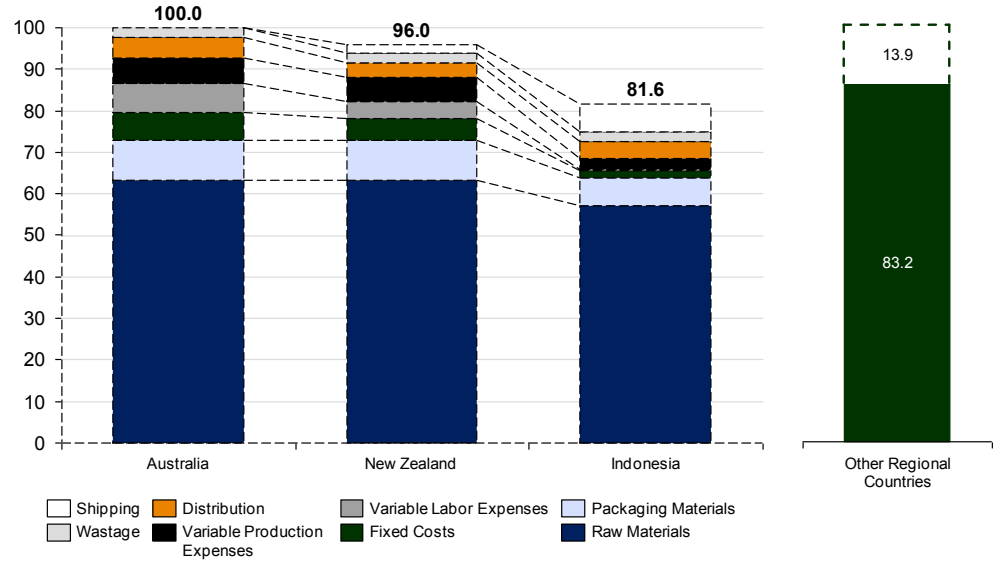


Source: A.T. Kearney Benchmarking Model

3.2.6.3 Nappy Manufacturing

The relative cost position of Australian nappy manufacturing compared to Indonesia is expected to improve by about 3 percentage points under a business as usual scenario. This is driven by an increase in shipping costs as well as an expected decrease in the differential between Indonesian and Australian labour costs.

Figure 73: Relative Cost Comparisons for Nappy Manufacturing, Australia and Regional Alternatives
(Indexed to Australian costs, 2020)

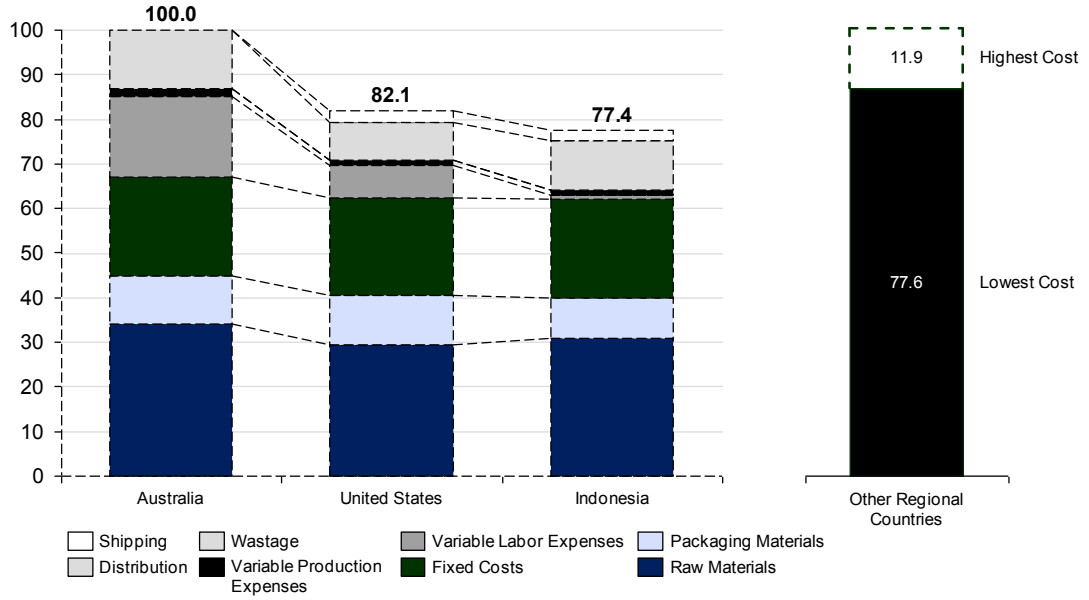


Source: A.T. Kearney Benchmarking Model

3.2.6.4 *Biscuit Manufacturing*

As with the other product families, the cost of manufacturing biscuit manufacturing in Australia relative to the United States and Indonesia is expected to be very similar in 2020 as it is today, changing by only 2 percentage points on the 2011 position.

Figure 74: Relative Cost Comparisons for Biscuit Manufacturing, Australia and Regional Alternatives
(Indexed to Australian Manufacturing costs, 2020)



Source: A.T. Kearney Benchmarking Model

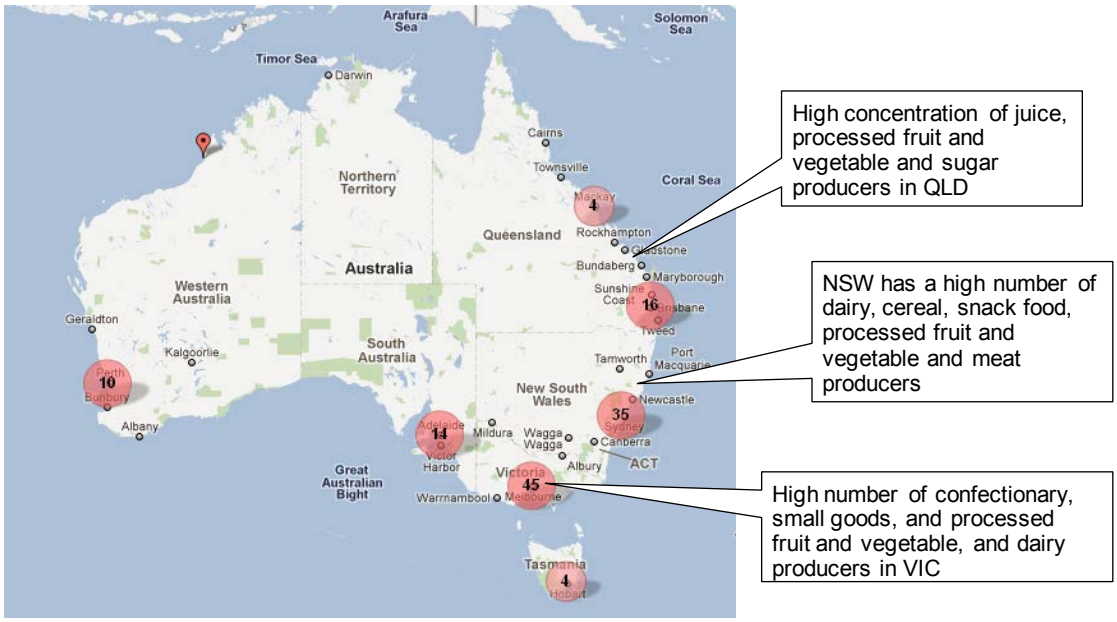
3.2.7 Implications at the Regional Level

The potential loss of industry growth and jobs is most likely to affect food and grocery manufacturers competing in the most exposed categories.

- *Highly exposed*: processed fruit and vegetable products, seafood processing, animal and bird feed, grain mill products, sanitary paper products, sugar, cleaning and personal care products, and cheese and other dairy
- *Exposed:* smallgoods, ice cream, bread, milk and cream, cereal, pasta and baking mix, confectionery, biscuits, and wine
- *Less exposed:* beer, soft drink and cordial, meat products, poultry products, leading brands in confectionery, biscuit manufacturing, wine, cake and pastry.

Today, Australian food and grocery manufacturing sites are distributed across the country with a concentration of sites in Victoria, New South Wales and Queensland, especially in rural and regional areas as is shown in Figure 75 below.

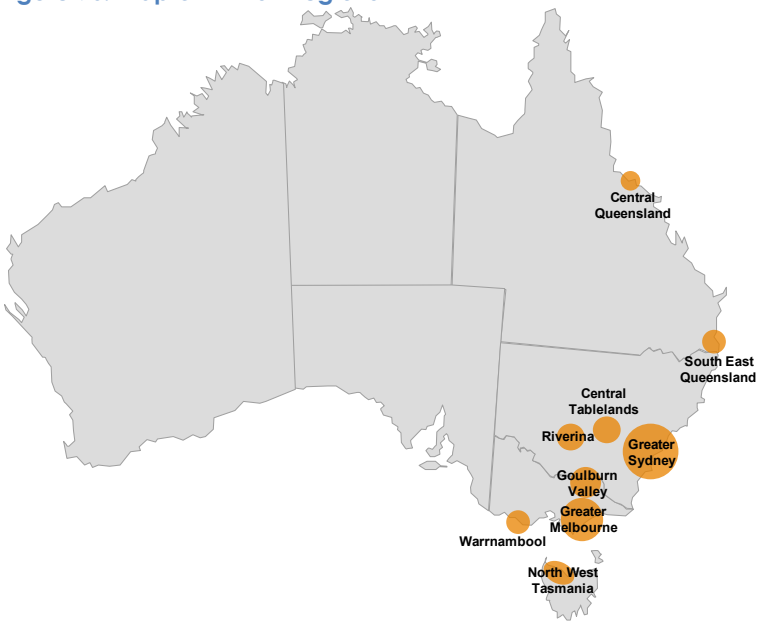
Figure 75: Distribution of Major Australian Food and Grocery Manufacturing Sites (2011)



Source: AFGC

Regions which are manufacturing hubs for highly disadvantaged product categories will be more exposed to job losses due to ongoing consolidation and site rationalisation. These regions are concentrated around South Eastern Australia as shown in Figure 76 below.

Figure 76: Map of At Risk Regions



Source: A.T. Kearney Industry Model

Under a business as usual scenario, with no policy or regulatory reforms, it is predicted that the industry will shrink slightly in size over the next decade. As a result of this drop in total industry turnover and improved labour productivity, the industry is expected to shed around 100,000 to 130,000 jobs across an estimated 480 to 630 manufacturing sites before the end of the decade.

The regions most highly impacted will be those for which food and grocery manufacturing sites form the main source of employment. This is expected to have a major impact on the economies of these towns which rely heavily on food and grocery manufacturing operations.

In addition to the direct impact of job loss, site closures will have an additional economic impact on these regions as a result of loss of demand for upstream agricultural enterprises, and reduced consumption spending in downstream industries.

4 Implications for Dependant Sectors and the Broader Economy

The food and grocery manufacturing industry in Australia is intrinsically linked to the rest of the Australian economy. Some of the key upstream industries whose outputs supply the food and grocery industry are listed in Table 3.

Table 3: Percentage of Industry Supply Used by Food and Grocery Manufacturing Sector[25]
(Select industries)

Percentage of supply to final industry use	
Supply Industry	**Food and Grocery Mfg Industry**
Agriculture	44.7%
Agriculture, forestry and fishing support services	33.2%
Pulp, paper and converted paper product mfg	26.9%
Fishing, hunting and trapping	19.0%
Polymer product and rubber product mfg	16.8%
Aquaculture	15.9%
Road transport	11.6%
Gas supply	7.7%
Wholesale trade	6.2%
Water supply, sewerage and drainage services	5.0%
Water transport	4.9%
Non-metallic mineral mining and quarrying	4.2%
Transport support services	4.1%
Electricity supply	4.1%

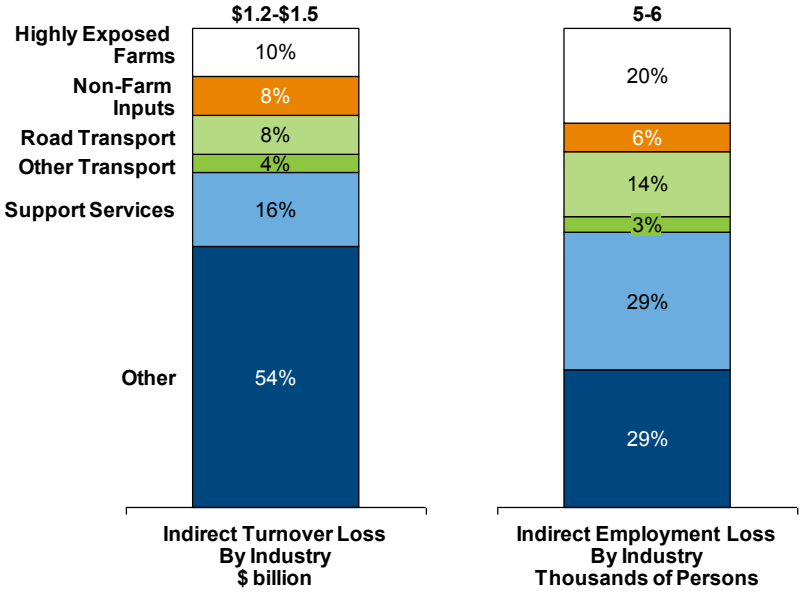
Source: ABS Catalogue Number 5209.0, Input-Output Tables (2006-07)

We estimate that a reduction in real food and grocery industry turnover by 0.2 per cent per annum over the next decade will reduce upstream sector real turnover by between $1.2 and $1.5 billion over the same period.

[25] The percentage of supply of the agriculture sector to final use categories combines the supply distribution of the sheep, grains, beef and dairy cattle industry, poultry and other livestock and other agriculture while removing the fresh component of horticulture which is accounted for as part of the defined industry

This estimate is based on ABS published input/output multipliers for the industry. It assumes that a reduction in size of the food and grocery manufacturing industry will lead to reduced demand for the goods and services of upstream input industries.

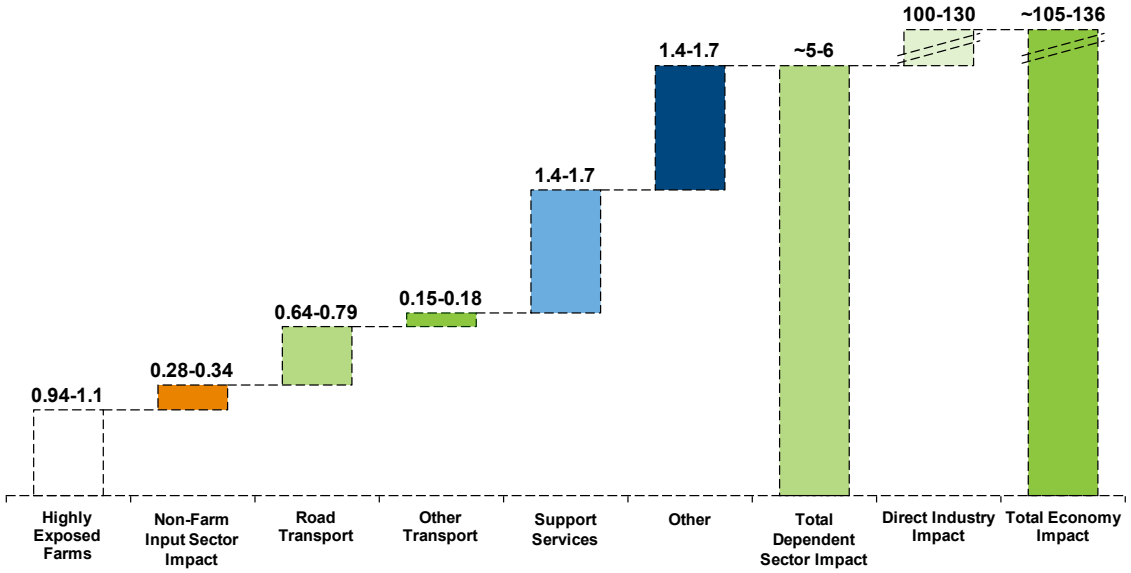
Figure 77: Dependent (Upstream) Industry Impact on Turnover and Employment



Source: ABS Catalogue Number 5209.0, Input-Output Tables (2006-07), A.T. Kearney Industry Model

As a result of the reduced activity in upstream industries, an additional 5,000 to 6,000 indirect job losses are forecast due to a combination of direct loss of demand and consolidation. This brings the estimated total job loss (direct and indirect) as a result of a less competitive food and grocery sectors to between 105,000 to 136,000 by 2020.

Figure 78: Direct and Indirect Impact on Employment as a result of a Weakened Food and Grocery Sector
(Net decline in employment, 2009-2020, thousands of persons)



Source: ABS Catalogue Number 5209.0, Input-Output Tables (2006-07), A.T. Kearney Industry Model

The agriculture industry is expected to be the most highly impacted upstream industry, as it has the greatest dependence on the food and grocery manufacturing sector (see Table 3). The total impact on the agriculture sector is estimated to be between $120 and $150 million by 2020. This estimate has been adjusted to account for those farmers who can substitute lost local demand with increased sales through the export market and those who can redeploy resources to alternative crops. An estimated 940 to 1,100 job losses are forecast in the agriculture sector as a consequence of reduced demand.

4.1 Implications for the Agriculture Sector

A weakened food and grocery manufacturing sector is estimated to reduce agricultural industry turnover by $120 to $150 million which will result in a loss of between 940 to 1,100 jobs by 2020. The overall impact on the agriculture sector is expected to be largely constrained to highly exposed farms. Highly exposed farms are defined as:

- Farms that produce crops with a domestic market focus rather than an export focus
- Farms with a more capital intensive production process
- Farms with permanent plantings (crops that do not need to be replanted after every harvest).

Australia's key agricultural outputs were evaluated against these factors to identify which farm types are most highly exposed.

Table 4: Exposure of Australian Agricultural Commodities[26]

Crop		Export Share of Total Output	Planting Cycle	Capital Intensity
Broadacre	Hay	Low	Temporary	Low
Broadacre	Cereal	High	Temporary	Low
Broadacre	Legumes	High	Temporary	Medium
Broadacre	Oilseeds	Medium	Temporary	Medium
Broadacre	Sugar	High	Temporary	High
Broadacre	Other (incl. Cotton)	High	Temporary	Low
Horticulture	Nursery	Low	Permanent	Low
Horticulture	Vegetables	Low	Temporary	Low
Horticulture	Citrus Fruit	Medium	Permanent	Medium
Horticulture	Tropical Fruit	Medium	Permanent	Medium
Horticulture	Orchard Fruit	Low	Permanent	Medium
Horticulture	Grapes	Medium	Permanent	High
Livestock	Cattle	Medium	N/A	Medium
Livestock	Milk	Medium	N/A	High
Livestock	Eggs	Low	N/A	Low
Livestock	Wool	High	N/A	Low

Source: ABARE Commodity Statistics, ABS Catalogue Number 7503.0, ABS Financial Performance of Farms, FAO Classification of Crops

The most highly-exposed farms are therefore those that produce grapes, fruit – particularly orchard fruit, fruit bearing vegetables such as tomatoes, and fresh dairy commodities. Conversely, broadacre crops and livestock farmers are expected to be less impacted in the long run.

We anticipate three types of flow on impacts on the agriculture sector as a result of a weaker, more consolidated food and grocery manufacturing sector.

[26] Milk refers to overall milk products including milk powder, cheese etc. and hence the export share of total output is medium. However, if only fresh milk were to be considered, this would be rated as low export exposure. Similarly, wine grapes have a greater export exposure, and elevate the overall trade exposure for this crop.

Direct Loss in Demand

Direct loss in demand from a diminished food and grocery manufacturing sector is expected to have a short-term impact on all agricultural commodity farmers.

Crops that predominantly serve the domestic market, have permanent plantings, or are based in climatically challenging areas will be most impacted in the medium term.

The re-adjustment period within which farmers re-plant crops will be longest for crops with more permanent plantings such as citrus, grapes and tomatoes. Some farms may be constrained in which alternative crops they can feasibly produce. On the other hand, farmers with crops that have a high export focus and those with temporary planting crops are likely to recover lost demand either through increased sales to the export market or by switching to an alternative crop.

In the long term, loss in demand is not expected to have a significant impact on the agricultural sector. The growing world demand for food is not expected to ease within the next decade and as a result arable land will continue to be farmed for agriculture. The weakened food and grocery sector may force farmers to use land for alternative uses however it is unlikely that in the long run arable land will remain unfarmed.

Switching Cost for Crops

Switching cost is expected to be a significant impost on farmers with permanent plantings and those with capital intensive farming processes such as horticulture.

The switching cost associated with re-planting arable land includes the sunk cost of stranded capital assets, the capital investment needed to set up a new plantation and the opportunity cost associated with the time lag between re-planting and the first yield of the new crop. This cost and the time lag between re-planting and the first yield is highly dependent on the type of crop.

Increased Exposure to Export and Retailer Markets

All agricultural enterprises are expected to become further exposed to the volatility of the export market and to the consolidated fresh produce retail market as a result of diminished demand from food and grocery manufacturers, it is anticipated that this will have a flow on impact on overall profitability of the farming sector in Australia.

4.2 Implications for Non-Agriculture Sectors

Impact on Non-Farm Raw Material Suppliers

As illustrated in Figure 77 and Figure 78, real demand for non-farm raw material suppliers such as manufacturers of paper pulp, polymer products and packaging is estimated to decline by between $100 and 120 million by 2020. As a result, an estimated 280 to 340 additional indirect job losses are forecast.

Impact on Transport and Logistics Services

Similarly, real demand for road transport is expected to decline by between $100 and $120 million while the demand for other forms of transport and warehousing services is estimated to decline by between $40 and $60 million as a result of a weakened food and grocery sector. This will have a combined impact of 790 to 970 jobs lost in the transport and logistics industry.

Impact on Support Services

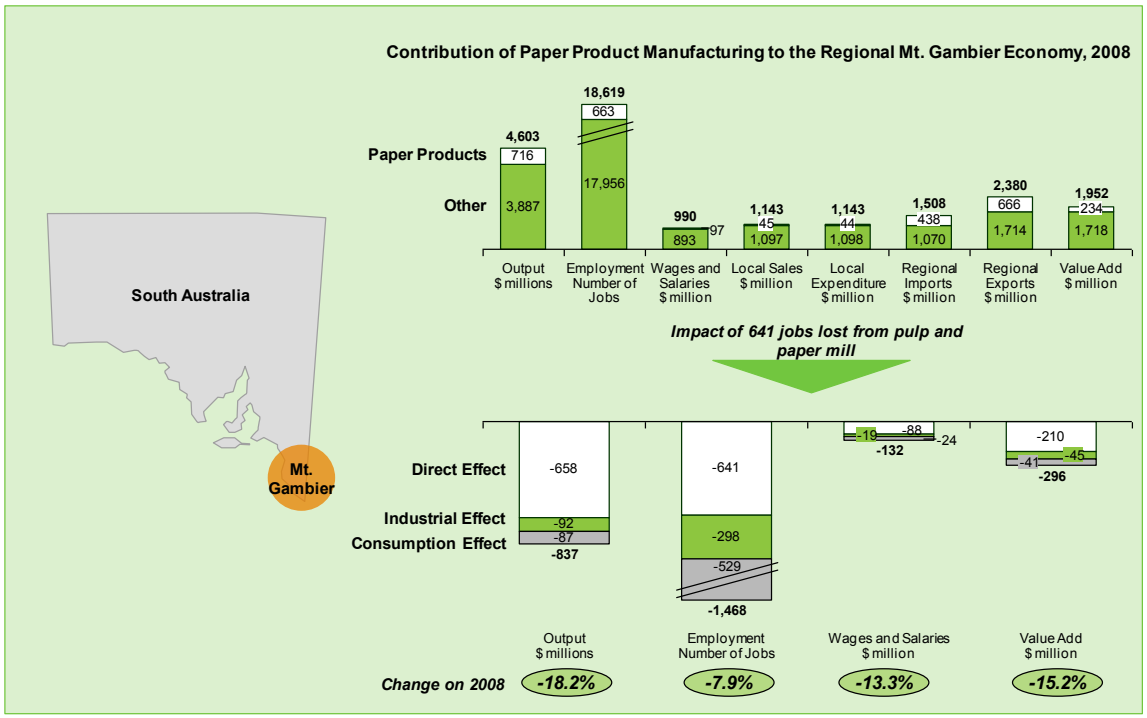
Support services including electricity supply, agriculture, forestry and fisheries support services, professional, scientific and technical services are expected to see a combined decline of between $190 and 230 million in total real demand by 2020 which will result in additional 1,400 to 1,700 job losses from the Australian economy.

4.3 Flow on Implications for Regional Towns

Potentially one of the most significant impacts of a less competitive food and grocery manufacturing industry is the flow on impact on regional community infrastructure as a result of population displacement. If a food or grocery manufacturing site that is the major source of employment for a regional town shuts down, the population of site workers will re-distribute according to where alternative manufacturing employment exists. This will reduce the amount of income flowing through the regional economy, which will have a direct impact on local businesses, schools, health care facilities and other infrastructure.

The magnitude of this consumption impact is illustrated in the case study on the impact that would flow from a complete pulp and tissue mill closure in Millicent, near Mount Gambier in South Australia's south east in Figure 79 below.

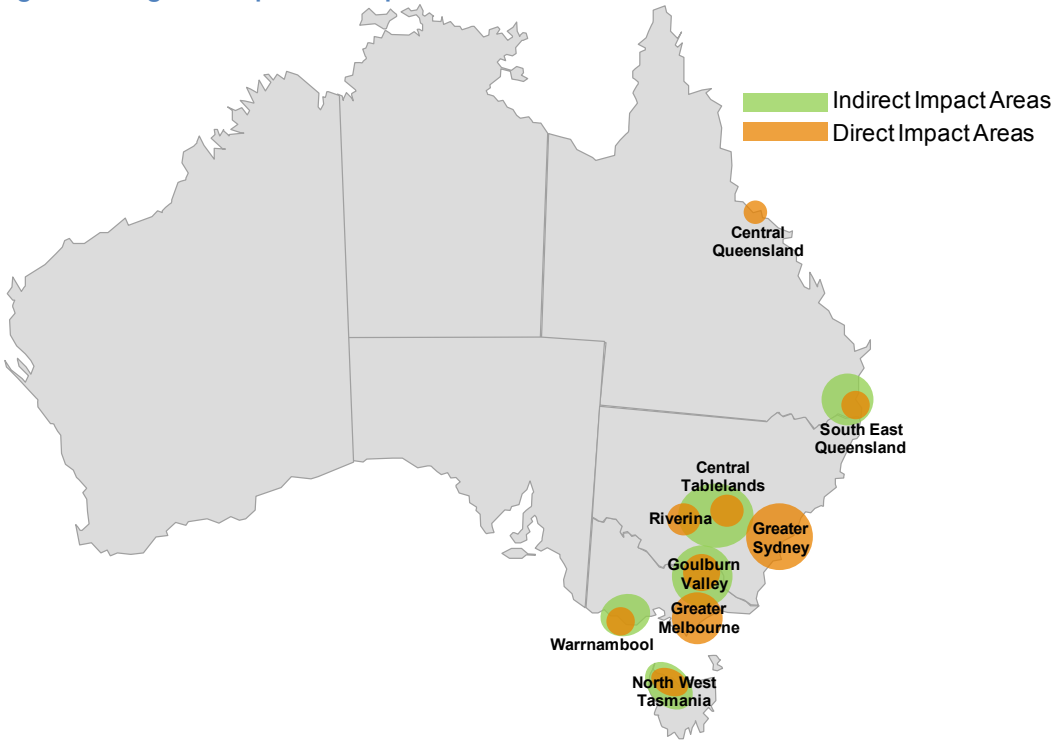
Figure 79: Case Study on Paper Mill Closure



Source: Economic Data Report: Kimberly-Clark Australia's Pulp and Paper Mill, Compelling Economics, 2008

The regions which are most likely to be impacted by a weakened food and grocery manufacturing sector are those in the regions identified in Figure 80.

Figure 80: Regional Impact on Dependent and Direct Industries



These regions are located with the high risk food and grocery manufacturing locations identified in Section 3.2.7.

The product categories that were identified to be the most highly exposed to retailer and trade pressures are processed fruit and vegetable products, seafood processing, animal and bird feed, grain mill products, sanitary paper products, sugar, cleaning and personal care products, wine, and cheese manufacturing. The raw material inputs to these sectors that are also highly exposed agriculture commodities are fruit and vegetable crops, fresh milk and dairy commodities, and fibre and polymer based non-farm inputs (see Table 5).

These are the farms that are most highly at risk due to a reduced ability to pick up lost demand through the export markets, high switching cost associated with re-planting to alternative crops and the capital intensity of production.

The processing facilities for these raw material inputs are often co-located to the farm. This is because these commodities do not lend themselves to being transported far due to their fragility, the low value cost per unit of volume and uneconomical freight, and their relatively low shelf-life compared to non-perishable crops such as wheat or sugar.

Table 5: Highly Exposed Agricultural Inputs

Highly Exposed Product Category	Main Agricultural Raw Materials	Export Share of Turnover	Planting Cycle	Capital Intensity
Fruit and Vegetable Processing	Fruit and Vegetables	Low	Permanent	Medium
Seafood Processing	Seafood	Medium	N/A	Medium
Animal and Bird Feed	Meat products, vegetables, fruits	Low-Medium	Temporary	Medium
Grain Mill Product	Cereals	High	Temporary	Low
Polymer Film and Packaging	Non-Farm Inputs	N/A	N/A	High
Cheese	Milk, Milk Fat	Low-Medium	N/A	High
Sanitary Paper Products	Non-Farm Inputs	Low	N/A	High
Cleaning Compounds	Non-Farm Inputs	N/A	N/A	High
Wine	Grapes	Medium	Permanent	High
Sugar	Sugar	High	Temporary	High

In summary, the turnover and employment implications of a weakened food and grocery sector are expected to extend beyond the direct industry into upstream (dependent) sectors and the broader Australian economy.

Of the dependent sectors, the agriculture sector is estimated to be the most highly impacted. Within the agriculture sector, many farms will face a short term impact from diminished demand from food and grocery manufacturers.

Farmers with crops that have a strong export focus and temporary plantings are likely to be able to respond more rapidly to lost manufacturing demand by either substituting to the export markets or switching to another crop. Therefore, these farmers are unlikely to face a long term impact as a result of a weakened food and grocery sector.

On the other hand, farmers with crops that primarily serve the local market and have a permanent planting cycle are more likely to face longer term turnover and job loss. Much of this job loss is likely to come from regions within ‗at risk' sites such as North East Victoria, North East Tasmania, Warrnambool, and Central New South Wales.

Beyond dependent sectors, a weakened food and grocery sector has broader implications for the Australian economy. A decline in food and grocery turnover by between $2.1 and $2.5 billion is estimated to result in a reduction of between $3.3 and $4.0 billion in total economy wide turnover (direct and indirect) which is equivalent to between 0.25 per cent and 0.30 per cent of current GDP[27].

[27] Reserve Bank of Australia, GDP Statistics

5 Conclusions

Under a ‗business as usual' scenario, the key pressures and challenges battering the Australian food and grocery manufacturing industry are expected to continue unabated over the coming decade. If nothing changes, the industry is expected to be significantly less competitive in 2020 than it is today as a lack of real growth translates into job losses and an inability to reinvest in capital and innovation. This will be particularly so for those parts of the industry that are most trade exposed, are subject to high levels of retailer pressure and are already of marginal profitability.

The Challenge

Over the coming decade, real industry manufacturing turnover is forecast to decline by 0.2 per cent per annum despite a growth in retail demand of 3.7 per cent per annum over that same period. This gap in growth between locally manufactured supply and retail demand is expected to be increasingly filled by imports, retailers' private label products and parallel importing.

As a consequence, the industry will need to shed an estimated 100,000 to 130,000 jobs through a combination of productivity gains and direct job losses to ‗right size' the industry. Towns in regional New South Wales, Victoria and Queensland are expected to be most impacted by any employment loss, as these towns act as manufacturing hubs for the most highly exposed product categories.

A less competitive food and grocery manufacturing industry will also have a flow on impact to upstream dependant industries. The estimated upstream loss of employment arising from the reduction within the food and grocery manufacturing industry will be a further 5,000 to 6,000 job losses by 2020. The most significant upstream impact is expected to be on highly exposed parts of the agriculture industry (domestic focused, with long planting cycles and high switching costs), where an estimated 940 to 1,100 job losses are forecast.

The Dilemma

Given the challenges facing the industry and the implications for growth and profitability, it is highly uncertain whether the industry as a whole has the ‗appetite' to make the scale of investment required in capital and innovation to ensure its future competitiveness

While it is reasonable to assume that large national and multi-national food and grocery manufacturers will make ongoing incremental investment to improve productivity and cut costs, it is unclear whether they will be prepared to make the large scale investment required to eventually renew and upgrade manufacturing plants. As these manufacturers evaluate their options, it is highly likely that some will determine that offshore locations are a more attractive investment option than Australia.

For small to mid-size national players, it is unclear whether many will have the balance sheet strength required to undertake major capital investment. Even for those smaller national players with sufficient balance sheet strength, it is highly unlikely given the industry's fundamentals, that the Return on Investment would be sufficient to justify investment.

Similarly, it is highly uncertain if the industry will be in sufficient financial health to make the level of investment in innovation required to ensure its future competitiveness. A large majority (88 per cent) of surveyed companies currently invest less than $10 million in R&D and over 80 per cent cite cost as the major barrier to investment. Without major investment in new product development and testing it will be increasingly difficult for major food manufacturers to maintain their value proposition and connection with the consumer. If food and grocery manufacturers' relevance to the consumer is weakened, they face the increasing risk of being bypassed by the major retailers as they pursue their private label strategies. Looking forward, major retailers are expected to increasingly import private label products where shelf life and AQIS restrictions allow.

Should this investment scenario eventuate, Australia would become much bigger net importer of food and grocery items than it is today. This has significant longer term implications for Australia's food security and safety since many of these lower cost food manufacturing countries in Asia are not subject to the same levels of regulation and scrutiny as their Australian equivalents.

The Path Forward

"I do genuinely believe that we can be a country that continues to invent things and make things." ***– Prime Minister Julia Gillard, October 6, 2011.***

"A strong food processing industry is critical to our economy, our environment, and our way of life!" ***– Federal Industry Minister Senator Kim Carr, October 27, 2010.***

Australians and our political leaders overwhelmingly want a local, value-adding food and grocery manufacturing sector – it's an industry Australia can't live without.

Consumers must be confident about the quality and safety of manufactured food and grocery products, be able to buy food and grocery brands they know and trust, all underpinned by Australia's world-class regulatory system.

As the nation's largest manufacturing sector, employing more than 312,000 Australians, the food and grocery sector is also a major driving force for the nation's economy.

Government and industry therefore have a fundamental responsibility to deliver safe, nutritious, clean, affordable and sustainable Australian-made food and grocery products produced by a thriving local manufacturing sector over the coming decade and beyond.

To achieve these long-term goals, there needs to be an urgent "U-turn" in strategic policy direction and a greater national policy focus to allow the industry to continue to grow and create jobs. Australia needs a proactive, whole-of-government strategy, supported by industry that will ensure long-term sustainability, protect the health of Australians and ensure future growth and local jobs. Adopting a "do-nothing" approach on this issue of national importance is not an option.

A Vision for Reform

Food production, manufacturing and distribution systems must be safeguarded with robust future planning. Industry is encouraged by the Federal Government's commitment to forge ahead with the National Food Plan and Food Processing Industry Strategy to ensure the long-term growth of this essential and complex $108 billion manufacturing sector which is under immense pressure to remain competitive.

But to be successful, these strategies must deliver:

- A thriving and profitable food and grocery industry to provide a wide range of safe, nutritious, sustainable, clean and affordable products for Australia and the world.

- Increased farm production to feed Australia's forecast population of 36 million people by 2050. With the world's population forecast to reach 9 billion by 2050, Australia has an obligation and opportunity to feed ourselves and contribute to the world's food supply and feed up to 100 million people across the region. To meet these targets, Australia must calculate and identify the amount of quality land and water needed for agricultural production and put in place policies to ensure its availability.

- A consistent, national, transparent regulatory framework with better infrastructure and consistent rules and regulations. The system must recognise the importance of efficient

movement of fast-moving consumer goods around Australia in contributing to productivity growth.

- Coordination and alignment of Government policies relevant to food and grocery manufacturing across all portfolios.
- A level playing field in the highly-concentrated retailing environment where trusted food and grocery brands can compete equitably and fairly on supermarket shelves and have reasonable access to market.
- An environment conducive to Research and Development leading to product innovation, reformulation and improved branded products. This will also lead to increased production and jobs across the entire food and grocery manufacturing and agrifood sector.
- A business environment where Australian products can be competitive with imports and in the export market.
- A strong commitment from governments to the principles of good regulatory practice as an indispensable, fundamental policy to which all government departments and related agencies adhere.
- An environmentally sustainable food chain – with a focus on better packaging, efficient use of water, minimising food waste and energy/carbon footprints.

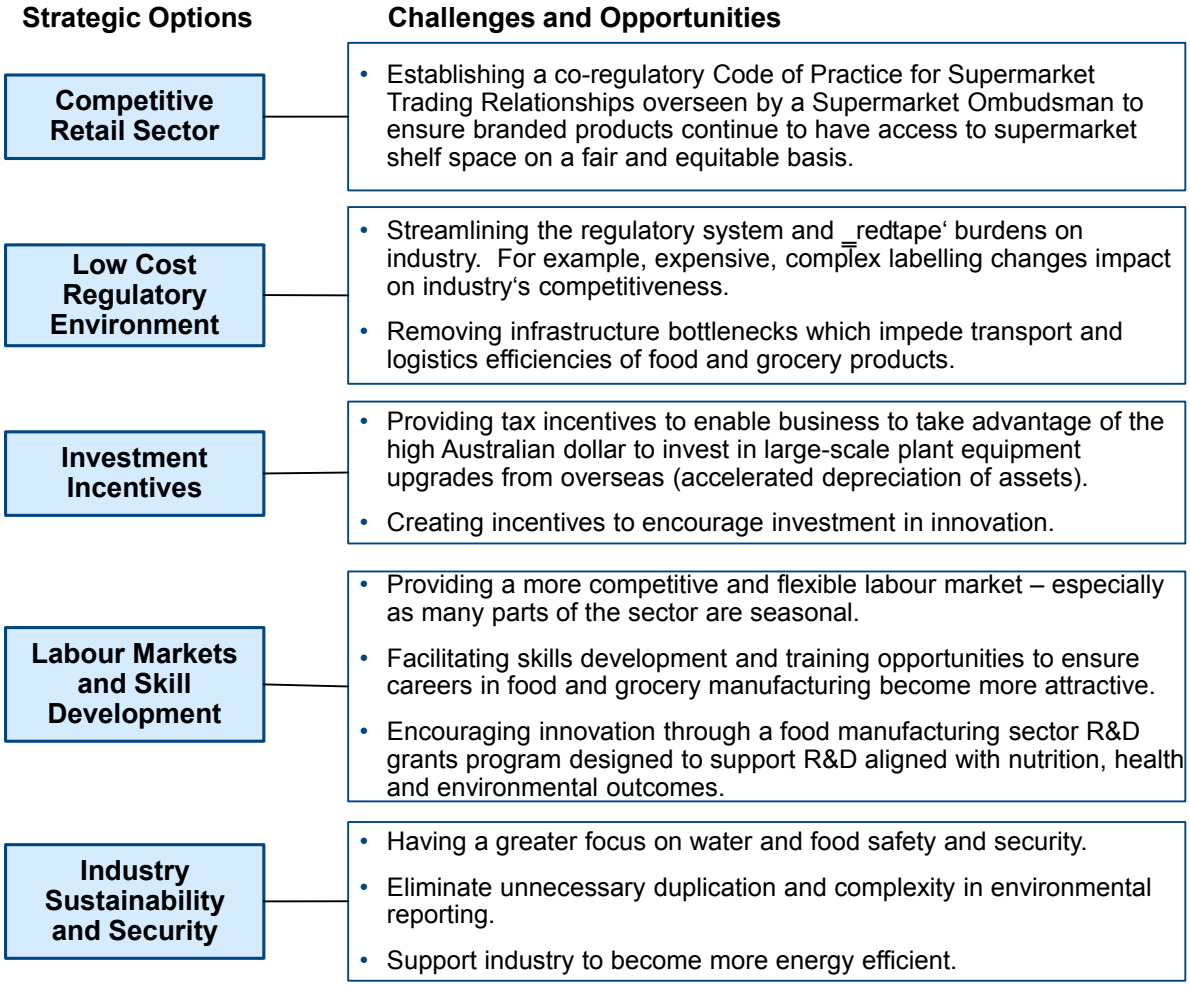
From a policy perspective, industry can no longer be treated in a haphazard – if not hazardous – fashion. The National Food Plan and the Food Processing Industry Strategy are a good first step but they must be developed in concert with each other and relevant State and Territory initiatives to provide coordination of the policy settings.

National Strategic Options

To start this important reform process, it's fundamental for Government, industry and the wider agrifood sector to work closely to develop and implement a range of workable solutions.

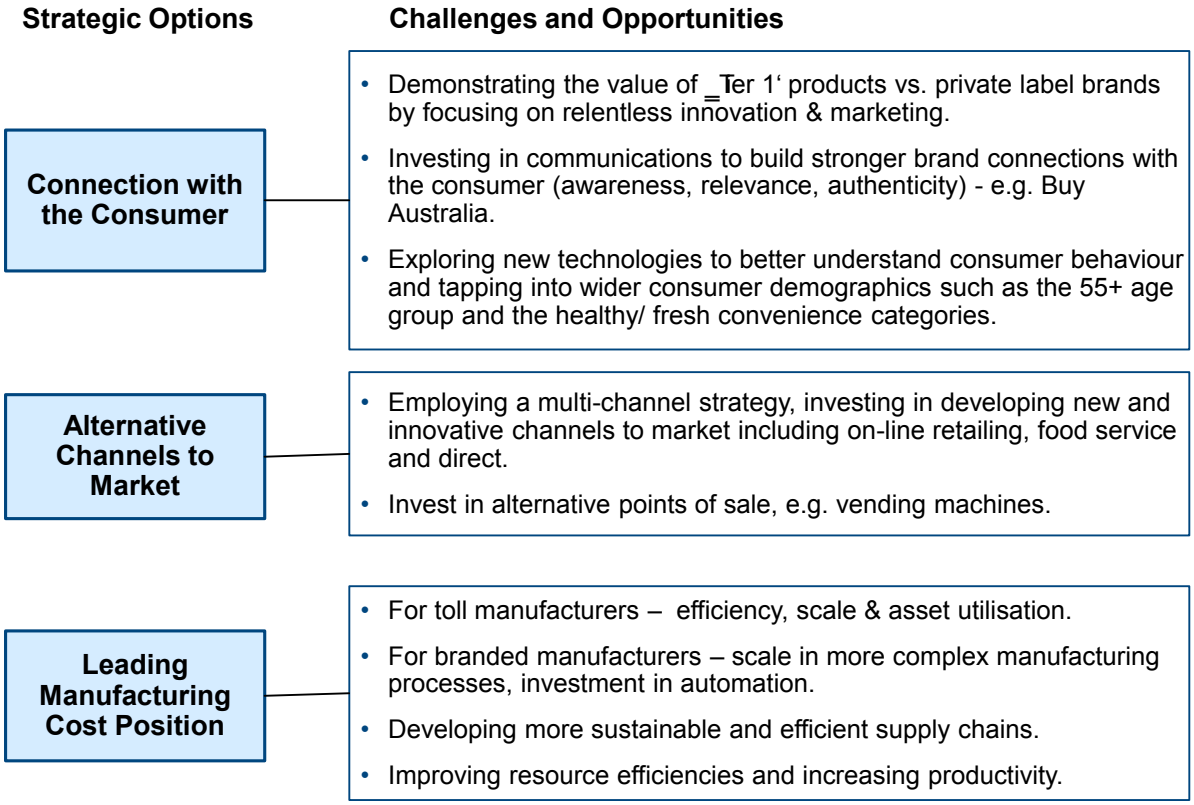
The strategic options Government *must* explore are outlined in Figure 81.

Figure 81: Strategic Options for Government



The strategic options industry *must* consider are outlined in Figure 82.

Figure 82: Strategic Options for Industry



If these reforms are fully embraced and industry has the capacity to grow and innovate, it will stimulate widespread job growth across Australia, especially in regional areas.

Industry will be strongly positioned to pick up the slack created when jobs in Australia's booming mining and minerals industry start to wane over the coming decades.

However, if these food and grocery manufacturing reforms are not forthcoming, the forecast as outlined in this report for local jobs – and key regional centres with manufacturing hubs – is diabolic, with an estimated 100,00 to 130,000 jobs set to be shed by 2020.

A 'Golden Opportunity' for Leadership

There is a golden opportunity for Government to demonstrate bold leadership on this major issue which matters to every Australian and has global significance.

By introducing a responsive policy and regulatory framework safeguarding industry's long-term future and growth, increasing its export capacity and competitiveness, boosting job opportunities and skills development, creating a level playing field in the concentrated retail environment and guaranteeing access to Australian-made safe, affordable, sustainable food and groceries will provide benefits for all Australians.

A "do-nothing" approach in this area is no longer acceptable – the time for a new policy menu to encourage investment, innovation and growth is now as the jobs and livelihoods of 312,000 Australians, and the future of our food supply, depends on it.

6 Appendix

A Glossary of Terms

Acronym / Term	Definition
ACCC	Australian Competition and Consumer Commission
AQIS	Australian Quarantine and Inspection Service
CAPEX	Capital Expenditure
EBITDAR	Earnings Before Interest Tax Depreciation Amortisation and Rent
EITE	Emissions Intensive Trade Exposed
GFC	Global Financial Crisis
R&D	Research and Development
Turnover	Turnover includes: sales of goods, income from services, rent, leasing and hiring assets.
VWAP	Volume Weighted Average Price

B Detailed Industry Definition

The sectors and sub-sectors included in the definition of the Australian food and beverage, grocery and fresh produce processing sector are listed in the following table.

Table 6: Food and Beverage, Grocery and Fresh Produce Processing Sector

ANZSIC Code	Sector Description	ANZSIC Code	Sub-sector Description
Fresh produce			
732	Packaging Services	7320	Packaging Services
012	Mushroom and Vegetable Growing	0121	Mushroom Growing
		0122	Vegetable Growing (under covers)
		0123	Vegetable Growing (outdoors)
013	Fruit and Tree Nut Growing	0131	Grape Growing
		0132	Kiwifruit Growing
		0133	Berry Fruit Growing
		0134	Apple and Pear Growing
		0135	Stone Fruit Growing
		0136	Citrus Fruit Growing
		0137	Olive Growing
		0139	Other Fruit and Nut Growing
017	Poultry Farming	0172	Poultry Farming (Eggs)
Food and beverage			
111	Meat and Meat Product Manufacturing	1111	Meat processing
		1112	Poultry processing
		1113	Cured meat and small goods mfg
112	Seafood Processing	1120	Seafood processing
113	Dairy Product Manufacturing	1131	Milk and cream processing
		1132	Ice cream mfg
		1133	Cheese and other dairy product mfg
114	Fruit and Vegetable Processing	1140	Fruit and vegetable processing
115	Oil and Fat Manufacturing	1150	Oil and fat mfg
116	Grain Mill and Cereal Product Manufacturing	1161	Grain mill product mfg
		1162	Cereal, pasta and baking mix mfg
117	Bakery Product Manufacturing	1171	Bread mfg (factory based)
		1172	Cake and pastry mfg (factory based)
		1173	Biscuit mfg (factory based)
		1174	Bakery product mfg (non-factory based)
118	Sugar and Confectionery Manufacturing	1181	Sugar mfg
		1182	Confectionery mfg
119	Other Food Product Manufacturing	1191	Potato, corn and other crisp mfg
		1192	Prepared animal and bird feed mfg
		1199	Other food product mfg n.e.c.
121	Beverage Manufacturing	1211	Soft drink, cordial and syrup mfg
		1212	Beer mfg
		1213	Spirit mfg
		1214	Wine and other alcoholic beverage mfg

ANZSIC Code	Sector Description	ANZSIC Code	Sub-sector Description
Grocery			
152	Converted Paper Product Manufacturing	1524	Sanitary paper product mfg
184	Pharmaceutical and Medicinal Product Manufacturing	1841	Human pharmaceutical and medicinal product mfg
185	Cleaning Compound and Toiletry Preparation Manufacturing	1851	Cleaning compound mfg
		1852	Cosmetic and toiletry preparation mfg
191	Polymer Product Manufacturing	1911	Polymer film and sheet packaging material mfg

Source: AFGC

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