



## **COMPETITION AND REGULATION: COMPETITION, BARRIERS TO ENTRY AND INCLUSIVE GROWTH: CASE STUDY ON FRUIT AND VEG CITY**

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### **Abstract**

Located within a broader project on barriers to entry undertaken for National Treasury, this case study explores the typical challenges faced by new entrants in the supermarket industry in South Africa. It draws insights from the experiences of Fruit and Veg City Ltd. and Choppies Enterprises Ltd., successful entrants in the South African supermarket industry.

Vibrant competition in the supermarket industry not only benefits consumers across all income groups, but also has a significant impact on farmers, producers and manufacturers that supply supermarkets, given that supermarkets are often a key source of demand and route to market. Supermarkets can therefore contribute to poverty alleviation and inclusive growth objectives, making it a particularly important sector in South Africa. The formal South African supermarket industry however remains concentrated, with large supermarket chains - Shoprite, Pick n Pay, SPAR and Woolworths - dominating particularly in grocery retail. Nevertheless, Fruit and Veg City, a relatively new entrant, has managed to make substantial inroads into the industry. Further, reversing the trend of South African supermarket chains expanding into the southern African region, Botswana-owned supermarket chain Choppies has recently entered South Africa and has grown significantly with a focus on low-income consumers.

This case study highlights both the typical structural and strategic barriers to entry, including potential anti-competitive conduct by incumbent supermarkets, faced by new entrants in the supermarket industry in South Africa. In-depth understanding of the nature and extent of barriers to entry is important for policy makers to support the development of new players in order to generate more inclusive and shared growth outcomes in this sector.

## JEL classification

L1, L2, L5, O2

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## EXECUTIVE SUMMARY

The case study on the experiences of Fruit and Veg City Ltd. (FVC), a successful entrant into the grocery retail market in South Africa, is located within a broader project undertaken by the Centre for Competition, Regulation and Economic Development (CCRED) for National Treasury concerning entry barriers found in the different sectors of the South African economy. The overall project's primary objective is to identify, through firm-specific case studies and sectoral studies, the typical barriers to entry faced by new entrants into the different sectors and the impact that this may have on inclusive growth.

Using the experience of new entrants, this case study explores the typical challenges faced in entering the supermarket industry in South Africa. It evaluates the potential anticompetitive behaviour and strategies of incumbents towards entry; the growth and evolution of FVC; as well as the emerging trends in the operations of independent grocery retailers that appear to overcome certain key barriers they face.

Vibrant competition in this sector not only benefits consumers (across all income groups), but also has a significant impact on farmers, producers and manufacturers that supply supermarkets, given that supermarkets are often a key source of demand and route to market. The growth of supermarkets can therefore contribute to poverty alleviation and inclusive growth objectives, making it an important sector in South Africa. The formal South African supermarket industry however remains concentrated, with large supermarket chains - Shoprite, Pick n Pay, SPAR and Woolworths - dominating grocery retail markets. Nonetheless, FVC, a relatively new entrant, has made substantial inroads into the industry. Further, during the course of the research it emerged that a new player, Botswana-owned Choppies, has also recently entered South Africa and is growing significantly with a strong focus on low-income consumers in the LSM<sup>1</sup> 3-6 category.

Through desktop research and a series of semi-structured in-depth interviews with supermarkets, property owners, developers of retail space, buying groups and wholesalers, this case study highlights both the types of structural and strategic barriers to entry faced by entrants in the grocery retail sector in South Africa.

The structural barriers to entry are largely a function of the inherent characteristics of supermarket chains. The biggest of these barriers identified are the substantial investments required in distribution centres, logistics networks, scale and scope economies and advertising/promotions costs. Other major barriers for smaller (non-chain) players include access to finance, lack of business management skills and lack of retail capabilities. The regulatory barriers (zoning, packaging and labeling, health and safety requirements etc.) evaluated appear to not be a major concern for the larger new entrants.

The most prevalent potential strategic barrier to entry appears to be the practice of long term exclusive lease agreements entered into by incumbent supermarkets and property developers

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<sup>1</sup> Living Standard Measures (LSM) has become the most widely used marketing research tool in southern Africa. It divides the population into 10 LSM groups, 10 (highest) to 1 (lowest). LSMs segment the market according to their living standards using criteria such as degree of urbanisation and ownership of cars and major appliances.

in shopping malls or retail centres. FVC lodged a complaint at the Competition Commission of South Africa around such conduct which prevented it from locating in certain shopping centres.

While the practice is less prevalent in recent years (given increased awareness following the Competition Commission's intervention, construction of larger sized shopping malls etc.), new entrants and specialist retailers (such as butcheries) particularly in smaller shopping centres in rural areas still appear to be affected. The numerous recent complaints lodged at the Competition Commission reflect this. Reducing such barriers to entry would require firm undertakings by the incumbent supermarkets to either not enter into such agreements at all, or reduce the duration of the exclusivity clauses. In turn, this would require stronger enforcement action by the competition authorities (as opposed to just advocacy, which has not worked in the past) grounded in a view that such conduct has a distortionary effect on competition.

While initially faced with such barriers to entry, FVC managed to enter and expand successfully in South Africa and in neighbouring countries. The success of FVC can be attributed to a number of factors. It was able to identify a gap in the market for fresh fruits and vegetables, and differentiated itself from other supermarkets by focusing on an area where the major supermarkets traditionally did not have a strong focus. FVC also adopted a flexible business model which allowed it to target customers across different LSM groups, including moving into the upper-LSM Food Lovers Market format. FVC has also diversified into highly profitable export markets and into other markets such as franchised convenience stores at fuel forecourts and fast food. This flexibility appears to have allowed FVC to seize new opportunities and adapt its format quickly from its initial niche advantage in fresh fruit and vegetables. FVC further has an efficient procurement strategy which is centered on sourcing its fresh fruits and vegetables directly from municipal markets with significant cost advantages over other supermarkets (prices are estimated to be 20-25% lower than buying prices of other supermarkets). Regular benchmarking with United States' Wholefoods and partnership with United Kingdom's Waitrose has further contributed to improving its offering and competitive standing against the incumbent supermarkets. FVC has also invested in distribution centres and logistics networks.

Choppies Enterprises is also growing fast in southern African countries. With over 31 stores in the north-west regions of South Africa since the group entered South Africa in 2008, the chain has plans to grow further in South Africa and in the southern and East African regions.

While not the initial focus of this study, the role of independent supermarkets/retailers in the grocery retail space is of importance for inclusive growth outcomes in South Africa. Independent retailers target low income consumers and are a means through which small suppliers can enter into the supply chain. Recent trends in the independent grocery retail industry suggest that it is growing again (through foreign ownership) after facing a sharp decline in the late 90s/early 2000s. Independent retailing represents an alternative model of entry for small players in the supermarket industry as opposed to the traditional supermarket chain model. For entrants into grocery retail, buying groups who buy in bulk on behalf of independent retailers, can significantly reduce the barriers to entry identified above (scale and scope barriers; advertising cost barriers; investing in building retailers' capabilities etc.).

One way to encourage entry and participation in the grocery retail industry in South Africa is to therefore support and grow independent retailers. Although buying groups significantly

reduce barriers faced by independent retailers, the research highlights the clear benefits of accessing distribution centres and logistics infrastructure. Access to finance to construct such facilities (either for buying groups or for independent retailers) would afford them significant cost benefits from suppliers. Further, encouraging large suppliers to offer fair prices and terms of supply to independent retailers through buying groups (comparable to what is offered to supermarkets, based on fair commercial considerations) would also benefit this segment. There is a key role for public-private partnerships between government and private sector players (key suppliers, wholesalers and buying groups) in this regard, as well as to build capabilities of local independent retailers in advertising, marketing, cash flow management etc.

## 1. Introduction

Supermarkets in general, and grocery retailers in particular, have distinctive features that make them unique. It is often precisely these features that result in barriers to entry for new players in the supermarket industry. From a consumer point of view, supermarkets supply universal daily food products, including perishable food items. But beyond this, supermarkets and most grocery retailers offer the supplementary service of arranging a wide assortment of other, non-food, products selling concurrently in a convenient setting and location with a focus on quality, service, 'one-stop' shopping and an overall shopping experience (Basker and Noel, 2013). Supermarkets provide a variety of products at relatively cheaper prices, given economies of scale and global sourcing strategies, compared to independent (often just local) retailers (Haese and Van Huylbroeck, 2005). Generally, supermarkets also tend to invest in logistics, distribution centres, networks and inventory maintenance more than any other type of retailer. Moreover, major supermarkets bring in valuable footfall to shopping centres, making them key anchor tenants in almost every shopping centre in South Africa.

The format of supermarkets has evolved over the years, moving away from serving just the traditional high-end affluent consumers in urban areas and successfully penetrating new markets in low income communities. Supermarkets have been able to adapt their offerings and invest in more efficient procurement and distribution systems, facilitating their spread into low income rural areas in many countries (Weatherspoon and Reardon, 2003). This has put pressure on independent retailers in rural communities and township areas, in South Africa. However, as will be explored in this case study, recent trends in the independent retail segment of the food industry suggest that this alternative model of retailing to the traditional supermarket model has started showing signs of growth.

For producers and manufacturers (suppliers more generally), supermarkets are often a key source of demand and route to market. Supermarkets through their supply value chains and vertical linkages provide opportunities for suppliers to participate in the growth process.<sup>2</sup> Supermarkets can therefore contribute towards poverty alleviation and inclusive growth, as well as provide employment opportunities to young, informal, semi-skilled, particularly female and part-time, workers (Dihel 2011). This makes the supermarket industry, and the grocery retail industry more broadly, an important sector in South Africa in which the dynamism that effective competitive rivalry brings is crucial for both consumers and suppliers.

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<sup>2</sup> See Emongor and Kirsten (2006, 2009) for the impact of supermarkets on farmers in southern Africa.

From a competition perspective, certain practices of supermarkets with market power such as entering into exclusive supply agreements with large food processors and manufacturers; other forms of vertical restraints; exclusive leases with property owners of prime retail space etc. can heighten barriers for entrants trying to enter and compete in the supermarket or grocery retail industry.

Potential anticompetitive behaviour by the major supermarket chains in South Africa<sup>3</sup> was investigated by the Competition Commission between 2009 and 2013. One of the allegations stemmed from a complaint made by new entrant at the time, FVC, on the exclusionary effect of long term exclusive lease agreements entered into between the major supermarkets and property owners in shopping centres or malls. Other allegations investigated by the Commission included possible abuses of dominance through a range of different practices including exclusive arrangements with certain suppliers and onerous conditions on smaller suppliers<sup>4</sup>; category management practices which conferred decision making powers about product placement, promotion and pricing on the largest manufacturers; and potential dampening of competition by coordinated behaviour through disaggregated information collected and disseminated to supermarkets by third parties.<sup>5</sup> Each of these allegations, if found to be contraventions of the Competition Act, raise barriers to entry or expansion for new entrants in grocery retail markets.

This case study is set out as follows. **Section 2** maps out the main players in the supermarket industry in South Africa that compete with FVC, including the recent entry and growth of Botswana-owned Choppies Enterprises. **Section 3** then traces the evolution and growth of FVC. **Section 4** looks at general competition concerns and typical barriers to entry in the supermarket industry, including those faced by FVC. **Section 5** evaluates recent trends in the development of the independent retailer/supermarket segment in South Africa and how some of the barriers faced by this segment have been reduced. **Section 6** provides some preliminary conclusions.

## 2. Review of the supermarket industry and key players in South Africa

South Africa's supermarket industry has grown rapidly in the past 10 years. However, the industry is arguably saturated, and the relative higher growth and profitability opportunities in the African region has resulted in the rapid spread of South African supermarkets into southern African countries like Zambia, Zimbabwe, Namibia, Botswana etc. South Africa however is still home to the largest grocery retail chains in the southern African region (Reardon and Hopkins, 2006).

Several demand and supply-side factors have been attributed to the increase in the number and spread of supermarkets within and across developing countries. Demand-side factors include increasing urbanisation, the entry of women into the workforce, increased per capita

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<sup>3</sup> Pick n Pay, Shoprite/Checkers, Woolworths and Spar as well as wholesale retailers, former Massmart (now part of Walmart) and Metcash.

<sup>4</sup> Such as high listing fees, slotting allowances, payment policies, return policies, promotional discounts and other rebates.

<sup>5</sup> Such as AC Nielsen and Synovate who collect scanner data from supermarkets and disseminate the information back to the industry. Competition Commission Media Release: Competition Commission findings of the supermarket industry probe, 27/01/2011

income, rise of the middle class, lower unit costs due to economies of scale and scope resulting in lower prices, as well as transport and warehousing economies. From the supply side, a major driving force has been the increase in foreign direct investment (FDI) given saturation of home markets and greater profitability opportunities in other developing countries (Reardon, Timmer and Berdegue, 2004; Humphrey, 2007). For instance, Walmart entered the South African market via FDI through the takeover of Massmart in 2009, while many of the South African supermarkets have invested in regional markets. Improved and modern infrastructure is also a key factor driving the rapid expansion of supermarkets in South Africa. The construction of shopping malls and centres provide retailers with space to carry out their operations.<sup>6</sup>

In South Africa, estimates suggest that the modern retail industry accounts for approximately 70% of national retail markets, and within this, supermarkets are an important source of supply in the retail food sector.<sup>7</sup> As mentioned, this has historically put pressure on, and displaced, independent retailers (both formal independent supermarkets and 'spaza' shops), although it appears that this trend may be changing as independent retailers find alternative methods to benefit from economies of scale.

The South African supermarket industry is highly concentrated with four main retail supermarket chains. Shoprite and Pick n Pay dominate the market, while SPAR and Woolworths hold most of the remaining market share. Fruit and Veg City (FVC), the fifth main player, has within a relatively short period of time entered the market and grown rapidly. All five supermarket chains have operations in southern Africa. Their spread into the region is facilitated by favourable trade conditions under SADC trade agreements making it easy for South African supermarkets to invest and trade in the region. Further, the proximity of Zambia, Zimbabwe, Botswana and other countries in the region eases imports from South Africa.

**Shoprite Holdings**, the largest retailer in South Africa specialising in foodstuffs and household items, was the first supermarket to establish branches in the southern African region. Shoprite has a large network of 1,581 corporate stores across Africa<sup>8</sup> and almost 40 franchise stores in 14 African countries.<sup>9</sup> Within South Africa, Shoprite had 1,324 stores as of financial year 2014.<sup>10</sup> Its market share is estimated to be roughly 30% in what has been defined as a national mass grocery retail market.<sup>11</sup> While this is a national estimate of a market defined as the mass grocery retail market, it is likely that Shoprite commands higher market

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<sup>6</sup> The retail Industry on the rise in South Africa.

<http://www.treasury.gpg.gov.za/Documents/QB1%20The%20Retail%20Industry%20on%20the%20Rise.pdf>, accessed on 15/04/2015

<sup>7</sup> <http://bizconnect.standardbank.co.za/sector-news/retail-wholesale/south-africa-5-key-trends-affecting-the-retail-market-in-2014.aspx>, accessed on 01/06/2015.

<sup>8</sup> [http://shopriteholdings.co.za/InvestorCentre/Documents/2014/IntegratedReport2014/5206\\_Integrated\\_Report.pdf](http://shopriteholdings.co.za/InvestorCentre/Documents/2014/IntegratedReport2014/5206_Integrated_Report.pdf), accessed on 15/04/2015

<sup>9</sup> Angola, Botswana, Ghana, Lesotho, Madagascar, Malawi, Mauritius, Mozambique, Namibia, Nigeria, Swaziland, Uganda, Zambia, and DRC. Shoprite Integrated Report, 2013

<sup>10</sup> [http://shopriteholdings.co.za/InvestorCentre/Documents/2014/IntegratedReport2014/5206\\_Integrated\\_Report.pdf](http://shopriteholdings.co.za/InvestorCentre/Documents/2014/IntegratedReport2014/5206_Integrated_Report.pdf), accessed 15/04/2015

<sup>11</sup> <http://www.treasury.gpg.gov.za/Documents/QB1%20The%20Retail%20Industry%20on%20the%20Rise.pdf>, accessed 15/04/2015. However, these market share estimates from Gauteng Provincial Treasury are dated (2012), and it is unclear what is included in the mass grocery retail market definition. Nonetheless, these estimates provide an indication of relative size, and a similar figure of around 34% has been reported by PwC for 2012 (<http://www.pwc.co.za/en/assets/pdf/retail-and-consumer-products-outlook-2012-2016.pdf>, accessed 15/07/2015)

shares in narrower geographic markets which are more realistic given the maximum distance that shoppers are willing to travel to purchase their groceries and other supermarket needs.<sup>12</sup>

Shoprite Holdings has four core supermarket offerings<sup>13</sup>: Shoprite, Checkers, Usave and OK. It has managed to build a broad customer base catering for the different demographic profiles in South Africa and set up different store formats to meet the needs of the full spectrum of different income groups/LSM categories.<sup>14</sup> Checkers and Checkers Hyper stores target the high-end affluent consumers whereas Shoprite focuses on the broad middle to lower market segments. Shoprite is increasingly extending its offering to lower-income segments by penetrating into economically disadvantaged communities through Shoprite Usave. Shoprite Usave is also used as a tool to spearhead expansion into the rest of Africa. Further, Shoprite's OK franchise caters for a diverse range of mainly smaller convenience-oriented markets (which includes Friendly Supermarkets amongst others) that are located in rural towns, suburbs and neighbourhoods.<sup>15</sup> Estimates are that 67% of all South African customers shop in Shoprite stores and it provides employment opportunities to more than 100,000 people.<sup>16</sup>

**Pick n Pay Holdings**, the second largest retailer in South Africa specialising in groceries, clothing and general merchandise, is also a prominent chain operating in the retail sector on the African continent. Pick n Pay supports 1,128 operations across Africa.<sup>17</sup> The supermarket has 937 stores in South Africa and 104 stores in the region as of financial year 2013.<sup>18</sup> It has an estimated 30% market share in the (national) mass grocery retail market in South Africa.<sup>19</sup>

Pick n Pay also operates across multiple store formats, both franchised and corporate-owned. The retail chain has four main store formats: Pick n Pay Hypermarkets, Pick n Pay Supermarkets, Pick n Pay Family Franchise stores and Pick n Pay Butcheries. Pick n Pay Hypermarkets' business model is to offer a one-stop discount retailing outlet with a mix of foods and general merchandise. Pick n Pay's corporate-owned supermarkets specialise in convenience rather than price. They are smaller in nature which allows them to experiment with merchandising that serves customers whose priority is convenience shopping. Pick n Pay also recently opened Pick n Pay Express franchise stores in collaboration with BP Southern Africa. These are small-format convenient stores located at BP forecourts offering convenience meals, bakery products, groceries, as well as a selection of hot foods, in addition to usual forecourt shop products like cigarettes, magazines and newspapers.<sup>20</sup>

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<sup>12</sup> For instance, the UK Competition Commission in its inquiry into the UK grocery retail market, defined local geographic markets as being limited to within 5 to 15 minutes-drive time (depending on whether they were categorised as large, mid-sized or convenience grocery stores (UK Competition Commission, 2008)

<sup>13</sup> With regards to grocery and supermarket offerings only. It has a range of other outlets that offer furniture, liquor, fast food and pharmacy services, amongst others.

<sup>14</sup> Living Standard Measures has become the most widely used marketing research tool in southern Africa. It divides the population into 10 LSM groups, 10 (highest) to 1 (lowest). LSMs segment the market according to their living standards using criteria such as degree of urbanisation and ownership of cars and major appliances.

<sup>15</sup> [http://shopriteholdings.co.za/InvestorCentre/Documents/2014/IntergratedReport2014/5206\\_Integrated\\_Report.pdf](http://shopriteholdings.co.za/InvestorCentre/Documents/2014/IntergratedReport2014/5206_Integrated_Report.pdf), accessed 15/04/2015

<sup>16</sup> <http://www.fastmoving.co.za/retailers/shoprite-holdings-ltd-2>, accessed 15/04/2015

<sup>17</sup> Including in Botswana, Mozambique, Namibia, Zambia, Zimbabwe, Lesotho and Mauritius

<sup>18</sup> [http://www.sharedata.co.za/Data/000686/pdfs/PICKNPAY\\_ar\\_feb13.pdf](http://www.sharedata.co.za/Data/000686/pdfs/PICKNPAY_ar_feb13.pdf), accessed 15/04/2015

<sup>19</sup> <http://www.treasury.ppg.gov.za/Documents/QB1%20The%20Retail%20Industry%20on%20the%20Rise.pdf>, accessed 01/06/2015. Other estimates suggest it has between 19% and 28% market share.

(<http://www.pwc.co.za/en/assets/pdf/retail-and-consumer-products-outlook-2012-2016.pdf>, accessed 15/07/2015 and <http://mg.co.za/article/2011-11-04-big-five-fight-for-food-market-share/>, accessed 15/07/2015 respectively).

<sup>20</sup> <http://www.picknpay.co.za/news/smallformat-stores-on-their-way>, accessed 25/09/2015

Like Shoprite, Pick n Pay is increasingly targeting lower income consumers, moving away from its traditional, upper income customer segment.<sup>21</sup> As part of this strategy, Pick n Pay acquired Boxer in 2002.<sup>22</sup> It is estimated that after Shoprite, most South African customers shop in Pick n Pay outlets.<sup>23</sup> The retail chain has around 47,000 employees in South Africa.

The **SPAR Group**, the third largest mass grocery retailer specialising in foodstuffs and general merchandise in South Africa, operates in ten African countries<sup>24</sup> Through primarily a franchise model, SPAR supports 1711 stores in South Africa and 153 stores in the rest of sub-Saharan Africa (as of year-end 2014). SPAR is said to hold an estimated 26% market share in the mass grocery retail in South Africa.<sup>25</sup> Like Shoprite and Pick n Pay, SPAR expanded into four store formats designed to meet the needs of different customer groupings.<sup>26</sup> SPAR's traditional target consumer was typically the older population, but it is moving towards middle-class, younger customers and also entering into more rural communities.<sup>27</sup> The four SPAR Brands are Superspar, SPAR, Kwikspar and SaveMor.<sup>28</sup> SPAR is the core supermarket format focusing on neighbourhood retailing and supermarket shopping. This brand's emphasis is on locating as close to the consumers as possible, offering a comprehensive range of groceries in addition to fresh produce, in-store bakeries, butcheries, delis and home-meal replacement departments. Superspar is a larger supermarket format focusing on weekly family shoppers with aggressive pricing and promoting SPAR's own branded products (private labels). Kwikspar is a convenience offering with an emphasis on speedy purchases operating for longer hours. SaveMor is exclusively focused on rural and township markets. It gives the option to existing small store owners to convert their store into a SaveMor store offering a limited range of basic products that are mainly targeted at rising single and two-person households. SPAR also opened a forecourt convenience store in 2013, SPAR Express, in collaboration with Shell. However, it is unclear whether this concept has taken off. The retail chain has 4,025 permanent (non-franchisee) employees.<sup>29</sup>

**Woolworths Holdings**, the fourth largest retail chain in South Africa specialising in food and clothing, is one of the leading retailers targeting higher LSMs in the southern hemisphere. Woolworths has 1,162 store locations in a number of African countries<sup>30</sup> with 82 store locations and 33 franchise stores in these countries. Woolworths' market share in South Africa is estimated at 8-11% of the mass grocery retail.<sup>31</sup> The group only has a single brand store,

<sup>21</sup> <http://www.moneyweb.co.za/archive/the-investment-case-pick-n-pay-stores-ltd/>, accessed 15/04/2015

<sup>22</sup> <http://www.boxer.co.za/company-history/>, accessed 11/09/2015

<sup>23</sup> [http://www.supermarket.co.za/news\\_articles.asp?ID=4115](http://www.supermarket.co.za/news_articles.asp?ID=4115), accessed 15/04/2015

<sup>24</sup> South Africa, Mozambique, Zambia, Zimbabwe, Swaziland, Botswana, Lesotho, Namibia and, recently, Angola.

<sup>25</sup> <http://www.treasury.gpg.gov.za/Documents/QB1%20The%20Retail%20Industry%20on%20the%20Rise.pdf>, accessed 15/04/2015. Other estimates suggest around 28% (<http://mg.co.za/article/2011-11-04-big-five-fight-for-food-market-share/>)

<sup>26</sup> <http://www.spar-international.com/sparworldwide/multi-retail-format-strategy.html>, accessed 15/04/2015

<sup>27</sup> <http://www.123helpme.com/spar-case-study-view.asp?id=164139>, accessed 15/04/2015

<sup>28</sup> [http://www.spar.co.za/getattachment/fc16b138-ed55-4d20-9305-ef34e24c7af8/00000000-0000-0000-0000-000000000000-\(11\).aspx](http://www.spar.co.za/getattachment/fc16b138-ed55-4d20-9305-ef34e24c7af8/00000000-0000-0000-0000-000000000000-(11).aspx), accessed 15/04/2015

<sup>29</sup> [http://www.spar.co.za/getattachment/fc16b138-ed55-4d20-9305-ef34e24c7af8/00000000-0000-0000-0000-000000000000-\(11\).aspx](http://www.spar.co.za/getattachment/fc16b138-ed55-4d20-9305-ef34e24c7af8/00000000-0000-0000-0000-000000000000-(11).aspx), accessed 15/04/2015

<sup>30</sup> Zambia, Zimbabwe, Botswana, Namibia, Swaziland, Kenya, Ghana, Mauritius, and Mozambique. Recently Woolworths closed down its operations in Nigeria so that it could better focus on growing its operations in the southern African countries.

[http://www.woolworthsholdings.co.za/investor/annual\\_reports/ar2014/whl\\_2014\\_integrated\\_reprt1.pdf](http://www.woolworthsholdings.co.za/investor/annual_reports/ar2014/whl_2014_integrated_reprt1.pdf) accessed 01/06/2015

<sup>31</sup> <http://www.treasury.gpg.gov.za/Documents/QB1%20The%20Retail%20Industry%20on%20the%20Rise.pdf>, accessed 01/06/2015; and <http://mg.co.za/article/2011-11-04-big-five-fight-for-food-market-share/>, accessed 15/07/15

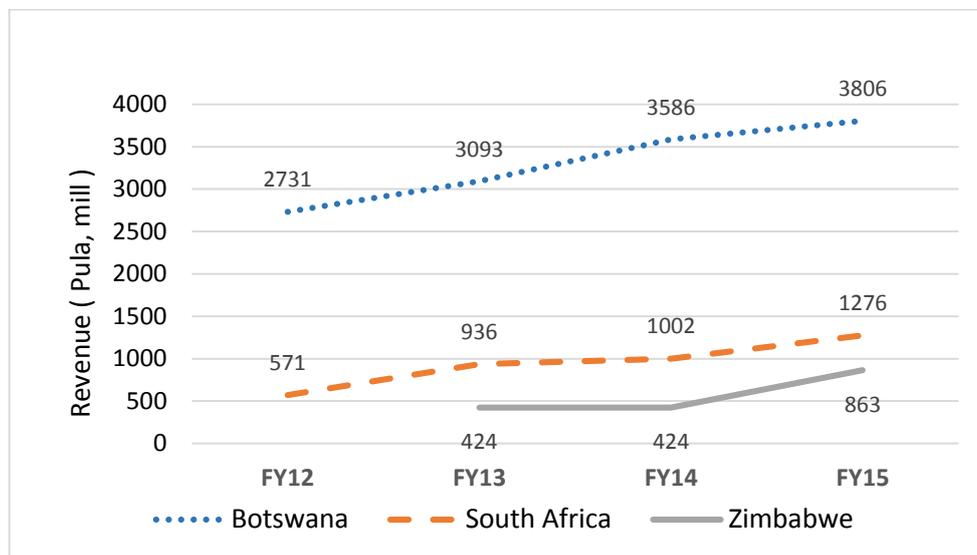
which emphasises providing superior quality and product innovation and exclusively targets the high-end, affluent niche market. Woolworths, like the other supermarkets, ventured into convenience stores at fuel forecourts. Partnering with Engen, Woolworths has a number of Woolworths Foodstops stores.<sup>32</sup> The retail chain employs approximately 38,000 people across all their operations in all the countries.<sup>33</sup>

The fifth largest grocery retailer in South Africa, the main subject of this case study, **Fruit and Veg City Holdings (FVC)**, entered the grocery retail market in 1993 with a single store in Kenilworth, Cape Town. It expanded rapidly and by 2006/7 had around 80 stores nationally. Section 3 assesses the growth and evolution of FVC in more detail.

More recently, Walmart-owned **Game** has also branched into food products (retailer of non-perishable groceries and wholesaler of basic foods).<sup>34</sup> Because its operations in food are still at the early stages, there is very little publically available information on its performance.

While the past trend (since the mid-to late-1990s) in southern Africa has been that South African supermarkets have aggressively spread in the region, this trend is now changing with supermarkets from other SADC countries entering South Africa and the region. The most successful example of such entry is by **Choppies Enterprises**. A grocery and general merchandise retailer from Botswana, Choppies has over the last 15 years grown from two stores in Botswana to over 125 stores in Botswana, Zimbabwe and South Africa, with plans to enter Zambia, Kenya and Tanzania in 2015.<sup>35</sup> The rapid growth in Choppies' revenue in South Africa and number of stores in southern Africa is given in Figures 1 and 2 below.

**Figure 1: Growth in Choppies' Revenue in southern Africa**



Source: Choppies Interim Results, 2015

<sup>32</sup> <http://www.bdlive.co.za/business/retail/2013/12/02/forecourt-store-concept-gains-momentum>, accessed 25/09/2015

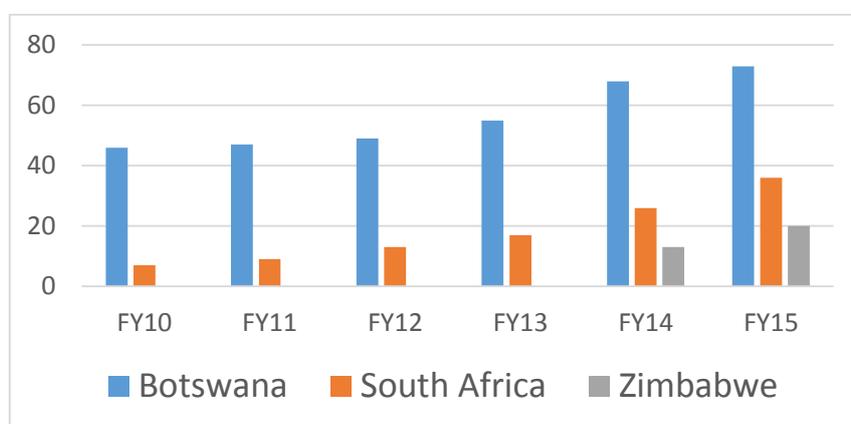
<sup>33</sup> [http://www.woolworthsholdings.co.za/investor/annual\\_reports/ar2014/whl\\_2014\\_integrated\\_reprt1.pdf](http://www.woolworthsholdings.co.za/investor/annual_reports/ar2014/whl_2014_integrated_reprt1.pdf), accessed 01/06/2015

<sup>34</sup> <http://www.game.co.za/get-to-know-us/about-game/>, accessed on 10/06/2015

<sup>35</sup> <http://www.howwemadeitinafrica.com/why-botswanas-largest-retailer-ventured-into-risky-zimbabwe/45858/>, accessed on 07/01/2015

Note: Revenue growth rate in South Africa however saw a sharp dip in 2014, attributed to the platinum sector strike. Most of Choppies stores in South Africa presently are in the platinum mining areas in South Africa (Northwest province).

**Figure 2: Growth in the number of Choppies' stores in southern Africa**



Source: *Choppies Annual Report, 2014 and Pre-listing statement, 2015*

On May 6 2015, Choppies announced its intention to list on the South African JSE in an attempt to boost its profile among investors. On 27 May 2015, Choppies listed on the JSE. It is already listed on the Botswana Stock Exchange.<sup>36</sup> Choppies' target market is low-to middle-income consumers (LSM 3-6), but it is increasingly attracting middle-to-upper income consumers. It stocks branded international products but also has a wide and growing range of private label products. Choppies also stocks fresh fruit and vegetables and has a butchery, bakery and take away. It targets value-conscious, high frequency, small basket size, cash paying shoppers. Like the other South African supermarkets, it has recently introduced value-added offerings (ATMs, Sim cards, Mobile money and money transfer etc.). It is presently located mainly in the semi-urban and rural areas in the north western region of South Africa, near transport nodes such as taxi ranks but has recently started locating in shopping malls. Its format is mainly compact superstores, with only a few hyperstores and small value stores. Choppies employs around 11,000 people.<sup>37</sup>

While not the initial focus of this study, the role of **independent retailers** (or independent supermarkets) in the grocery retail space is of importance for inclusive growth outcomes in South Africa, given that they typically target low income consumers. Recent trends in the independent grocery retail industry suggest that this alternative model of retailing to the traditional supermarket model is growing.

Independent retailers have been defined as businesses that are privately owned and that do not belong to a larger chain or group.<sup>38</sup> However, while each store is owned by separate

<sup>36</sup> [http://www.iol.co.za/business/international/botswana-s-choppies-to-seek-sa-listing-1.1854541#.VU3Ha\\_mqgko](http://www.iol.co.za/business/international/botswana-s-choppies-to-seek-sa-listing-1.1854541#.VU3Ha_mqgko), accessed on 9 May 2015

<sup>37</sup> Choppies 2014 Annual report and pre-listing statement

<sup>38</sup> Syndicate One (2011), 'Independent Food Retailers in the Republic of South Africa. Can they Ensure Sustainability in an Evolving Retail Landscape?' W&RSETA ILDP Programme 2011

individuals, the stores may be branded under a common name, for instance 'Foodzone' (of which there are around 127 retail supermarkets organised by buying group, The Buying Exchange Company, in South Africa)<sup>39</sup> or Food Town and Powertrade (with over 40 stores<sup>40</sup> organised by buying group, United Management Services). Independent supermarkets are typically small businesses, targeting lower LSM customers in peri-urban, township, industrial and central business district (CBD) areas of cities.

Independent retailers include sellers of food and non-food items such as cash and carry's that have both wholesale and retail supermarket offerings (hybrid format) as well as numerous informal<sup>41</sup> spaza shops, spazarettes and superettes. It is estimated that there are around 100,000 informal stores in South Africa, of which the majority (70%) are foreign-owned/run.<sup>42</sup> These stores are frequented by both hawkers and customers who are looking for top-up, daily purchases or even weekly purchases. While these consumers may shop at a supermarket chain store at the beginning of the month (for instance after receiving social grants) or when there are promotions, they frequent independent retailers towards mid-month and month-end. These independent retailers typically stock fast moving items and operate at very low profit margins.

### 3. The growth and evolution of FVC

FVC entered the grocery retail market in 1993 with a single store in Kenilworth, Cape Town (taking over The Carrot King). The founders, brothers Michael and Brian Coppin, identified a gap in the market for fresh fruits and vegetables. At the time, the major incumbent supermarkets traditionally did not have a strong focus on fresh fruit and vegetables. FVC's entry and differentiating strategy was therefore to initially focus on trading fresh fruit and vegetables.<sup>43</sup>

In 1999, a number of corporate stores were opened in Johannesburg, while franchise stores were opened in Port Elizabeth, East London, Durban, Bloemfontein and Pretoria. By 2006/7, FVC had around 80 stores nationally. In 2007, the Competition Commission recommended that the Competition Tribunal prohibit the large merger between Pick n Pay and FVC on grounds that the merger would result in the removal of an effective competitor in the retail market for fresh food. The Commission found that FVC was a growing effective competitor to Pick n Pay and the other major retailers, and would provide an even greater product offering in the future. Allowing the merger would therefore stifle both current and future competition. It appears that the Commission was not far off in its prediction of FVC's future growth.

FVC showed impressive growth as seen in Table 2. Turnover has grown steeply from R1.6 billion in 2006 to R15 billion in 2015, with a growth rate well ahead of the major listed food retailers.<sup>44</sup> FVC's turnover grew by approximately 21% per year, compared to the 15% growth

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<sup>39</sup> Interview on 22/09/2015

<sup>40</sup> Powertrade stores are hybrid wholesale and retail stores.

<sup>41</sup> It is estimated in 2012 that 30% of the country's food expenditure goes through informal outlets (PwC, 2012)

<sup>42</sup> Minanawe Marketing (2015), 'The Invisible Matrix at the Heart of the Informal Economy'

<sup>43</sup> <http://www.entrepreneurmag.co.za/advice/success-stories/entrepreneur-profiles/fruit-and-veg-city-michael-and-brian-coppin/>, accessed 25 August 2015

<sup>44</sup> Growth rates of the major listed supermarket chains were reported at about 15% per year between 2006 and 2012, while that of FVC was 20% per year. <http://www.financialmail.co.za/business/2012/07/18/fruit-veg-city-grows-market-share>, accessed 15/01/2015.

rate of the other major supermarkets.<sup>45</sup> The number of stores has also grown particularly between 2006 and 2012.<sup>46</sup> According to FVC, it has around 10% of the grocery retail market in South Africa.<sup>47</sup>

**Table 1: FVC annual turnover and number of stores**

	Annual turnover	Number of stores
2006	R1.6 billion	80
2009	R2.1 billion	98
2012	R5 billion	101
2013	R6 billion	+100
2015	R15 billion	+100

Sources: <http://www.entrepreneurmag.co.za/advice/success-stories/entrepreneur-profiles/fruit-and-veg-city-michael-and-brian-coppin/>; <http://www.financialmail.co.za/business/2012/07/18/fruit-veg-city-grows-market-share>; <http://www.frontierssa.com/frontiers-news/62-food-lover-s-market-to-deliver-a-unique-food-experience-at-the-2014-cape-town-tens>; <http://www.foodstuffsa.co.za/news-stuff/latest-sa-news/3302-sas-food-retailers-battle-for-lsms-8-10>;

Note: FVC is not a listed company and turnover figures are confidential. The estimates in the table above are from publically sourced documents and from the interviews

There are now over 100 FVC stores throughout southern Africa including in Namibia, Zambia, Zimbabwe, Mauritius, Reunion, as well as in Australia. In South Africa, FVC is present in all the main cities (Figure 3).

**Figure 3: Spread and location of Fruit and Veg City in South Africa**



<sup>45</sup> <http://www.financialmail.co.za/moneyinvesting/2013/10/31/woolworths-rides-high-in-sa-food-sector>, accessed 25 August 2015

<sup>46</sup> See also <http://www.entrepreneurmag.co.za/advice/success-stories/entrepreneur-profiles/fruit-and-veg-city-michael-and-brian-coppin/>, accessed 25/08/2015

<sup>47</sup> Interview on 26/08/2015

Source: <http://www.fruitandvegcity.co.za/store-locator/>

FVC's owners credit its success, in addition to its core principles of high quality healthy foods at affordable prices, to its flexible business model which allows it to target customers across different LSM groups. This flexibility appears to have allowed FVC to seize new opportunities and adapt its format quickly from its initial niche advantage in fresh fruit and vegetables.

Unlike the other major supermarkets, FVC's model is focused predominantly on the sale of fresh fruit and vegetables, with only a smaller proportion of other grocery item lines.<sup>48</sup> FVC franchises mainly target LSM 2-6.<sup>49</sup> The rebranding of the traditional FVC stores to the more up-market **Food Lover's Market** (FLM) format in affluent suburbs is one example of the group's flexibility. FLM targets LSM 8-10.<sup>50</sup> In 2005, FVC invented this new premium store brand in response to the changing habits of the growing middle-class consumer. The first FLM was opened in Hillfox, Johannesburg. This saw FVC diversifying its product range to include essential grocery items and other fresh produce such as fresh fruit juice, meat, cheese and baked products.<sup>51</sup> At the end of 2009, the company had opened twelve FLM stores.<sup>52</sup> The new FLM format also includes a modern eatery or 'food emporium' in addition to the traditional offering to its regular customers. FVC is planning to convert all its stores to corporate FLM outlets in the future. FVC franchisees that do not want to convert or upgrade their stores into the FLM format are being bought back by FVC. This shift sees the group moving towards a more corporate model.<sup>53</sup> This, according to FVC, ensures that quality and consistency is maintained across outlets, allowing it to remain competitive.

FVC has also expanded into franchised convenience stores (**Fresh Stop** stores) through a joint venture with Caltex, offering fresh produce, meat, fish, delicatessens etc. at Caltex forecourts. These stores have grown rapidly since 2009, with 180 outlets all over South Africa presently.<sup>54</sup> Reinventing itself even within the Fresh Stop brand, FVC has further introduced an in-house fast food brand, **Crispy Chicken**, in the Eastern Cape in November 2014.<sup>55</sup>

Other branches of the company include an import and export business primarily of fresh fruits (**FVC International**). Through this business, relationships have been built with farmers and packaging houses, and FVC offers customised packing solutions to its import and export customers. Exports are mainly to Asia and Europe.<sup>56</sup> The FVC International arm is also vertically integrated with its own logistics company and is in partnership with two of South Africa's largest fruit growers.<sup>57</sup> FVC International is 49% owned by an individual and 51% owned by FVC and is a very profitable arm of the overall business according to FVC.<sup>58</sup> Exports allegedly account for 80% of the total revenues.<sup>59</sup> In terms of product standards, FVC's export phytosanitary standards are high (Grade A), which is what is demanded by export customers,

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<sup>48</sup> Ibid

<sup>49</sup> Interview on 26/07/2015

<sup>50</sup> Interview on 26/07/2015

<sup>51</sup> <http://www.bus-ex.com/article/fruit-and-veg-city>, accessed 25/08/2015

<sup>52</sup> <http://www.bus-ex.com/article/fruit-and-veg-city>, accessed 25/08/2015

<sup>53</sup> Interview on 26/07/2015

<sup>54</sup> <http://www.financialmail.co.za/business/2012/07/18/fruit-veg-city-grows-market-share>

<sup>55</sup> <http://www.freshstop.co.za/freshstop%E2%80%99s-crispy-chicken-opens-first-outlet-in-the-eastern-cape/>, accessed 19/01/2015

<sup>56</sup> Interview on 26/07/2015

<sup>57</sup> <http://www.fruitandvegcity.co.za/the-fvc-international-story/>, accessed 19/01/015

<sup>58</sup> Interview on 26/07/2015

<sup>59</sup> <http://www.entrepreneurmag.co.za/advice/success-stories/entrepreneur-profiles/fruit-and-veg-city-michael-and-brian-coppin/>, accessed 25/08/2015

while local standards are usually grade C or B. This is another example of how FVC has managed to grow so strongly- by diversifying into lucrative export markets.

FVC's latest entry has been into the liquor market after it acquired a 50% stake in Diamond's Discount Liquor in July 2012. FVC has rebranded these stores under the name '**Market Liquors**', selling both retail and wholesale of liquor and soft drinks.<sup>60</sup>

FVC also attributes its success to its constant innovation, benchmarking itself regularly with the US's 'Wholefoods' brand with regards to look, feel, quality and packaging. It further considers its strong relationship with suppliers key to its success.<sup>61</sup> In terms of procurement strategy and relationship with suppliers, FVC sources its fresh produce from the two main municipal markets in Johannesburg and Pretoria as well as directly from farmers, including for sale in FVC stores in neighbouring countries. This produce often comes from farmers who have excess produce over and above their fixed contracts. FLM uses spot purchasing where product is basically bought from the markets everyday (with some future buying of certain produce). FVC's purchases from municipal markets account for 40-60% of all their goods, making them the largest buyers on the municipal markets.<sup>62</sup> Indeed, FLM differentiates itself from other supermarkets by sourcing a portion of their offering directly from the fresh produce market on spot terms. Given the volatility of pricing resulting from daily or near-daily purchases on the spot market, FVC tries as far as possible to use average pricing.<sup>63</sup> Sourcing directly from municipal markets is said to give FVC a competitive edge in price over their competitors, allowing them to charge prices that are between 20% and 25% lower than the other major retailers, in addition to being able to offer good quality and a wide range of fresh produce.<sup>64</sup>

FVC also owns two distribution centres (DC), in Pretoria and Johannesburg (with the Pretoria DC being located in the municipal market). The importance of DCs is evaluated in Section 4.1 below. The Pretoria DC is co-owned with Gastaldi Distribution. Franchisees are given the freedom to source from suppliers as they wish (considerable discretion), but if they source through the DC, they are expected to pay towards its running costs. An amount is calculated at 5% and added onto the cost of the produce purchased, with a 10 day credit limit imposed on franchisees.<sup>65</sup> Farmers from the municipal markets generally deliver straight to the DC. Groceries/ambient goods are also delivered to the DC. The FVC DCs are said to be very low cost, with slim operating margins. Their ability to maintain their keen pricing structure has also been attributed to their very low margin DCs.<sup>66</sup>

FVC's growth has however not been without challenges initially, including allegedly as a result of market power exerted by the major incumbent supermarket chains. This includes concerns raised in a complaint by FVC to the Competition Commission around exclusive lease agreements between the major food retailers (who are anchor tenants), and property

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<sup>60</sup> <http://www.fruitandvegcity.co.za/market-liquors/>, accessed 19/01/2015

<sup>61</sup> Interview on 26/07/2015

<sup>62</sup> <http://www.entrepreneurmag.co.za/advice/success-stories/entrepreneur-profiles/fruit-and-veg-city-michael-and-brian-coppin/>, accessed 25/08/2015. This may have changed in more recent years as they have moved more into grocery lines.

<sup>63</sup> Interview on 26/07/2015

<sup>64</sup> <http://www.entrepreneurmag.co.za/advice/success-stories/entrepreneur-profiles/fruit-and-veg-city-michael-and-brian-coppin/>, accessed 25/08/2015

<sup>65</sup> <http://www.fruitandvegcity.co.za/franchisee-info/>, accessed 25/08/ 2015

<sup>66</sup> <http://www.entrepreneurmag.co.za/advice/success-stories/entrepreneur-profiles/fruit-and-veg-city-michael-and-brian-coppin/>, accessed 25/08/2015

developers, owners and managers of shopping malls which is discussed in more detail in the next section.

Other general challenges faced by FVC include controlling wastage and culling. Given the nature of their main product offering, it was important that FVC devise strategies to turn over their product fast enough to avoid stock wastage. This was necessary if FVC was to maintain its competitive edge. FVC started taking stock once every week as opposed to once every month or three months.<sup>67</sup> More recent concerns include load shedding, which has had a significant negative impact particularly on the FLM bakery line.<sup>68</sup> Another major challenge faced by FVC is maintaining uniform standards, quality and consistency across the different franchised stores. As explained, FVC is slowly moving away from a franchise model to a corporate model by converting all their stores to FLMs.

#### **4. Competition concerns and typical barriers to entry in the supermarkets industry**

There have been numerous competition concerns in the supermarket industry throughout the world, with large-scale market inquiries undertaken by the UK and Australian competition authorities. The South African Competition Commission has also received a number of complaints regarding the conduct of large supermarket chains. Existing competition concerns create barriers to entry for new grocery retailers. The food retail value chain comprises a complex series of inter-related markets in which multi-product retailers like supermarkets play a central role. In many countries, including South Africa, a few supermarket chains dominate the market as explained in Section 2. The competition concerns that typically arise in supermarket value chains are two-fold:

- supermarkets abusing their market power in terms of creating barriers to entry and engaging in conduct that excludes rival supermarkets; and
- supermarkets exerting market power on the buyer side with regards to vertical relationships with suppliers (OECD, 2013).

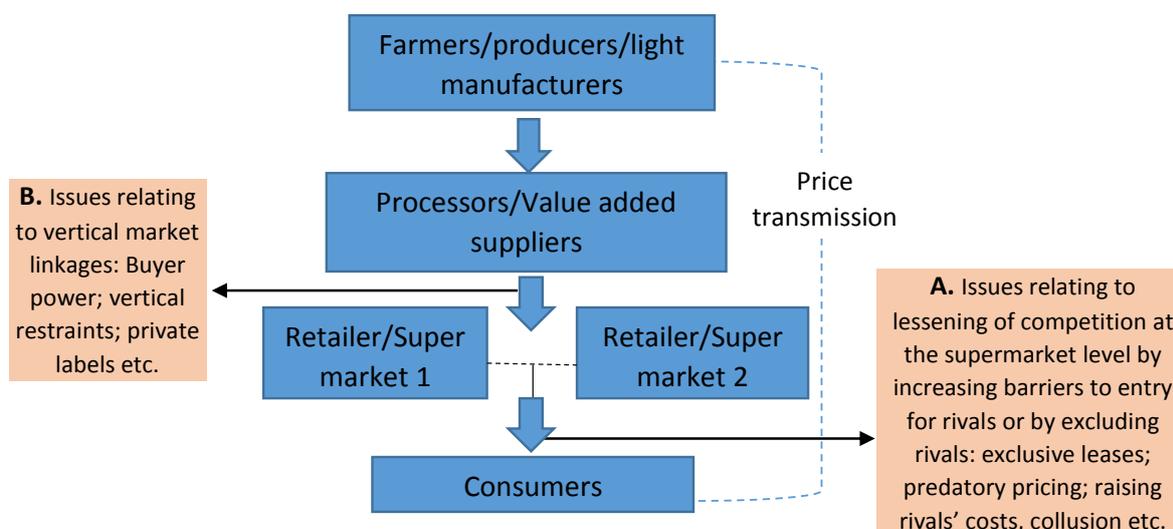
A stylised figure (Figure 4) illustrates the potential competition concerns in the retail value chain with respect to supermarkets:

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<sup>67</sup> <http://www.entrepreneurmag.co.za/advice/success-stories/entrepreneur-profiles/fruit-and-veg-city-michael-and-brian-coppin/>, accessed 25/08/2015

<sup>68</sup> Interview on 26/07/2015

**Figure 4: Competition concerns in supermarket value chains**



*Source: Adapted and modified from OECD, 2013*

In addition to strategic barriers to entry which involve dominant supermarkets engaging in conduct that creates or increase barriers for new entrants or excludes current rivals, new entrants typically face structural barriers to entry. These are discussed in Section 4.1 below. Section 4.2 describes strategic barriers to entry (which usually involve the type of conduct described in **A** in Figure 1 above).

Not the direct focus of this case study are the types of conduct which pertain to vertical relationships (**B** in Figure 1 above). Such practices stem from the considerable buyer power of large supermarket chains and include supermarkets introducing private labels which could result in the foreclosure of independent suppliers. Such practices can affect competition at the various upstream levels (producers, manufacturers, processors). However, of relevance to this case study is that such conduct can affect the success of new entrants that compete with incumbent supermarkets who try to access key suppliers that sell ‘must have’ products. These are also discussed in Section 4.2.

#### **4.1. Structural, including regulatory, barriers to entry in the supermarket industry**

Structural barriers exist because of factors inherent in the nature of the market and the unique features of grocery retailing mentioned above. The fact that supermarkets sell perishable foods, for instance, affects the organisation of firms and consumer buying patterns. Consumers tend to shop regularly and from local supermarkets located within a very short distance from their residential or work locations. This typically creates competition between supermarkets at a very local level in terms of **physical location and space**. Supermarkets often therefore compete for space in close proximity to residential locations (Basker and Noel, 2013), in central business districts (CBD) near the workplace or in townships. The location limitations for large modern retailers in dense urban neighbourhoods or in CBDs to provide ease of access to customers is therefore a form of a structural barrier to entry.

None of the supermarket chains interviewed in South Africa however raised this as a serious barrier to entry and concerns related to location were primarily around exclusivity clauses in leases as discussed later.

The perishable nature of food requires supermarkets to make **large investments in logistics, distribution and inventory maintenance** such as refrigeration, backup generators, refrigerated trucks and distribution centers. Supermarkets internationally appear to be increasingly switching to own centralised distribution centres instead of store-to-store procurement (Reardon and Hopkins, 2006). This reduces coordination costs and congestion diseconomies which can outweigh the transport costs to and from distribution centres that are located in more remote parts of the city (Reardon and Hopkins, 2006). Investment in large scale distribution centres increases the costs for new entrants. It has been argued that such substantial investments in logistics and technologies have transformed the supermarkets sectors globally to becoming one of the most technologically advanced sectors, heightening barriers to entry for small scale operators who cannot afford to make such large investments (Basker and Noel, 2013). There is also a substantial investment risk for new entrants (Marion, 1984). A key characteristic of supermarket competition is indeed endogenous sunk cost investments such as these.

In South Africa, all the major supermarket chains with multiple stores have invested significantly in DCs. Investments in DCs are costly and appear to be necessary for supermarkets with multiple stores. According to Fruit and Veg City, DCs are important for successful retailing because it is cheaper for corporate or franchise stores to procure their goods from DCs than individually negotiating and buying stock directly from main suppliers. This is because of the scale economies and associated discounts and rebates that can be secured from the suppliers when the DC buys in bulk.<sup>69</sup>

As highlighted by Choppies, DCs support the uninterrupted and timely supply of goods to stores. Stores place orders with the centralised warehouse periodically based on each store's individual supply requirements. Typically, DCs are run as independent business units with profit targets within the supermarket group. Choppies has 7 distribution centres, 2 of which are in Rustenberg, South Africa, and the rest of which are in Botswana and Zimbabwe.<sup>70</sup>

SPAR also has a number of DCs which serve stores throughout the region. SPAR franchisees are free to source from independent suppliers, but given the cost savings from sourcing from DCs, the franchisees often opt to go this route.<sup>71</sup>

Other major supermarket chains also have DCs and have invested significant amounts of capital in them. For instance, Shoprite's financial reports highlight the considerable increase in capital expenditure between December 2013 and December 2014 in DCs, as well as contracted capital commitments in December 2014 for future investments (Table 2). Shoprite's DCs (including those managed by Freshmark) are in Centurion, Gauteng, Cape Town and Durban. The Centurion DC has doubled in size from 80 000 m<sup>2</sup> to 180 000 m<sup>2</sup> and is the largest DC under one roof on the continent. The facility serves as the distribution point for about 90% of ambient products delivered to stores in the Gauteng area and in southern Africa. More than

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<sup>69</sup> Interview on 26/07/2015

<sup>70</sup> Choppies prelisting statement (2015)

<sup>71</sup> Interview on 11/08/2015

1,100 suppliers deliver their products to the centre where they are stored, collated, and then distributed to retail stores on a high-frequency basis.<sup>72</sup>

Pick n Pay has also invested significantly in DCs (Table 2). It has 10 DCs around the country, in addition to a perishables inland distribution centre as seen in Table 2 below. According to Pick n Pay, these investments in 2010 were essential to maintain competitiveness- “Our decision to move to centralised distribution was motivated by changes in South Africa’s retail landscape which had seen us fall behind our competitors, who were investing significantly in their supply chains and in improved service to their stores through centralised distribution systems. Throughout the world, the most successful retail groups have unlocked massive value from their supply chains, and most of them have moved away from direct-to-store delivery distribution” (Former CEO Nick Badminton).<sup>73</sup>

**Table 2: Capital expenditure in distribution centres<sup>74</sup>**

	Capital expenditure		Contracted Capital Commitments
<b>SHOPRITE</b>			
	Dec 2013 (ZAR m)	Dec 2014 (ZAR m)	Dec 2014 (ZAR m)
Distribution centre	137	228	241
Distribution centre- related equipment and vehicles	91	181	
<b>PICK n PAY</b>			
	2010 (ZAR m)		
Distribution centre	628 (Longmeadow); total investment estimated at ZAR 2 bill		

Source: Shoprite February 2015 Financial Highlights; <http://www.moneyweb.co.za/archive/r628m-distribution-centre-for-pick-n-pay/>, accessed 25/08/2015

Distribution centres are also essential according to a representative of Woolworths.<sup>75</sup>

Aside from the large capital investment required to set up DCs, the cost benefits (scale and scope economies) that large DCs offer confer a competitive advantage and present a barrier to entry for new retailers who enter the market with multiple stores who do not have DCs.

With regards to **logistics**, supermarkets either own their vehicle fleet (including refrigerated trucks) or outsource this function. Shoprite for instance has its own fleet under the Freshmark name. The fleet operates 24 hours a day, seven days a week. Choppies also owns their transport fleet of over 500 vehicles. Pick n Pay on the other hand outsources its logistics to Imperial Logistics<sup>76</sup> with dedicated trucks. It is unclear at this stage what benefits are associated with owning trucks as opposed to leasing, especially for new entrants. Choppies however suggested that owning their own fleet was a major competitive advantage to them.<sup>77</sup>

<sup>72</sup> <http://www.shopriteholdings.co.za/GroupServices/Pages/Supply-Chain-Management.aspx>, accessed 11/09/15

<sup>73</sup> <http://www.moneyweb.co.za/archive/r628m-distribution-centre-for-pick-n-pay/>, accessed 25/08/2015

<sup>74</sup> FVC does not publish its financial results and information on investments in distribution centres is confidential.

<sup>75</sup> Interview on 26/08/2015

<sup>76</sup> <http://www.imperiallogistics.co.za/imperial-news/509/imperial-reduces-costs-and-boosts-service-pick-n-pay/>, accessed 11/09/15

<sup>77</sup> Interview on 5/05/2015

Another feature of supermarkets is the extensive investment in **advertising** and **promotions** used to create loyalty and attract greater footfall with the aim of converting this into greater sales. Advertising costs can be a significant barrier to entry for new players in the market. Incumbents may make it even more difficult for new entrants strategically by spending excessively on advertising. To gain market share, new entrants have to match this spend out of a much smaller revenue base. This puts new entrants wishing to compete directly with large supermarkets at a huge cost disadvantage (Marion, 1984).

FVC views advertising as a major barrier to entry. FVC advertises, *inter alia*, through pamphlets, newspapers, TV and radio. It highlights that advertising costs are lowered with greater number of stores as the costs are spread out over a number of stores<sup>78</sup>, again putting new entrants with single stores or few stores at a disadvantage. Advertising costs are significant for franchise stores of the major supermarkets as well. According to a franchise store of Shoprite, OK Value (Delarey), advertising is crucial and a significant cost factor. Even though the franchisee uses Shoprite's internal radio station to advertise its store, any additional advertising is paid for by the franchisee.<sup>79</sup> SPAR similarly explains that a large proportion of the advertising budget comes from the SPAR head office, while a much smaller proportion is paid for individually by the franchisee at its discretion.<sup>80</sup> New methods of advertising however, such as social media, may be cheaper and supermarkets are increasingly engaging in such methods. Buying groups like UMS (discussed later) offer considerable support to franchised independent retailers with regards to advertising, promotions and marketing. This may also alleviate some of these cost pressures.

Large supermarket chains also have the advantage of significant **economies of scale and scope** by exploiting advances in logistics and operations technologies, as well as by procuring large volumes for multiple outlets through DCs. Economies of scale refer to the reduction in average costs achieved by selling a higher overall quantity, whereas economies of scope refer to cost savings gained from selling many different products in the same store. Economies of scale and scope create natural barriers to entry for new entrants as they have to enter with sufficient scale and product range, including through numbers of outlets, to benefit from the cost savings that large incumbents have (Basker and Noel, 2013).

Aside from cost savings due to scale and scope, modern retailers greatly reduce the consumers' overall cost of acquiring a typical basket of food and household products. Supermarkets offer the convenience of a '**one stop shop**' that traditional or independent retailers are often not able to. This includes a wider variety of products, easier access, longer opening hours, consumer credit and other services. This reduces search and transport costs for customers. Furthermore, supermarkets are able to signal better quality and safety standards via stringent supply chain management practices and better adherence to regulations than traditional retailers (Reardon and Hopkins, 2006).

Reardon and Hopkins (2006) further describe related reasons why the rapid spread of supermarkets has increased competitive tensions between supermarkets and traditional retailers in many countries. As explained, supermarkets are able to charge lower prices due to economies of scale. There have been two other major contributions to declining costs. First, as mentioned above, supermarkets are switching to own centralised distribution centres

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<sup>78</sup> Interview on 26/07/2015

<sup>79</sup> Interview on 29/07/2015

<sup>80</sup> Interview on 11/08/2015

instead of store-to-store procurement. Second, there has also been a shift from spot market procurement to procurement from dedicated specialised wholesalers as well as direct purchases from selected growers or grower associations. This has increased efficiencies and cut out wholesaler margins (Reardon and Hopkins, 2006).

Even for FVC, competing with the incumbent supermarkets on general grocery lines is difficult. FVC estimates that at the moment, its grocery line is only 10% of its business, with the majority of its offering being in fresh fruits and vegetables (45%<sup>81</sup>) and the rest split between other offering such as butchery, bakery etc. It is even more difficult for independent retailers and smaller supermarket chains to compete with incumbent supermarkets. However, independent retailers appear to be able to reduce these barriers of scale by partnering with buying groups as discussed later.

A number of business-related barriers to entry also exist for supermarkets and independent retailers alike. These include lack of skills and capabilities to produce **sustainable business models/plans** and manage **cash flow** effectively. In the experience of Retail Network Services, only 1 in 10 new business retail applicants are successful.<sup>82</sup> Cash flow management is a therefore a major problem for new entrants. Small retailers need substantial equity on hand as it usually takes 2-3 years to become profitable and retailers often incur large losses in the first couple of years. Poor planning and inadequate stocking of shelves can have devastating effects on the business.<sup>83</sup>

Banks in general prefer financing properties that have tenants which are **corporate**-owned as opposed to **franchise**-owned. This is because of the higher risk associated with franchisees.<sup>84</sup> This presents yet another barrier to small businesses that want to enter as franchisees. Corporate-owned stores have the advantage that they are able to trade on the margin or make losses for the first few years before they start making profit, while still being backed by the corporate, something that cannot be done by franchises.<sup>85</sup>

Another factor highlighted by interviewees on what is essential for the success of new grocery retail businesses is that the owners need to be actively involved in the day-to-day running of the business, and not outsource this essential function to non-owner managers.<sup>86</sup>

Structural barriers to entry can also be regulation-related. **Regulatory barriers** constitute laws, regulations or other requirements in line with industrial or other government policies. While regulatory barriers cut across structural and strategic barriers to entry, we assess them here under structural barriers. They are structural barriers in the sense that they are fixed and exogenous conditions encountered by every firm seeking to enter the industry. On the other hand, regulatory barriers can be classified as strategic barriers to entry when they can be manipulated by incumbent firms in their favour. This can be through lobbying and other forms of pressure on regulatory agencies. Regulatory restrictions although theoretically socially desirable can present significant barriers to entry for new competitors in the market (Kotsios, 2010).

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<sup>81</sup> This is the most profitable part of their business. Interview on 26/07/2015

<sup>82</sup> Interview on 11/06/2015

<sup>83</sup> Interview on 11/07/2015

<sup>84</sup> Interview on 12/07/2015

<sup>85</sup> Interview on 20/07/2015

<sup>86</sup> Interview on 11/06/2015

The most significant regulatory barriers in the supermarket industry are **food safety** legislations/regulations. Food safety regulations are measures imposed by law regarding different characteristics of a product including the conditions under which it is produced, stored, transported, maintained and consumed. Supermarkets unlike other (especially open-air or informal) markets are characterised by stringent quality and food safety standards and consistency requirements across all outlets (Kotsios, 2010). These requirements could potentially entail substantial investments in capital, infrastructure and new processes which are beyond the reach of new entrants and small players (Basker and Noel, 2013). These players may be pushed to operate in the less profitable informal markets with fewer regulations (Reardon and Berdegue, 2002). This is even more significant for fresh food products such as fruits, vegetables, seafood and meat. New entrants need to overcome such barriers by developing the capabilities to ensure safety of their food products in order to compete effectively in the market (Unnevehr, 2000).

In addition to food safety legislation, **food labelling and packaging regulations** are required to avoid false claims or false advertising and promote food safety. Every food product must be clearly labelled and all labelling should contain certain mandatory information and all claims on a product must be scientifically proven. However, this has the effect of increasing operating costs for retailers. Further, supermarkets need to standardise their products and in certain countries, this involves agricultural departments verifying such processes. Failure to meet these requirements means that a product may not get listed on supermarket shelves (in which case, this is also a barrier to entry for suppliers to supermarkets). These requirements however place more of a burden on suppliers than supermarkets.

In South Africa, aside from the standard regulations that affect all industries, such as labour regulation, the main specific regulations affecting supermarkets with regards to food products include the Foodstuffs, Cosmetics and Disinfectants Act, 1972 (Act No 54 of 1972), The Health Act, 1977 (Act No 63 of 1977) (which deals with issues of hygiene), general consumer protection legislation through the Consumer Protection Act as well as various legislations pertaining to standards (Global G.A.P, Local G.A.P etc.). These legislations deal with the conditions under which it is produced, packaged, labelled, stored, transported, maintained and consumed.

Retail premises need regular audits to ensure that such legislations are complied with. Particularly in South Africa, the inspection and audit function to ensure compliance with some of these standards is not undertaken by government, but by private parties. For instance, one company, Prokon, is said to be the only official assignee of the Department of Agriculture, Forestry and Fisheries to enforce the regulations applicable to the grading, packing and marking of potatoes for sale in South Africa in accordance with the Agricultural Products Standards Act.<sup>87</sup> Similarly, with regards to meat, South African Meat Industry Company (SAMIC) is the only quality assurance company which was created by the Red Meat Industry of South Africa to ensure the quality and safety of meat. The Department of Agriculture has appointed SAMIC for the classification and marking of meat intended for sale in the Republic of South Africa.<sup>88</sup> There have been concerns raised around the fees that such companies charge given that there are few or no other alternatives to undertake the services they provide

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<sup>87</sup> <http://www.prokonsa.co.za/About%20us.html>, accessed on 21/05/2015

<sup>88</sup>In accordance to the Agricultural Product Standards Act (no 119 of 1990) <http://www.samic.co.za/>, accessed on 27/05/2015

which is necessitated by legislation.<sup>89</sup> Other companies like Q-Pro South Africa appear to also offer food safety assessments. The alternatives available would have to be investigated further and are out of the scope of this case study. Again, such standard requirements appear to affect suppliers more than the supermarkets.

Notwithstanding the above, from the interviews conducted with supermarkets, it appears that the regulatory barriers are not prohibitively high in South Africa. FVC is of the view that the regulatory requirements, such as food safety and packaging/labelling, are not significant.<sup>90</sup> These were also the views of representatives of Woolworths and Pick n Pay. For supermarkets that have delis (where cooked food is served), regulations are more stringent. Other safety requirements that need to be adhered to include standard fire and first aid training,<sup>91</sup> and health and safety inspections. Supermarkets like SPAR, however, note that the legislations around liquor licences is a difficult area.

**Zoning regulations** by local authorities impose restrictions on the size and location of retail developments. Zoning restrictions are meant to reduce negative externalities such as congestion that comes with developments. According to the UK Competition Commission (2000), zoning restrictions can lessen competition in the grocery retail sector and increase barriers to entry.<sup>92</sup> This was more pronounced for supermarkets setting up one-stop stores requiring large sites in out-of-town locations. The Australian Competition and Consumer Commission (2011) concurs that local planning laws act as a barrier not only to the expansion of independent supermarkets by making it difficult to secure sites, but also by limiting opportunities for new supermarkets to establish within the same areas.<sup>93</sup>

These do not appear to be a major concerns to the supermarkets in South Africa. From the property developer's perspective however, there are a number of regulatory hurdles to overcome with regards to council approvals when it comes to construction of a shopping centre.

#### 4.2. Strategic barriers to entry

While structural barriers to entry make it difficult for new entrants, so does the strategic behaviour of incumbent firms that serve to keep new entrants out or to limit their growth. Such conduct reduces competition at a horizontal level ("**A**" in Figure 1). The types of strategic barriers to entry or exclusionary conduct in the supermarket industry can come in many forms.

A common competition concern in the supermarket industry in South Africa and internationally is that of incumbents entering into leases with property owners that contain exclusivity clauses in prime shopping locations (referred to as **exclusive leases** henceforth). This prevents new entrants from locating in lucrative retail spaces, limiting their ability to enter or expand. Attractive store sites are necessary if a new entrant is to become an effective competitor, and especially so in grocery retailing. Property developers provide supermarkets with store sites, with the most desirable sites being located inside a shopping mall/centre or close to the centre

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<sup>89</sup> Interview on 26/05/2015

<sup>90</sup> Interview on 26/07/2015

<sup>91</sup> Interview on 29/07/2015

<sup>92</sup> [http://webarchive.nationalarchives.gov.uk/+http://www.competition-commission.org.uk/rep\\_pub/reports/2000/446super.htm](http://webarchive.nationalarchives.gov.uk/+http://www.competition-commission.org.uk/rep_pub/reports/2000/446super.htm), accessed 29/06/2015

<sup>93</sup> <https://www.accc.gov.au/system/files/Grocery%20inquiry%20report%20-%20July%202008.pdf>, accessed 29/06/2015

where customer traffic is dense. The exclusivity clauses in leases signed between property developers and supermarkets (anchor tenants) grant them exclusive rights to operate as the sole supermarket or grocery retailer in the shopping centre. Property owners or landlords would then require permission from the incumbent if they wished to rent to other ancillary tenants who overlapped with the incumbent supermarket's offering.

Exclusivity can either be 'blanket' exclusion on all grocery retail offerings or on particular product lines (butchery, bakery, pharmacy etc.). Exclusivity clauses can also mandate that product lines cannot be greater than a stipulated size, for instance, a specialist butchery in a shopping mall cannot be in excess of 300-400m<sup>2</sup>.<sup>94</sup> With fewer competing supermarkets in a given location, customers are ultimately left with reduced choice in terms of product range, pricing and quality.

From the property owners' point of view, dominant incumbent supermarkets are 'must have' tenants to secure financing from the banks given the high footfall that they attract. Therefore they often accede to the demands of supermarkets, which can include exclusivity clauses in leases. From the anchor supermarket's point of view, the typical argument for exclusive leases is that they are crucial to the development of the mall and contribute to investments in the mall. Therefore the counterfactual is that property developers would not construct a mall in the first place without commitments from the supermarket. In addition, they argue that the exclusivity is needed to protect their investments. This highlights the strong bargaining position of anchor supermarkets.

Internationally, the Australian Competition and Consumer Commission's (ACCC) grocery inquiry has found exclusive leases to be an impediment to competition. It found that the major supermarket chains in Australia entered into leases with restrictive provisions to ensure that they maintained exclusive access to prime sites. Particularly, the ACCC found that such restrictive leases hindered entry of new and small supermarkets into local areas. The major supermarket chains argued that exclusivity was necessary to foster investment in densely populated urban areas. The ACCC however found that it was in fact still possible to enter and invest in metropolitan areas without exclusive leases. Given the possible procompetitive benefits of exclusive leases in terms of encouraging investments, the ACCC through advocacy efforts set out certain conditions under which exclusive leases could be entered into, included allowing exclusive leases in areas where there was still room for future growth and not in larger urban areas.<sup>95</sup> After the ACCC's intervention, some of the major supermarkets voluntarily undertook to phase out these provisions over a few years, and these undertakings were enforceable by law (OECD, 2013). Furthermore, all future lease agreements entered into would no longer have exclusivity clauses.<sup>96</sup> Similarly, the UK authorities investigated the potential anticompetitive impacts of exclusive leases. Out of 384 stores operating in highly concentrated markets, the Commission found that 30 existing exclusivity arrangements created barriers to entry. The Commission proposed a five year exclusivity limit for new shopping centres and the annulment of existing exclusivity arrangements after five years of their report being published.<sup>97</sup>

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<sup>94</sup> Interview on 21/09/2015

<sup>95</sup> <http://www.compcom.co.za/wp-content/uploads/2015/03/Competition-Commision-January-Newsletter-WEB.pdf>

<sup>96</sup> Ibid

<sup>97</sup> Ibid

### **Concerns around exclusivity clauses in lease agreements in South Africa**

The Competition Commission in June 2009 initiated an investigation against the major supermarket chains, Shoprite, Pick n Pay, Woolworths and Spar as well as wholesalers and hybrid stores - former Massmart and Metcash. In addition to allegations of abuse of buyer power, engaging in category management practices and information sharing, the Commission looked into the practice of supermarkets entering into long term exclusive leases.<sup>98</sup> Subsequent allegations around exclusive lease agreements between the major retailers and property developers were made by Fruit and Veg City (FVC), the A&M Hirsch Family Trust and Mr Ismail Ganchi of Aquarella Investments 437 (Pty) Limited.<sup>99</sup>

The Commission's investigations revealed the widespread existence of long-term exclusive lease agreements between food retailers and landlords. The Commission found that these had the potential of dampening competition because the anchor tenant was unlikely to approve entry of competing supermarkets or specialist stores like bakeries and butcheries. This leaves the anchor tenant as the only grocery retailer in the premises free from effective competition and customers are left with limited choice regarding product range, pricing and quality.

However, after investigating the complaint, the Commission concluded that there was insufficient evidence to prove that exclusive leases had the effect of substantially lessening competition. The Commission non-referred the allegations. This reflects the high threshold or burden of proof in the South African competition regime. Conduct that clearly has an exclusionary effect on competitors, and a distortionary effect on competition, is not sufficient to make a finding given the high standard of proof of anti-competitive effects on the consumer that is required by the law (or more accurately, the interpretation of the law by the courts).

The Commission instead engaged in softer, ongoing advocacy measures to deal with exclusive leases. The Commission took part in discussions with supermarkets, property developers and banks, recommending the use of long term exclusive lease agreements only in cases where the supermarkets can prove that they undertook substantial investments in certain shopping centres. The Commission also made recommendations on the duration of exclusivity granted. The Banks Association made a step towards addressing the issue by agreeing that the major banks no longer required exclusivity clauses in agreements between developers and anchor tenants before accessing funding.<sup>100</sup> However, as discussed later, it appears that the banks do not insist on exclusivity clauses in anchor tenant leases in any case.

Notwithstanding these passive undertakings, new complaints were lodged at the Commission from October 2013 onwards. These led to the Commission announcing that it would be re-opening investigations into such practices. In October 2013, Massstores (now Walmart) lodged a complaint against the exclusive lease agreement between Shoprite Checkers and Hyprop Investments for the Cape Gate Regional Centre in Cape Town. In September 2014, the South African Property Owners Association (SAPOA), filed complaints against Pick n Pay, Shoprite and SPAR for exclusive lease agreements in a number of shopping malls. The main

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<sup>98</sup>Competition Commission Media Release: Competition Commission findings of the supermarket industry probe, 27 January 2011. A number of similar allegations were made by relatively new entrant, Fruit and Veg City (FVC), the A&M Hirsch Family Trust and Mr. Ismail Ganchi of Aquarella Investments 437 (Pty) Limited. Source: <http://www.compcom.co.za/wp-content/uploads/2015/03/Competition-Commission-January-Newsletter-WEB.pdf>

<sup>99</sup> <http://www.compcom.co.za/wp-content/uploads/2015/03/Competition-Commission-January-Newsletter-WEB.pdf>

<sup>100</sup> <http://www.compcom.co.za/wp-content/uploads/2015/03/Competition-Commission-January-Newsletter-WEB.pdf>

concern was that as anchor tenants, Pick n Pay, Shoprite and SPAR were granted exclusive rights to trade as the only supermarkets in the premises and restricted entry of competing smaller and independent firms into the shopping malls. In October 2014, Massmart made the same complaint against the major retailers Pick n Pay, Shoprite and SPAR, following the difficulties that one of Massmart's subsidiaries, Game, is presently facing in locating in certain centres.<sup>101</sup>

Given these extensive complaints and other concerns in the grocery retail industry, following authorisation by the Economic Development Department Minister, the Commission on 13 May 2015 announced that it would undertake a market inquiry into the retail sector. Minister Patel announced that the inquiry would examine the tenancy arrangements in shopping malls, in addition to the growth of township enterprises such as spaza shops in order to ascertain whether the retail sector is competitive and inclusive. The inquiry would involve big supermarket chains, grocery stores and small retail outlets.<sup>102</sup>

According to a survey undertaken by SAPOA (one of the complainants mentioned above), in 2012,<sup>103</sup> 94% of the respondents (property owners) were of the view that they would prefer not to have exclusivity clauses in their leases for a range of reasons:

- It prevents the landlord from placing free-standing bakeries, butcheries or green grocers;
- It prevents the landlord from optimising the best tenant mix suited for the shopper coming to the centre;
- Exclusivity is only beneficial to the retailer and enforcement of the exclusivity is usually detrimental to tenant mix;
- The market has changed to the extent that consumers want to have the option of specialist retailers that offer greater product ranges. Exclusivity clauses prevent landlords from placing such specialist retailers;
- It prejudices the centre as a whole in terms of trading strength and expansion;
- It takes away owners' flexibility;
- Market changes bring new and unpredictable changes in formats, and exclusivity is not suitable for long-term value optimisation;
- Grocery anchor tenants change their product mix over the term of the lease (suggesting that blanket exclusivity clauses are not practical);
- Exclusivity limits competition and opportunity to expand;
- It limits independents coming in and forces them to pay higher rentals, and independents offer a variety of products and services which the nationals cannot always offer.

56% of the respondents agreed that exclusivity clauses had no benefit (presumably to property owners) and were actually detrimental to the management of their assets. Also according to

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<sup>101</sup> In the same period, Mr. SA Mahwiliri, a franchisee of Pick n Pay, laid a complaint against the manager of Kwa-Mhlanga Shopping Complex after he was refused retail space, allegedly following an order from Shoprite, the anchor tenant. Similarly in December 2014, Mr Hlope, a businessman operating a liquor store filed a complaint against the major retailers after he was also denied lettable space in malls.

<sup>102</sup> <http://www.bdlive.co.za/business/retail/2015/05/13/patel-gives-go-ahead-for-probe-of-fairness-in-retail-sector>

<sup>103</sup> 15 respondents were surveyed. SAPOA members control the bulk of South Africa's private sector commercial land and building stock, as well as managing the majority of property funds listed on the JSE.

SAPOA, the bargaining power rests with the large supermarkets, who often demand exclusivity.<sup>104</sup>

Property developers separately interviewed<sup>105</sup> have confirmed that it is not the banks that insist on exclusivity clauses in leases, but the supermarkets. Banks are mainly concerned about the number and types of lessees (for instance, they check how many key national retailers are present in a centre).

A range of factors appear to affect whether exclusive clauses in leases are insisted upon. These include size of shopping centre, whether the centre is a new or existing centre, whether the centre is in a rural or urban area or whether it is a corporate or franchise store, amongst others.

With regards to **shopping centre size**, in larger malls, there is usually space for more than one anchor tenant at different ends of the mall. Shopping centres of 12,000m<sup>2</sup> can usually only support one anchor tenant; centres of >25,000m<sup>2</sup> can support two and centres of >40,000m<sup>2</sup> can support up to three supermarkets. Exclusive leases are more likely to be insisted upon when the size of the centre is between 12,000 and 12,500m<sup>2</sup>.<sup>106</sup> Other estimates are that shopping centres between 14,000 and 20,000m<sup>2</sup> are where there are typically still fights around exclusivity.<sup>107</sup> According to the South African market classification of shopping centre size (Table 3), exclusive leases are likely to be more prevalent in neighborhood and community shopping centres.

**Table 3: Categorisation of size of shopping centre**

Super-regional	>100,000 <sup>2</sup>
Regional	50,000 - 100,000m <sup>2</sup>
Small regional	25,000 - 50,000m <sup>2</sup>
Community	12,000 - 25,000m <sup>2</sup>
Neighbourhood	5,000 - 12, 000m <sup>2</sup>

Source: *South African Property Owners Association, 2014*

Note that the term 'regional' in refers to the size of the shopping centre rather than the location.

A property developer provided an example where an initial property of 12,000m<sup>2</sup> was expanded to 25,000m<sup>2</sup> and it was of the opinion that another anchor tenant could be put in. The existing anchor tenant supermarket however did not easily agree to this.<sup>108</sup> Another property developer currently developing phase 2 of a mall was unable to place a second anchor tenant given the current exclusive lease with the incumbent anchor tenant. This prevented new entry in that mall.<sup>109</sup>

Negotiating leases is difficult in **new centres** as the dominant anchor tenant is critical in obtaining finance from banks. Property developers may end up allowing or giving in to

<sup>104</sup> Interview on 04/08/2015

<sup>105</sup> Interviews on 12/06/2015 and 20/07/2015

<sup>106</sup> Interview on 20/07/2015

<sup>107</sup> Interview on 12/06/2015

<sup>108</sup> Property developer has requested confidentiality.

<sup>109</sup> Property developer has requested confidentiality.

demands of exclusivity by major supermarkets just to kick-start the development process. Subsequently, property developers struggle to re-negotiate the terms of the leases. Exclusive leases therefore may be more prevalent in new centres where there is risk and uncertainty and where the anchor tenant seeks to protect his investment from competition. However, property owners and supermarkets interviewed also suggest that exclusivity clauses in leases were more prevalent historically, and that it was common practice in the grocery retail industry in South Africa for many years. Potentially given the increased attention by the Competition Commission around this practice recently, there is greater sensitivity around exclusive leases in new centres, while in existing centres the problem persists given that the leases were signed many years ago. In practice exclusive leases usually span for 10 years, but many leases can have up to five options for renewal for large supermarkets. This means that exclusivity for large supermarkets can span for over 30 years.<sup>110</sup> While exclusive leases might arguably be justified in the initial phases of the investment to allow the anchor supermarket to recoup its investment, gain footfall and establish a market, it is hard to see how such justifications can be reasonable for clauses that span several decades. This is especially the case if supermarkets are able to recoup their investments within a few years of establishment, which appears to be the case typically.<sup>111</sup>

It also appears that small property developers, particularly for developments in **rural areas**, who do not have bargaining power against major supermarkets are more inclined to succumb to entering into leases with exclusivity clauses to kick-start developments. Lack of competition has far reaching consequences in rural areas where pricing is a key factor for low-income consumers.<sup>112</sup> Further, small specialised businesses in rural areas like grocers, bakers, butchers, delicatessens etc. are prevented from locating in centres if there is exclusivity. A specialised butchery, Roots Butchery, has encountered such problems in rural areas. In the case of Roots, it is alleged that it started selling other grocery products such as canned food, dry grocery products, mealie meal etc. (over and above their butchery offering as per their lease agreement) and that the anchor supermarkets in the shopping centres have been unhappy about this.<sup>113</sup>

Models of retailing, whether **franchise** or **corporate**, also appear to impact on whether the supermarket insists on exclusive leases. It appears that in the case of franchise stores, individual store owners typically insist on exclusivity clauses in leases to protect his/her individual investment.<sup>114</sup> SPAR has existing exclusive lease agreements in place for some of its stores. According to SPAR, an individual owner typically invests around ZAR 5-10 million to set up the store and these owners often insist on exclusivity clauses in leases.

In general, as highlighted above, majority of the stakeholders interviewed suggested that the practice was more prevalent historically than it is now,<sup>115</sup> although it is still a concern as revealed by the number of complaints. The decline in prevalence might well be as a result of

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<sup>110</sup> Interview on 11/06/2015

<sup>111</sup> This was the view of most of the property developers interviewed.

<sup>112</sup> Interview on 21/09/2015, a property developer who predominantly develops shopping centres in rural areas.

<sup>113</sup> Interview with [Confidential]. [Confidential] further noted that the large anchor tenants also violate the terms of their contracts by encroaching into other product lines such as electronics that are outside their terms of the lease agreements.

<sup>114</sup> Interview on 11/08/2015

<sup>115</sup> This was the view of most of the property developers interviewed.

the increased attention by the Competition Commission in this area, but is also partially due to larger shopping centres being built and some of the other factors stated above.

According to FVC (one of the first supermarkets to complain about the conduct), the only shopping centre in which they faced concerns of exclusivity in its early years of operations was in Park Meadows near Eastgate. Pick n Pay allegedly had an exclusivity clause in their lease in this centre but ultimately did not enforce it when FVC took over Furniture City. FVC itself does not typically demand exclusivity from landlords as, in its view, it is not big enough (relative to Shoprite for instance) to demand this. FVC also appears to be of the view that this practice is less prevalent now, providing examples of malls, such as Menlyn Mall, in which Pick n Pay, Checkers and FVC are all near each other.<sup>116</sup> Other property developers also provided several examples of malls in which two or more supermarkets are present.

There is little doubt however that new entrants, independent retailers and specialist stores are disadvantaged in entering shopping centres. In addition to being riskier, smaller new entrants are uncertain traffic builders, resulting in landlords charging them higher rental rates even if they do manage to secure a lease in the premises. Moreover, securing a strong anchor tenant in the shopping centre determines the types of line stores<sup>117</sup> that will populate the centre and the rental that the landlord can extract from them. It is easier to extract higher rentals from ancillary line stores if the anchor store is a Shoprite for example, as opposed to a smaller store like a Choppies. Generally, prices charged per m<sup>2</sup> to all line tenants depend on the position of the store in the centre, the size of the mall, and its proximity to the anchor tenant.<sup>118</sup> Therefore the incentive is to secure large incumbents as anchor tenants, and this results in the exclusionary effects on new entrants.

Exclusive leases is not the only way through which dominant supermarkets can restrict access to lucrative geographic locations. Retailers can also control land or engage in '**land banking**' as a means of frustrating competitor entry. Such land banking includes purchasing or leasing land but delaying the development of sites into new stores. This is however a costly means of keeping new entrants out, and the UK Competition Commission concluded that the dominant UK grocery retailers did not hold undeveloped land as a strategy to impede the entry by rival grocery retailers into local markets (UK Competition Commission, 2008).

In South Africa, one property developer interviewed said that it was aware that Shoprite has done forms of 'land banking', although the interviewee was not able to provide any details. There have also been concerns expressed by new entrant Choppies that dominant supermarkets are engaging in such practices as a means of keeping it from expanding in southern Africa.<sup>119</sup>

Aside from entering into exclusive leases and land banking, incumbent supermarkets might engage in forms of **predatory pricing** to drive out the new entrant or affect its profitability. Predatory pricing refers to a situation where firms price below costs. Under the South African Competition Act, it is prohibited for a dominant firm to sell goods or services below their marginal or average variable cost if this conduct has an anti-competitive effect which is not outweighed by technological, efficiency or other pro-competitive gains. Specifically in the retail

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<sup>116</sup> Interview on 26/07/2015

<sup>117</sup> For instance, clothing stores like Edgars and Foschini

<sup>118</sup> Interview on 20/07/2015

<sup>119</sup> Interview on 5/06/2015

industry, predatory behaviour has taken the form of '**zone pricing**'. This is a practice by multi-store chain retail stores where prices are cut only in the geographic regions where the new entrant is located. This forces the new entrant to charge even lower prices in an effort to attract sales and in the process, the entrant sustains losses which could eventually lead to closure. The incumbent is able to engage in some degree of cross-subsidisation between stores in different regions to sustain this form of predation (Marion, 1984).

Also from the perspective of a horizontal lessening of competition, there have been concerns of **collusive conduct** in specific product ranges between supermarket chains. Collusive conduct also serves to create barriers to entry. In 2002 the UK's Office of Fair Trading (OFT) initiated an investigation into price fixing of processed dairy products by the major supermarkets in the country. Two supermarkets, Sainburys and Asda, were found to have engaged in fixing the price of milk, cheese and butter. This conduct is estimated to have cost consumers approximately GBP 270 million. There are ongoing investigations of price fixing against some of the UK's biggest supermarkets.<sup>120</sup>

There has been no suggestion of collusive conduct between supermarkets that has served to keep new entrants out from the interviews conducted. There has also been no suggestion of predatory or zone pricing from the interviews conducted. However, a full assessment of such conduct is out of the scope of this case study and no definitive conclusions can be reached in this regard without full investigations by competition authorities.

Although not the direct focus of this case study, with regards to other types of conduct which pertain to vertical relationships (**B** in Figure 1 above), there have again been several competition concerns internationally. Such practices stem from the considerable market power and buyer power of large supermarket chains. Such practices can affect competition at the various upstream levels (producers, manufacturers, processors - suppliers in general). However, such conduct can also affect the success of new entrants that compete with incumbent supermarkets as described below.

Supermarkets in both developed and developing countries are increasingly producing their own brands of food and household products (see OECD, 2013 for an account of the growth of private labels in European supermarkets). These **private label** brands are proving to be highly successful and fast sellers for supermarkets as they increasingly compete on price, value and quality, particularly for cost-conscious customers. Given the lack of branding and advertising for many of these products, their costs of sales are often lower than other well-known branded products. This has raised concerns for suppliers of branded products in instances where supermarkets favour their own private labels at the expense of theirs. It has also raised concerns around the bargaining power of retailers against branded manufacturers, and concerns around increased store loyalty for consumers. Further, there are concerns that private labels could potentially also lead to lower levels of innovation when brands are just copied. There is a horizontal element to private labels too as they are seen as a method by which retailers can differentiate themselves from other retailers. However the competitive impact of private labels is ambiguous. Mills (1995) suggests that private labels are welfare-enhancing as double mark-ups are eliminated and that the additional competition created between the brand and private label could lead to lower prices. But other studies suggest that private labels actually result in an increase in price of the branded product given a core base

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<sup>120</sup> <http://www.theguardian.com/business/2007/dec/08/supermarkets.asda>

of loyal customers for the branded product (Gabrielsen and Sørsgard, 2007, as cited in OECD, 2013).

There has indeed been growth in private label products in supermarket shelves in southern Africa. Every major supermarket chain has their own brand/label product. Shoprite has its 'Ritebrand' and 'Housebrand' in Checkers, which covers around 300 products.<sup>121</sup> Pick n Pay has its 'No Name' brand and they are looking to further expand their own label range. According to Pick n Pay, private labels are a way in which they can differentiate themselves. They also see this as a means of supporting small local suppliers. Food Lovers Market produces its own house brands 'Freshers' and 'Food Lovers Signature' for products such as toilet papers, tomato sauce etc. SPAR also has its own branded products. SPAR does not allow major suppliers like Tiger Brands to manufacture its own private label products, thus allowing smaller players to enter the supply chain. New entrant Choppies has over 50 of its own branded products, including food, beverages, household cleaning products and cosmetics and is increasing its private label offering.

Private or own label brands tend to perform better in that they have higher profit margins (given lower costs due no advertising and marketing margins added on by suppliers). However, new entrants may not be vertically integrated with manufacturers, or may not be able to launch their own label brand without first establishing a market presence and reputation. In this sense, private labels of incumbents may act as a barrier to entry.

However, private labels confer some bargaining power to supermarkets over large suppliers which may assist new entrants that have access to manufacturers. In some instances, brands are developed explicitly by the supermarket to provide it with leverage against dominant suppliers.<sup>122</sup> Further, private labels offer an opportunity for small suppliers to potentially enter supermarket value-chains.

Irrespective of development of private labels, South African supermarket chains both in South Africa and in the region have considerable market power. Market power refers to a situation where firms are able to act independently of their suppliers, customers and competitors in a market. Acting independently of suppliers can take the form of **buyer power**. This has led to concerns of the impact of the exertion of buyer power on upstream suppliers to supermarkets. Buyer power has been defined as:

*"...the situation which exists when a firm or a group of firms, either because it has a dominant position as a purchaser of a product or a service or because it has strategic or leverage advantages as a result of its size or other characteristics, is able to obtain from a supplier more favourable terms than those available to other buyers"* (OECD, 1981 cited in OECD, 2013:23);

*"a firm or group of firms obtain from suppliers more favourable terms than those available to other buyers or would otherwise be expected under normal competitive conditions"* (Dobson, Waterson and Chu, 1998:5)

Dominant supermarkets can exert buyer power by suppressing the price they pay to suppliers of products, imposing contract terms that suit them, requiring payments from suppliers in

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<sup>121</sup> <http://www.iol.co.za/business/news/more-private-labels-to-hit-shelves-1.1162970#.VffwNdKqpHw>, accessed 15/09/2015

<sup>122</sup> Interview with a freeze-dried coffee supplier to supermarkets, 22/07/2015

return for shelf space etc. At first glance, it may appear that buyer power serves to reduce the price paid by supermarkets to suppliers, thereby reducing costs. If such cost reductions are passed on to consumers, then consumer welfare is increased. Therefore buyer power may not be considered harmful to the end consumer.

However, buyer power can be harmful to the competition process if the intention of the dominant supermarket is to exclude its rivals from the industry. Several jurisdictions, such as Canada, the UK and Germany, view buyer power as a competition concern only if this is the intention (OECD, 2013).<sup>123</sup> This could occur if the dominant supermarket uses its buyer power to enter into exclusive agreements with key suppliers, preventing them from supplying 'must-have' products to rival supermarkets.<sup>124</sup>

FVC and Choppies have not alluded to such practices by the incumbent supermarkets that prevented it from accessing key suppliers. The supermarkets interviewed stated that they typically do have evergreen contracts with key suppliers, trading terms which are negotiated usually on an annual basis, but did not disclose if these were exclusive. It appears that exclusivity is usually with private label brand suppliers, particularly when the supermarket itself invests heavily in developing the supplier. This is usually the case with Woolworths, who invest significantly in developing their supplier base.

However, there is no doubt that the major supermarkets have considerable buyer power. Interviews with poultry producers for example (as part of the Agro-processing sector study) highlight that a very large proportion of chickens is sold to supermarkets, with Shoprite being a significant customer, and that supermarkets are able to influence pricing and terms of sale.<sup>125</sup> In addition, there were concerns raised that supermarkets engaged in bargaining games to depress the prices they pay to chicken suppliers, playing on the perishable nature of the product.

## **5. Barriers faced by independent retailers and how certain barriers have been alleviated**

As introduced in Section 2, independent retailers are a means by which consumers, particularly low income consumers, can access grocery retail products. The characteristics of independent retailers that appeal to consumers include lower prices, personalised customer service, availability of specialist products, location advantages and convenience.<sup>126</sup> As previously stated, independent retailers are usually low-margin businesses that have to closely manage overheads and other expenses (such as wastage and stock shrinkage).

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<sup>123</sup> The UK Competition Commission implemented the Groceries Supply Code of Practice (GSCOP), based on the existing Supermarkets Code of Practice (SCOP) to counter concerns of buyer power (UK Competition Commission, 2008).

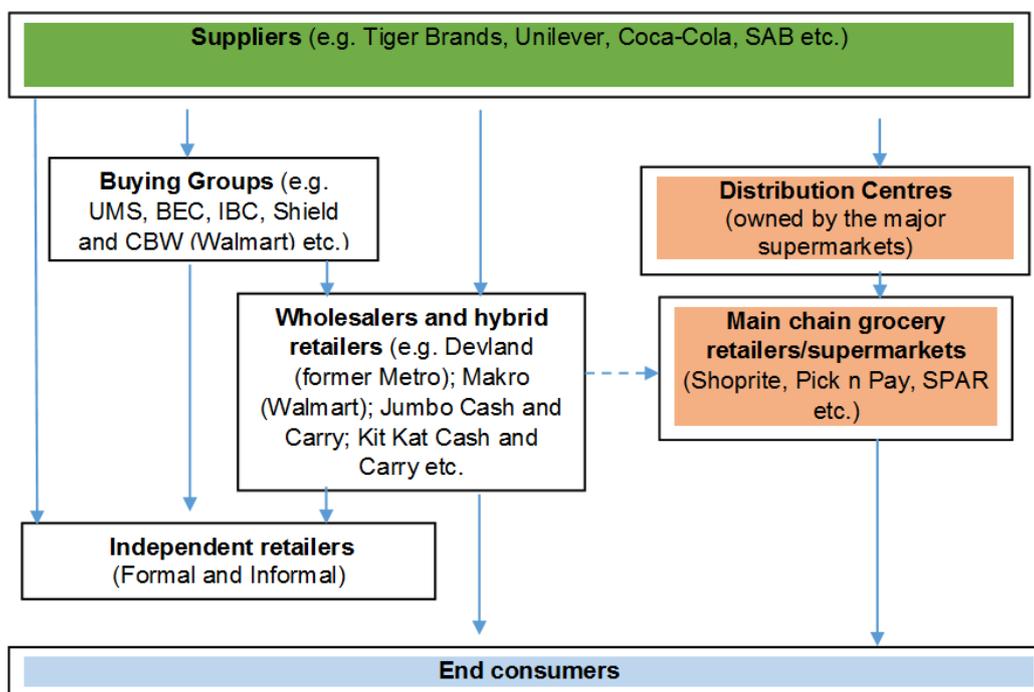
<sup>124</sup> Specific to the supermarket industry, abuse of buyer power can result in what is called the 'waterbed effect', where large retailers negotiate price reductions with suppliers that are not cost-related, and then the suppliers increase prices to smaller grocery retailers and wholesalers to compensate for this (Davis and Reilly, 2009).

<sup>125</sup> Interviews held with chicken producers highlighted this.

<sup>126</sup> Syndicate One (2011), 'Independent Food Retailers in the Republic of South Africa. Can they Ensure Sustainability in an Evolving Retail Landscape?' W&RSETA ILDP Programme 2011

Figure 5 below illustrates the different routes through which consumers can buy grocery retail products.

**Figure 5: Supply chain of grocery products**



Source: Adapted from Ravhugoni and Ngobese (2010); Masscash/Finro Tribunal decision Case No: 04/LM/Jan09

As can be seen, buying groups occupy a similar space for independent retailers in the supply chain as distribution centres do for the major supermarkets.<sup>127</sup> Buying groups provide a way new entrants to derive some of the benefits of distribution centres (including scale and scope) without the costly investment.

There have been concerns that independent retailers are declining in South Africa. Around 2009/2010, the Competition Commission evaluated a number of mergers in the independent wholesalers space, reflecting the degree of consolidation.<sup>128</sup> A concern raised through these mergers was that the independent food sector (both independent wholesale and retail) was under immense pressure from large chain retailers/supermarkets, leading to the closure of several such outlets. The Tribunal found that it was essential for independent wholesalers to procure products from suppliers at competitive prices if they wanted to remain competitive against supermarkets who were increasingly encroaching lower LSM consumer segments. As reflected in Section 2, major supermarkets are indeed moving into the townships and rural areas. Shoprite is doing so with its lower LSM targeting USave stores, while Pick n Pay has done so with its Boxer acquisition and Pick n Pay Family franchise model. SPAR is buying independent retailers and giving them the option to convert their store into SaveMor store formats.

<sup>127</sup> This was also highlighted by the Competition Tribunal in the Masscash/Finro merger.

<sup>128</sup> Masscash/Finro large merger, Tribunal Case NO: 04/LM/Jan09. See also <http://www.tradeintelligence.co.za/TradeProfiles/independentredirect.aspx>

There is very little research on the independent retailer market in South Africa. However, new trends are emerging which hint at a 'rebirth' of profitable and sustainable independent outlets in South Africa.<sup>129</sup> As described below, buying groups appear to be growing, indicating that the independent retailers they supply to are also growing. Sector research suggests that the 'share of basket' for independent retailers is also growing as is their turnover.<sup>130</sup> Recognised to be driven mainly by foreign owners and some younger South African business owners, independent retailers are allegedly becoming more profitable and sustainable.<sup>131</sup> Rough estimates are that independent retailers account for around 40% of the total food retail market, while formal chain supermarkets account for the balance in South Africa.<sup>132</sup> The outlook is that the segment is fast-growing given the large collective base of lower LSM consumers<sup>133</sup> The Competition Commission appears to still have concerns around this market segment nonetheless, and its recently announced a retail market inquiry mentioned above which looks into issues of foreign ownership amongst other concerns of competition and participation.<sup>134</sup>

In South Africa, the main independent buying groups are Unitrade Management Services (UMS), the Buying Exchange Company (BEC), the Independent Buying Consortium (IBC), the Independent Cash & Carry Group (ICC) and Elite Star Trading (EST). As Figure 5 above shows, buying groups can sell to both independent retailers and wholesalers.

**Unitrade Management Services (UMS) Limited**<sup>135</sup> operates in South Africa and in neighbouring southern African countries such as Botswana and Namibia.<sup>136</sup> UMS is looking to expand into Zimbabwe, Zambia and Mozambique via the same model. It buys on behalf of independent wholesalers and retailers, offering a broad range of products and professional services. Operating out of Gauteng (Northern division), Cape Town (Southern division) and Kwa-Zulu Natal (Coastal division), UMS supports independent stores that are 'housed' under one of three brands: Powertrade, Food Town and BestBuy. Members are store owners, independent wholesalers and independent retailers. According to UMS, many of their members are foreign (mainly Indian, Chinese and Pakistani-owned) and are largely run as family businesses. All the three brands cater for the lower income consumers mainly LSM 2-6, and on-sell to retailers who also target lower income end consumers. Independent retailers, like those under UMS member stores, offer a wide range of food and non-food products (although not as wide a range as traditional supermarkets). There are 42 stores under the Northern division, 22 stores in the Southern division and 26 stores in the Coastal division for the 3 brands collectively. They are therefore not insignificant and their growth is reflective of the growth of independent retailers. Typical Food Zone stores are depicted in Figure 6 below.

UMS negotiates with big suppliers on behalf of all its members in order to secure better pricing deals through buying in bulk. As a buying group, UMS makes its money from rebates from the large suppliers. Rebates are linked to the amount of stock/volume of sales. Large suppliers often do not deal directly with small, independent retailers. UMS therefore performs the role

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<sup>129</sup> <http://www.shoppingandretail.co.za/2014/June/IndependentOutlets.php>, accessed 10/09/2015

<sup>130</sup> <http://www.tradeintelligence.co.za/TradeProfiles/independentredirect.aspx>

<sup>131</sup> Ibid

<sup>132</sup> Interviews on 22/09/2015, 06/10/2015 and 06/10/2015

<sup>133</sup> Interviews on 22/09/2015 and 24/07/2015. This is also known as the 'Base of the pyramid' in developing countries.

<sup>134</sup> <http://www.bdlive.co.za/business/retail/2015/05/13/patel-gives-go-ahead-for-probe-of-fairness-in-retail-sector>

<sup>135</sup> Interview on 24/07/2015

<sup>136</sup> In Botswana, there are two groups: TransAfrica with 10 stores and Sefalana with 56 stores and still growing. In Namibia, there are 13 Metro stores under Sefalana and 21 stores under Independent Traders Namibia (ITN) and 18 stores under Ran Brothers who are independent wholesalers. UMS is the buying group for all of these players.

of a large buying intermediary which facilitates more favourable deals for independent retailers. UMS estimates that it accounts for a significant volume of sales from large suppliers.<sup>137</sup>

Given that UMS's business is a volume-driven business, it has an incentive to upskill and enhance capabilities of independent retailers so that they in turn sell greater volumes. This is precisely what UMS does. UMS provides marketing assistance to the independent retailers, integrated information technology, human resources assistance and training, merchandising and branding, knock and drop advertising, direct marketing and credit support. UMS also advertises on behalf of the retailers, including through printing leaflets and pamphlets. UMS further organises and promotes store competitions for retailers which increases footfall and sales. As highlighted above, advertising and marketing are major barriers for new entrants. UMS also provides training for the retailers at little/no cost to the independent retailer.

Similar to the role that UMS plays, the **Buying Exchange Company (BEC) Limited** was established in 1999 by a group of independent traders as a buying support group for both independent retailers and wholesalers.<sup>138</sup>The BEC trades under two separate trading divisions – Food Zone catering for the retail market and Trade Zone catering for the wholesale market (although the latter is no longer operational)<sup>139</sup> These operate in all the main hubs in South Africa as well as in Namibia and Botswana. The company aims to increase numbers '*rapidly in all provinces of South Africa.*'<sup>140</sup>

Individual owners own the Food Zone-branded store after paying a once-off fee of ZAR120,000 to the BEC, essentially a form of franchising.<sup>141</sup> In return, the BEC provides a range of services to the store such as centralised buying and access to all major suppliers; centralised accounts; assistance with store layouts; radio, television advertising, monthly promotions and on-going point of sale material etc. Continuous and in-house training is organised, contacted or provided directly by BEC. Training is also provided for new owners without any retail experience.

### Figure 6: Typical Food Town branded stores

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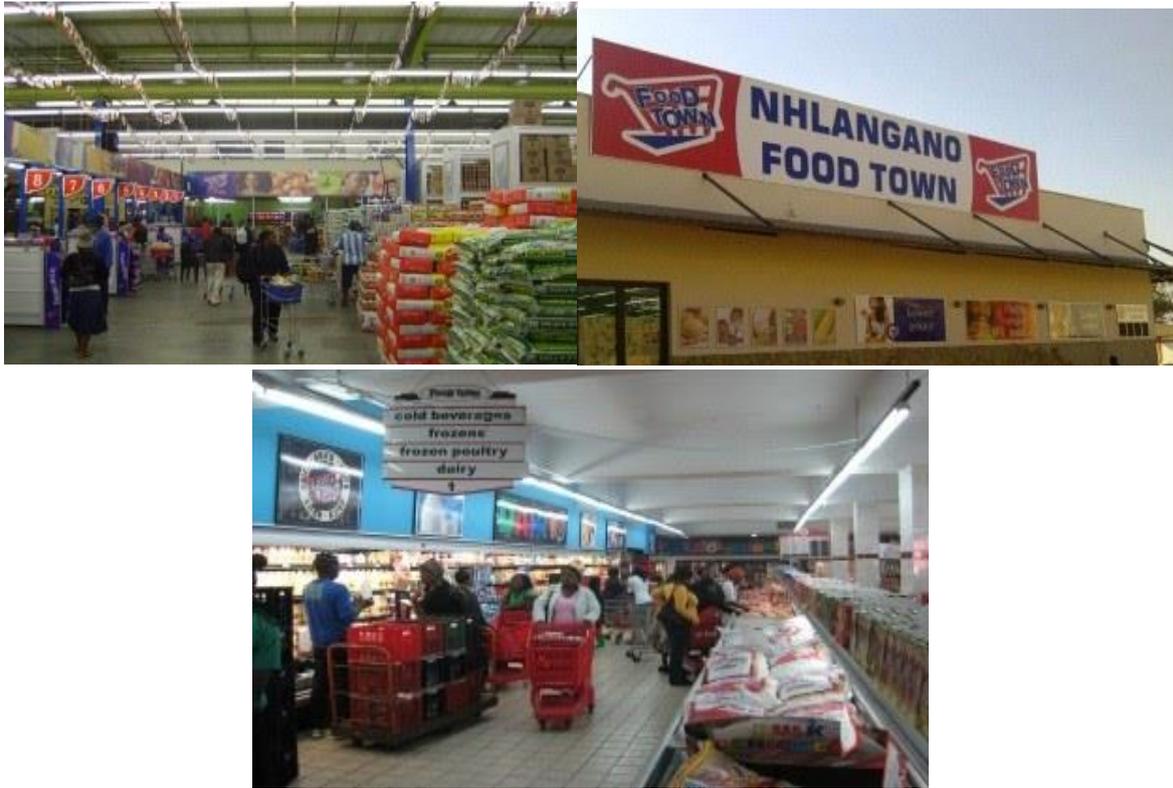
<sup>137</sup> It estimates that it is often the 3<sup>rd</sup> or 4<sup>th</sup> largest buyer in terms of volumes from many key suppliers. This has not been verified with the suppliers.

<sup>138</sup> <http://www.foodzone.co.za/background.html>

<sup>139</sup> Interview on 22/09/2015

<sup>140</sup> [http://www.foodzone.co.za/company\\_overview.html](http://www.foodzone.co.za/company_overview.html)

<sup>141</sup> This is unlike most franchising agreements where there is a monthly or % payment.



Source: UMS website

**Elite Star Trading**, like the above buying groups offer a range of services to their franchised independent retailers. They have around 149 stores in South Africa, as well as stores in Botswana and Namibia. Their bigger stores have their own warehousing facilities.<sup>142</sup>

Offering similar support to independent retailers is also the **ICC Buying Group**, a division of the Independent Cash & Carry Group. ICC is estimated to be one of the biggest buying groups in South Africa. ICC supports independent retailers under the Lifestyle brand, with stores including Lifestyle Supermarket, Lifestyle Express, Lifestyle Liquor and Lifestyle Hardware & Building Supplies. However, unlike the other buying groups, ICC does not merely just provide an intermediary or brokerage role between the supplier and the independent retailer, it actually has its own warehouses and a DC, in addition to its own transport fleet. ICC highlights that it has been growing at around 38% in the past few years.<sup>143</sup>

Another emerging trend is the move into retail by established wholesalers through the development of '**Hybrid**' formats. This enables wholesalers to compete for lower LSM customers with supermarkets and independent retailers.<sup>144</sup> As shown in Figure 5 above, wholesalers can sell directly to the end consumer through a hybrid offering or through independent retailers. In recent years, wholesalers have been re-positioning their businesses to target end customers directly.<sup>145</sup> They have added offerings that were typically seen in supermarkets, such as butcheries, bakeries, delis and fresh produce sections. This is a move away from their traditional focus on independent retailers only.

<sup>142</sup> Interview on 06/10/2015

<sup>143</sup> Interview on 06/10/2015

<sup>144</sup> <http://www.tradeintelligence.co.za/TradeProfiles/independentredirect.aspx>

<sup>145</sup> Interview on 24/07/2015

Cash and Carry's like **Devland** comprise hybrid stores and wholesale stores selling mainly to independent retailers. Devland also has operations in the southern African region, including in Zimbabwe, Zambia, Mozambique and the DRC. Although not yet on par with the incumbent supermarkets in terms of its retail offering, Devland has been able to penetrate the retail market using its strong wholesale background which allows it to leverage its buyer power from its wholesale operations to provide better prices in its retail offerings.

Notwithstanding the buying power benefits of buyer groups for independent retailing, the lack of a centralised warehousing and logistics system still appears to place buying group-run independent retailers at a disadvantage compared to buying for wholesale operations. This is illustrated in Table 4 below in a comparison of buying group-derived price benefits for independent retailers versus wholesale buying through a warehouse system (or DC equivalent). For the same volume of product from the same supplier, a wholesaler gets around a 9% greater discount off the price from the supplier than an independent retailer gets. This is purely because of the additional allowances/rebates given to wholesalers that have warehouse facilities or DCs, which independent retailers do not have. Further, large suppliers allegedly tend to favour formal supermarkets, and often give them better terms and prices than they give the buying groups, even for the same volume of product.<sup>146</sup>

**Table 4: Cost benefits to a wholesaler/DC vs independent retailer**

Typical trade agreement with suppliers for <b>independent retailers</b> (direct store delivery/own transport)	Typical trade agreement with suppliers for <b>wholesalers/DC</b> (delivery to warehouse)
Rebates (e.g. 6%)	Rebates (e.g. 6%)
+ Advertising allowance (e.g. 2%)	+ Advertising allowance (e.g. 2%)
+ Additional add spend (e.g. 1.5%)	+ Additional add spend (e.g. 1.5%)
+ Other incentives (loyalty/volume rebates)	+ Other incentives (loyalty/volume rebates)
	+ Distribution allowance
	+ Warehousing allowance
	+ Other discounts, like pallet discounts
<b>TOTAL discount off price: around 20%</b>	<b>TOTAL discount off price: 20% plus around 9% = 29%</b>

Source: Constructed from information from Interview on 22/09/15

## 6. Some conclusions

This case study has traced the growth of FVC in South Africa, highlighting its success through its flexible business model and diversification into different formats, LSMs and markets, including lucrative export markets. Its procurement strategy for fresh fruits and vegetables from municipal markets has conferred it a significant cost advantage (estimates suggest 20-25% lower prices than other supermarkets can get). Regular benchmarking with US'

<sup>146</sup> Interview on 06/10/2015

Wholefoods and partnership with UK's Waitrose has improved its offering and competitive standing against the incumbent supermarkets.

This case study has also highlighted the nature and types of structural and strategic barriers to entry that FVC faced, and any new entrant including independent retailers, typically face. The structural barriers to entry are largely a function of the inherent characteristics of supermarkets. The biggest of these barriers are the substantial investments required in distribution centres (and the associated economies of scale benefits) and significant advertising/promotions costs. Other major barriers for small players include access to finance, lack of business management skills and lack of capabilities. Regulatory barriers assessed however appear to not be a major concern.

A number of strategic barriers to entry were evaluated, the most prevalent being the conduct initially complained about by FVC around exclusive leases. While the practice is less prevalent in recent years (given increased awareness following the Competition Commission's intervention, larger sized shopping malls etc.), new entrants and specialist retailers particularly in smaller shopping centres in rural areas appear still to be affected. The numerous recent complaints lodged at the Competition Commission reflect this. Reducing such barriers to entry would require firm undertakings by the incumbent supermarkets to either not enter into such agreements at all, or reduce the duration of the exclusivity clauses. In turn, this would require stronger enforcement by the competition authorities (as opposed to just advocacy, which has not worked in the past in this case) grounded in a view that such conduct has a distortionary effect on competition.

The resurgence and growth of independent retailers, either on the back of strong buying groups or offshoots from wholesalers through hybrid models, was also highlighted in this case study. This reveals an interesting alternative model to traditional supermarket chains in South Africa for consumers, new entrants, and local suppliers alike. For low-income consumers, they offer a range of branded products as the supermarkets do, often at lower prices given the low overheads incurred. For new entrants, the buying groups or wholesalers can significantly reduce the main barriers to entry identified (scale and scope barriers; investment in distribution centres, advertising cost barriers; investing in building retailers' capabilities, etc.). For suppliers, independent retailers offer an important alternative route to market to traditional supermarkets. Supermarkets are increasingly imposing escalating standards and conditions on suppliers, and independent retailers' requirements are likely to be less onerous than those of supermarkets.

One way to encourage entry and participation in the grocery retail industry is to therefore support and grow independent retailers. Although barriers they face can be reduced through buying groups, the benefits of accessing distribution centres and logistics infrastructure are clear. Access to finance to construct such facilities either for buying groups or for independent retailers directly would afford them significant cost benefits from suppliers (see Table 4). Further, encouraging large suppliers to offer fair prices and terms of supply to independent retailers (equivalent to those offered to large formal supermarkets for the same volumes of product) would also benefit independent retailers.

There is also a role for public-private partnerships between government and private players (key suppliers, wholesalers and buying groups) to build capabilities of local independent

retailers in advertising, marketing, cash flow management etc.<sup>147</sup> Currently, wholesalers like Devland are of the view that a big information gap exists on local independent retailers, where there is a critical lack of even basic information on what they sell, what capabilities they need to compete, how such capabilities can be built and what the options are to access capital. Wholesalers and suppliers have an incentive (and the ability) to do develop the capabilities of independent retailers so that they can increase their sales through them. It would be useful to have long-term partnerships between them and independent retailers in this regard. While there are efforts to support township independent retailers, for instance, through the Gauteng Department of Economic Developments' planned R650-million cash injection into township economy following a deal with Massmart which would see 500 retail shops established to give township entrepreneurs ownership opportunities<sup>148</sup>, such initiatives are only likely to succeed if there is a transfer of knowledge and building of capabilities from the private sector to the retail outlets.

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<sup>147</sup> This was also the view of interviewees on 24/07/2015

<sup>148</sup> <http://www.engineeringnews.co.za/article/gauteng-economic-development-strikes-deal-with-massmart-to-uptake-township-economy-2015-06-23>. Also as part of Township Economic Revitalisation Strategy, a deal was struck with Pick n Pay to secure spaza shops foothold in its distribution channels.

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