International Food and Agribusiness
Management Review 3 (2000) 381–402

International Food and Agribusiness Management Review

E.D. Smith and Sons, Ltd.[1]

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Abstract

Lew Smith, the chairman of a privately owned Canadian processor, must decide whether his company will build a plant in the United States. He has been asked to do so by one of his major customers, Loblaw. The company has been making many improvements to its operations but it's performance has been hurt by the Free Trade Agreement between Canada and the United States. The company has been doing very well, however, as it shifts its focus from making private label to controlled label. Is now the right time to expand the business into a foreign market? © 2002 Elsevier Science Inc. All rights reserved.

Keywords: Free Trade; foreign market entry; food processing; food retailing; building capabilities; changing business scope

1. Introduction

Just before Llewellyn Smith hung up the phone, he said, "George, we really appreciate this terrific opportunity you are presenting us with and we will think about it carefully." It was November 3, 1992, and he had been talking to George Sulty of the Loblaw organization. George had called to again encourage E. D. Smith and Sons Ltd. (EDS), one of its Canadian suppliers, to open a plant in the United States (US). By doing so EDS would be able to supply the US licensees of Loblaw's merchandising program with products. Loblaw was a major Canadian food retailer which also owned a chain of supermarkets in the midwestern US. Loblaw, which had annual sales of over two billion dollars, was having great success licensing its "President's Choice" program to retailers across the US.

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[1] This case was prepared by Kenneth F. Harling, Wilfrid Laurier University, Waterloo, Ontario. Management at E.D. Smith and Sons Ltd. cooperated in the preparation of the case. Financial data for the company have been disguised to protect its confidentiality. © K.F. Harling 2001

PII: S1096-7508(01)00056-8

Llewellyn Smith, or Lew as he was known to friends, was chairman of E.D. Smith and Sons Ltd.. The family-owned company was located in Winona, Ontario, Canada. This town was just east of Hamilton and was on the edge of the “Niagara fruit belt,” so-called because of the tender fruits grown in the area. The company manufactured grocery products, specializing in pie fillings, jams, and sauces. In 1992 it had sales of $76 million, comprised mostly of products consumers bought either under EDS’s own brands or under the controlled labels of food retailers. The company had a reputation with consumers for the high quality of its products.

Lew was in a thoughtful mood as he leaned back in his chair and looked out his office window at the company’s red brick plant. It stood out in sharp contrast to gray of the Niagara Escarpment which loomed up behind it. He thought about the many changes made at the company since he had become its chairman in 1986. He wondered whether the company was ready for a new plant in the US and how well it would fit with the company’s evolving strategy.

2. History of the company

EDS had been founded by Ernest D’Israeli Smith in 1882. Each generation of the family since then had a son interested in carrying on the business. In 1983, Llewellyn S. Smith, 31 years old and the only son of Llewellyn Smith Sr., was appointed president of the company. His father, who had been president for 27 years, became chairman. Then in the summer of 1986, his father retired and Lew became chairman of the company.

In 1986 the company faced financial, marketing and management challenges. Financially the company was heavily levered with a debt to equity ratio of 2:1 and its assets were pledged as security for the debt. Much of the debt had been incurred so the company could buy the equity held by some family members. Company sales were stagnant though industry sales were growing at 2 percent per year. EDS’s core products were losing market share and tonnage shipped was decreasing. Meanwhile, costs were rising as a percent of sales. Lew expected marketing problems would become even more severe should the proposed Free Trade Agreement between Canada and the US be signed. Finally, management of the company was still adjusting to Lew’s management style following the retirement of his father, Llewellyn Sr. His father, who had been internally oriented, was a hands-on manager who knew everything that was going on in the company. His skills were complemented by a professional management team he had hired. Lew, on the other hand, was externally oriented. He had chosen to focus on strategy, leaving the daily operations of the business to those under him. He felt that things would go well as long as good people were in place and they were allowed to make decisions. He saw his role as supporting the management team in the decisions it made.

On taking over as chairman in the fall of 1986, Lew Smith and Richard Sexton put together a program to deal with the situation the business found itself in. Sexton, formerly a senior partner in Cooper and Lybrand’s Hamilton, Ontario office, had been hired as president when Lew was promoted to the chairmanship of EDS. The two examined the company in detail from an office they rented in Burlington. Then, working with the board of directors, they developed a plan of action with the overall thrust of "serving the customer."

3. Changes made between 1987 and 1992

Many changes were made under Lew and Richard's leadership between 1987 and 1992 as their plan was implemented. These changes repositioned the company in the grocery product manufacturing industry–the industry is described in the Appendix. Because the changes started in 1987, a year before the signing of the Free Trade Agreement (FTA) between Canada and the US, EDS was ahead of its competitors in making changes to deal with the effects of free trade. The company's success in adjusting to the changing environment are shown in the gross measures of EDS's performance (see Exhibit 1). Lew recalled the various functional changes that had been made.

3.1. Procurement

In 1987, 60 percent of EDS's sales revenue came from products made with agricultural produce grown in Ontario and sold to processors under conditions specified by the province's marketing boards– even fruits grown on EDS's 179 acre farm next to its plant were subject to these regulations. Forty percent of its sales revenue came from produce that EDS bought fresh. This produce had to be processed immediately on receipt because it was highly perishable.

By 1992, EDS dealt with no fresh produce and had leased its own farm to others. Instead, partially processed products such as tomato paste and preserved strawberries were bought from primary processors in Chile, Mexico and the US. Some of these products were bought under long-term contracts that committed EDS to buying from particular suppliers. In return these suppliers had built processing plants producing ingredients of the quality that EDS required. Other products were bought under arrangements that seemed most appropriate given market conditions.

Exhibit 1
Measures of change in E.D. Smith and Sons, Ltd, 1987–1992*

Year	Sales	Employees	
		Full time	Part time
	$Millions	Number	
1987	87	375	250
1988	85	240	314
1989	70	240	175
1990	60	165	107
1991	70	168	100
1992	76	200	15

3.2. Processing

EDS's principal processing steps were blending ingredients, cooking them, and then packing the cooked product in containers. These activities were conducted in 7 cooking areas and on 11 packing lines. All activities were housed in a 175,000 square foot plant which had the capacity to produce 5 million cases annually. A 225,000 square foot warehouse formed part of the processing complex.

In 1987, processing operations were spread over three stories in the plant. Processing was further complicated because several different product lines used the same pieces of equipment. Most of the equipment was antiquated and cooking was done in batches using open kettles. This equipment was fully employed during the three months of the harvest season when the plant operated with three shifts a day while the rest of the year it operated with only one shift a day. Labour needs during peak periods were met by hiring a large number of part-time workers (see Exhibit 1). Once processed, the products went into finished goods inventory from where they were drawn over the rest of the year. The average annual value of this inventory in 1987 was $19 million.

At the time, quality was defined by management and managers chose to make products that they considered to be of premium quality. Lew said that producing this quality was possible because workers approached their work as craftsmen. Many of the full time workers had a family tradition of working at EDS with several generations working there at any one time. Many of the part time workers were the children of these workers.

By 1992, the number of product lines, products and sizes of containers had been reduced. This allowed most processing lines to be relocated and reconfigured on a single floor in the plant. However the number of cooking areas and packing lines had been maintained so that EDS would have sufficient capacity to respond quickly to customer needs. The plant had also adopted year-round operations using two shifts a day.

EDS had upgraded its equipment, spending $6 million on state-of-the-art technology bought from manufacturers around the world. Specialized equipment was introduced as cooking areas and packing lines were dedicated to particular products. For example, a fully automated ketchup line had been installed. This line included a continuous flow, computer-controlled cooker which was connected directly to the packing line through a pipeline so that product flowed directly from cooking to packing. The controlling computer's software was

Exhibit 2
Changes in product lines, E.D. Smith and Sons, Ltd., 1987 and 1992

	1987		1992	
	Sales	Products	Sales	Products
	$Millions	Number	$Millions	Number
Blended fruits	31	300	41	250
Tomato based sauces	13	80	18	200
Specialty sauces	15	8	17	50
Pickles	25	60	—	—
Vegetable juices	3	6	—	—
Total	87	500	76	500

developed exclusively for EDS. This investment allowed EDS to produce a more consistent product, to produce a product which had better color and flavor, to reduce cooking times from 20 to 5 minutes, to increase yields, to speed up production, and to cut costs by eliminating 20 workers from the line. Another example of new technology was the incorporation of high-speed packing equipment on some lines. EDS's engineering costs and depreciation expenses were higher than those of its competitors because of the cost of setting up and running this equipment.

Operations had become focused on serving customers in four ways. First, a quality improvement process based on conformance to customer requirements had been introduced. This was a customized process based on Phil Crosby's approach to managing quality. Quality was specified as "conformance to requirements" and the cost of failing to meet these requirements indicated how far the company was from its quality goal. Second, all workers had been taught problem solving and given more responsibility to help them satisfy these requirements. Third, the company had adopted an aggressive approach to potential sources of customer dissatisfaction. For example, a customer had given EDS a recipe with a mistake in it. A plant worker caught the mistake but not before the product had been shipped. EDS immediately informed the customer, took back the product and reprocessed it. Fourth, the company had adopted a "can do" attitude. Lew commented, "Our goal is to meet all customer needs. We'll accept a customer order even before we have the necessary equipment because we're confident that we can meet their needs. By serving their needs, we build our capabilities."

3.3. Marketing

In 1987, EDS's five product lines (see Exhibit 2) were sold across Canada by a sales force of 40 representatives and in Newfoundland by a broker. EDS's major markets were Ontario and Quebec because most of its products were heavy relative to their value. All products were distributed to customers through EDS's own trucking fleet of 10 tractors and 6 trailers.

The sales force sold products carrying national brands and controlled labels. National brands accounted for seventy percent of the company's revenues. These brands included those it owned outright (E.D. Smith), those it owned for particular products (Stafford and SunRype) and finally those for which it held Canadian licenses (Lea & Perrins, and HP sauces). Sales representatives had considerable latitude when selling these brands to customers. This created considerable confusion in the company's billing department because representatives did not always inform head office of the deals they had struck. Management was trying to rectify this problem by installing Electronic Data Interchange (EDI) so customers could order directly from EDS using electronic methods. Controlled label products were sold according to standard industry practice. EDS had developed a range of recipes for key products it was prepared to manufacture and that it thought would sell. Its representatives approached customers with samples and asked them if they wanted to use one for their controlled label program. Some customers such as Loblaw insisted on an exclusive supply contract. In such cases, EDS would use the recipe to make product for only that customers. Other customers then had to select from the remaining recipes EDS was prepared to use to make product.

Table 1
Comparative prices and discounts for a standard unit of product

	EDS	NBM	CLM
Price	$1.12	$1.36	$1.05
Discounts and allowances	0.12	0.27	0.05
Net revenue	1.00	1.09	1.00

Marketing activities were supported by a corporate marketing staff of 20 people. This staff had been given numerous awards by advertising associations for the work it had done. In 1987 the staff had just finished a two-year study of consumers. Using the results of this study, a new line of E.D. Smith brand jams was launched in 1989. The program included new packaging, new labeling, a quality seal, a warranty statement on each container, and a redesigned corporate logo. Around the same time a television advertising campaign, featuring Lew Smith and promoting the company as Canadian and family-owned, was conducted in Ontario and Quebec.

By 1992 EDS's sales staff had been reduced to five sales representatives, three key account managers, and 20 part-time merchandisers while brokers were used in smaller markets. Nearly all ordering and billing was done electronically using EDI with terms of sales being agreed upon before product was shipped. Distribution of product had been outsourced too, but EDS still had two tractors and three trailers to expedite shipments and to pick up ingredients.

Two product lines had been sold off, leaving EDS with three lines: (1) blended fruit products which included jams, jellies, pie fillings and fruit toppings; (2) tomato-based sauces which included ketchup, and chili, pizza, spaghetti and salsa sauces; and (3) specialty sauces, which included meat and ethnic sauces. EDS maintained a product line of 500 different products over the period, though the composition of the product line had changed (Exhibit 2). The geographic distribution of sales had changed little over the period because EDS acquired brands that allowed it to maintain market presence in spite of the reduction in the number of product lines. For example, selling the vegetable juice business had severely

Exhibit 3
Changes in customers, E.D. Smith and Sons, Ltd., 1987 and 1992

	1987	1992
	Thousands of cases	
Grocery		
National brands	2,500	1,520
Controlled labels	700	1,380
Food service	900	550
Industrial	400	450
Mass merchandisers	—	60
Export	—	40
Total	4,500	4,000

Exhibit 4
Market shares in selected product lines in Canada, 1987 and 1992

	1987	1992
	Percent of total	
Pie filling—national		
E.D. Smith	45.	51.
Cobi	16.	14.
Culinar	14.	14.
SunRype	6.	*
Other	8.	10.
Controlled labels	11.	11.
Jam—Ontario		
Campbells**	6.	*
E.D. Smith	9.	15.
Kraft	18.	15.
Other	40.	36.
Controlled labels	27.	34.
Jam—Quebec		
Campbells**	19	*
E.D. Smith	1.	20.
Kraft	13.	14.
Culinar	25.	26.
Other	27.	17.
Controlled labels	15.	23.
Steak sauce—national		
HP	67.	70.
Heinz	17.	15.
A1	12.	13.
Other	4.	2.
Worcestershire—national		
Lea & Perrins	48.	48.
Heinz	40.	39.
Other	2.	3.

* Now part of E.D. Smith.
** Campbells Soup Co owned the Habitant and Laura Secord brands in 1987.
Source: Company records.

reduced EDS's presence in Quebec. EDS had regained it by buying two brand businesses which held significant market share in Quebec. The Laura Secord brand business was bought in 1989 and the Habitant brand business in 1990. These acquisitions also maintained plant volume.

Nationally branded product represented only 40 percent of EDS's sales by 1992. Management had found it much harder to grow the national brand business than the controlled label business. To Lew, the introduction of the new line of E.D. Smith jams illustrated the problem. Following initial success, EDS had been unable to sell the quantities it had hoped to at prices above those of other national brands. This limited its ability to promote the jams

Exhibit 5
Profit and loss statements for E.D. Smith and Sons, 1992 (in million of dollars)*

Revenue		89.1
Disc. and allow.		13.1
Net revenue		76.0
Cost of goods sold		
Labor	5.4	
Materials	23.3	
Packaging	21.7	
Other	4.6	
Total		55.0
Gross margin		21.0
Freight	4.6	
Marketing	4.6	
Res. and devel.	0.8	
Administration	6.2	
Depreciation	2.4	
Total		18.6
Net margin B.I.T.		2.4
Interest		0.8
Net margin B.T.		1.6

* The company's financial data have been disguised to protect its confidentiality.

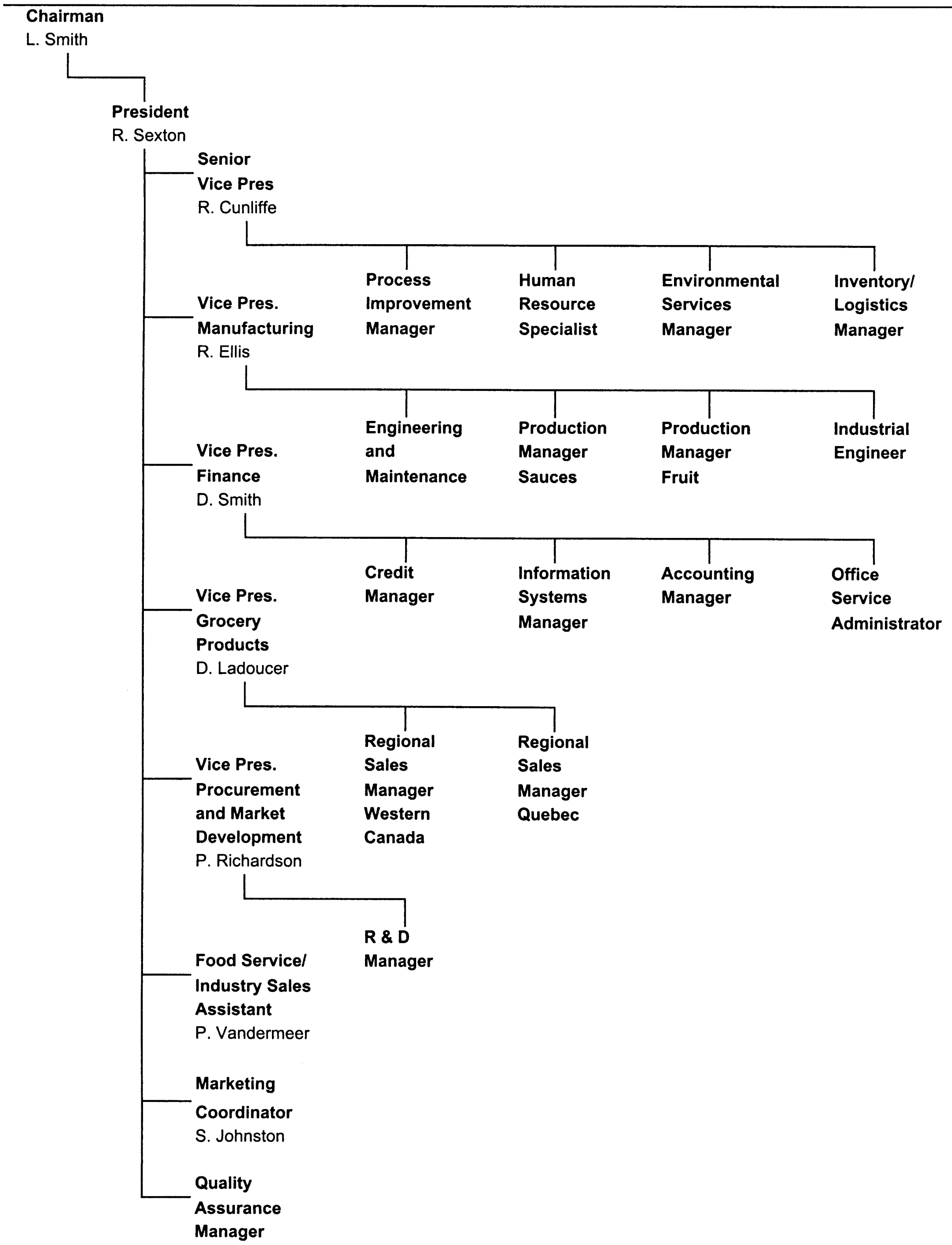
and pay retailers the fees they charged manufacturers when handling new product listings. Still, EDS was able to hold significant market share in the markets its brands served (Exhibit 3). Meanwhile volume in the controlled label business had grown considerably though the number of these customers was down. The customers were mostly food retailers who bought

Exhibit 6
Balance sheet for E.D. Smith and Sons, Ltd., 1992 (in millions of dollars)*

Assets		Liabilities and equity	
Current assets		Current liabilities	
Cash	1.1	Notes payable	4.3
Trade receivables	3.8	Current LTD	0.6
Inventory	6.3	Trade payables	3.5
Other	0.6	Income tax payable	0.2
Total current assets	11.8	*Other current liabilities*	1.8
Fixed assets	8.0	Total current liabilities	10.4
Intangibles	0.4	Long term debt	3.5
All other	1.0	Deferred taxes	0.4
Total assets	21.2	*All other liabilities*	0.4
		Total liabilities	14.7
		Net worth	6.5
		Total liabilities and net worth	21.2

* The company's financial data have been disguised to protect its confidentiality.

Exhibit 7: Organizational Chart of E.D. Smith and Sons, Ltd., 1991*



* Drawn from EDS's information system.

large volumes (Exhibit 4). One of the first had been Loblaw. EDS's success in making products sold under Loblaw's "President's Choice" label had increased its business with Loblaw to nearly $20 million and had also attracted other food retailers to the company.

The number of people employed in the marketing function had been reduced substantially, including the elimination of its internal marketing research capability. Lew explained, "A lot of marketing research is navel gazing. Now we learn what we need to know by talking with customers."

The result of EDS's marketing activities was that it offered products at an average list price between that of a National Brand Manufacturer (NBM) and that of a Controlled Label Manufacturer (CLM). See Table 1.

3.4. Research and development

EDS's management never believed the company's role was to pioneer basic research on food products–it relied on suppliers for that research. It chose to dedicate the company's resources to product development, thereby focusing on customers. In 1987, EDS had one food technologist and two technicians. By 1992, it had three food technologists and six technicians. This group was able to formulate a new product within a week and get it in production within one or two months. EDS's competitors took one or two months to formulate a new product and three to four months to get it into production.

3.5. Finance

In 1987, Lew Smith and Richard Sexton determined the financial resources the company would need to support their plans. To create the financial base needed, they cut the overhead burden and sold several associated business. Finished goods inventories were down by 40 percent with EDS's just-in-time manufacturing policy. By 1992, EDS's financial situation was much improved. EDS's financial statements for 1992 appear as Exhibits 5 and 6.

3.6. Administration

In 1987, Lew described the company as "bogged down in bureaucracy" and holding too many meetings. Administrative systems, especially for sales, were too rigid to deal with the flexibility allowed the employees.

By 1992, several administrative services had been out-sourced, the number of managers and secretaries had been pared down and the organization's structure reshaped to support the change in behavior. EDS's organizational chart for 1992 appears as Exhibit 7. The company had also invested $1 million in a computerized information system that was now essential to the way it operated. Virtually all EDS's information was on a centralized system that was accessible to employees through 105 terminals spread throughout EDS's facilities.

4. The US opportunity

Building a plant in the US was not a new thought to Lew. Lew made public comments about wanting EDS to be a North American company in 1988. He had held back from pursuing the US market until recently because of his concern about EDS's ability to compete. Now he felt the company had reached the point where it was ready to sell product in the US. Lew said,

> One of the best indicators of our readiness is our success with customers. We have not lost a customer in four years. We haven't lost a controlled label customer in 25 years and we're getting 90 percent of the bids we quote on. I could not think of a better test of our readiness to go into the US.

Lew also felt positive because executives with several retail customers, including A&P and Loblaw, were encouraging EDS to sell product in the US. They were familiar with the success of "premium" controlled brands in Canada and wanted to extend the concept into the US. Recently, Loblaw had arranged for seven US manufacturers to manufacture products carrying its "President's Choice" premium brand.

EDS started making sales calls in the US in the spring of 1992. By July, sales to customers in New York, Illinois, and Texas were generating 4 percent of EDS's sales revenue. All product sold to US customers was under controlled labels. Much more business appeared possible as many US retailers were approaching EDS for quotes. Said one employee, "The phones were ringing all day." Of particular interest was a request by Wal-Mart, a prominent mass merchandiser, for a quote on major quantities of product for its Sam's Club stores. A necessary condition for EDS to secure this business was that the products be made in the US.

Lew reflected on EDS's experiences so far, "US customers aren't the same as Canadian customers. They are price-oriented. Service and quality are secondary. If you want to compete, you have to be able to match market prices and these have been set already." Another feature of the US market was that, while the retail food business was nearly ten times larger ($211 billion versus $28 billion in 1989), there were proportionally fewer large chains in the US than in Canada. In the US market, chains with over 200 stores accounted for 44% of total sales while in Canada they accounted for 84%. Lew wondered if this would affect what customers wanted and limit potential.

EDS's principal US competitors appeared to be Redwing, a subsidiary of Rank-Hovis-McDougall, and Torbit and Castleman, a company owned by a venture capital group based in Seattle. Both companies were similar to EDS. They manufactured controlled labels; produced a similar line of products including ketchup, sauce, jam, and salad dressing; and were improving their product development capability. They were well entrenched in the US market and were well financed but neither was growing as fast as the market served.

Lew was now thinking about buying a plant in the southern US. This plant could be used to supply most of the US while the plant in Winona could supply Canada and the north-eastern US. He wanted a plant with two million cases capacity a year and room for further expansion. He thought that the plant could be tied into EDS's computerized information system and could use the same processing processes as EDS, but it would have to have different operating policies and separate financial statements.

Questions Lew had about the expansion were how much the company could afford to pay for a facility, and whether the company should be making such a commitment to controlled labels. Another concern was how to staff the new plant so that it did things the EDS way. In talking with fellow Canadian businessmen, he had heard that southern workers had a more relaxed attitude to work and often had limited work skills.

Appendix: Note on Canadian grocery products manufacturing

The manufacturers of grocery products focus on producing branded, packaged food products sold through retail establishments. The overall flow of grocery products is illustrated in Appendix Exhibit 1. This note describes the competitive forces affecting the profitability of the industry. Analysis of these forces is complicated by the food retailers' own strategic agenda which meant that retailers wanted brands they owned on products they sold. The consequence was two types of brands; brands owned by the manufacturers ("national brands" or "regional brands") and brands owned by wholesalers and retailers ("controlled labels"). Controlled labels could be further divided into three sub-types: "premium" brands which were superior in quality to national brands, "private" brands which were similar or somewhat lower in quality than national brands, and "generic" brands which were markedly lower in quality than national brands. All these products sat on the retailers' shelves, competing for the consumers' dollar.

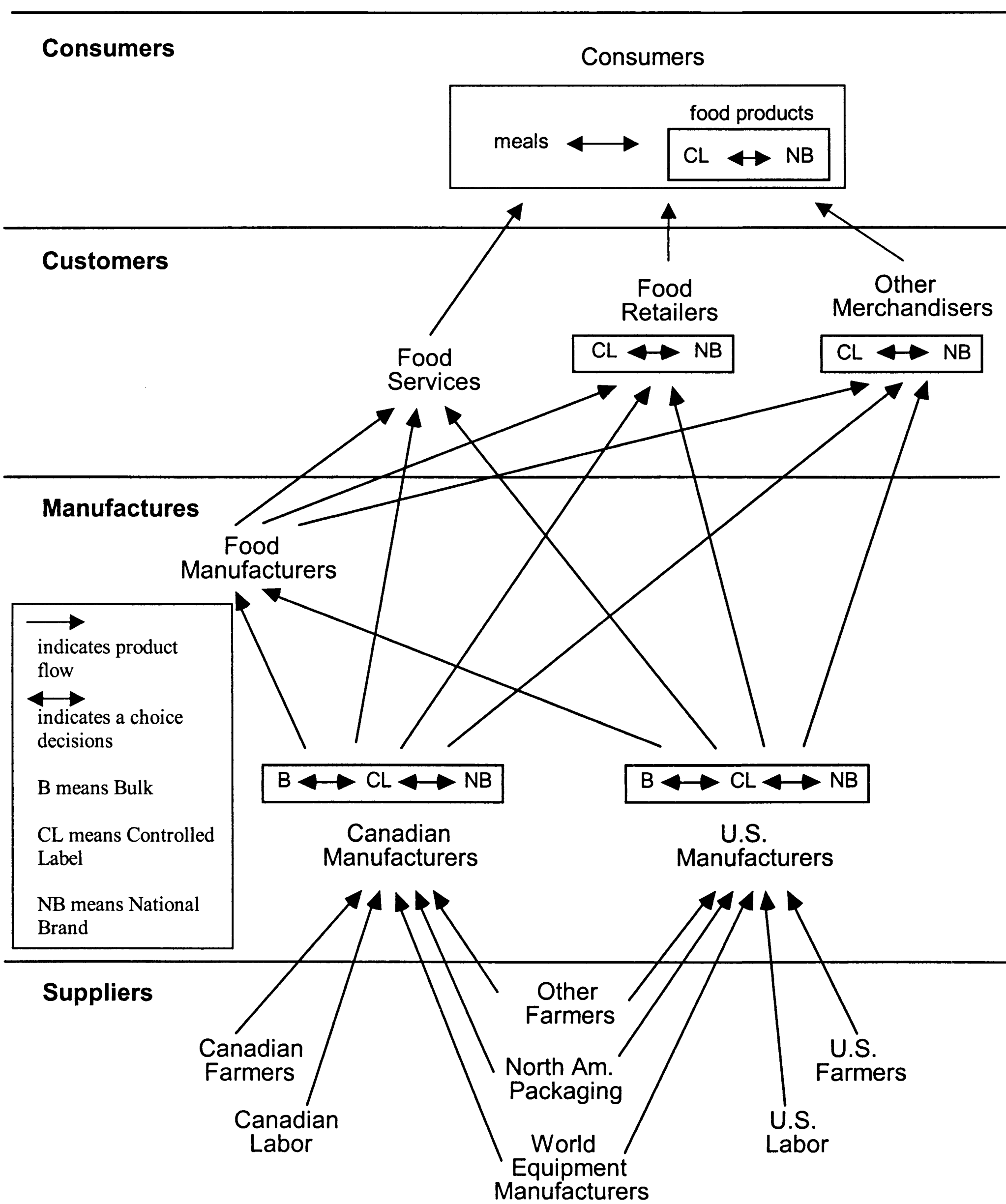
1. The competitors

In 1992 the Canadian grocery products industry was highly competitive with manufactures tending to focus on producing either "national brand" or "controlled label" products. Representative profit and loss statements for companies specializing in either type appear in Appendix Exhibit 2. For companies in the industry, the average ratio for sales to total assets was 2:1, the ratio for sales to net fixed assets was 8:1, and the ratio for sales to working capital was 12:1.

National Brand Manufacturers (NBMs) sought to dominate their chosen markets with their own brands. Most NBMs were divisions of large multi-nationals. They included Kraft General Foods Canada with sales of $1.6 billion and Heinz Co. of Canada with sales of $500 million. But there were also some large Canadian companies such as Culinar with sales of $600 million. Through the 1980s, many NBMs had increased their market shares through mergers and acquisitions. In addition, many multi-nationals with Canadian subsidiaries had taken their subsidiaries private by buying all their public shares.

NBMs marketed both to customers–wholesalers and retailers–and to consumers. Customers were encouraged to buy the product through various concessions that, in effect, lowered the price the manufacturer received below list prices. Their list prices were 30 percent higher than those of controlled label manufacturers. For example, the list price of a product from a controlled label manufacturer would be $1.05 while that of a similar product from an NBM would be $1.36. The actual price of nationally branded products was reduced, however, through the heavy allowances and discounts given to retailers–discounts given by NBMs were as much as five times greater than those given by CLMs. These discounts and allowances reduced the effective price difference between the two types of brands.

Appendix Exhibit 1
The Value Chain for Grocery Products



Appendix Exhibit 2
Comparison of profit and loss statements for a national brand and a controlled label manufacturer, 1992

	Common net revenue				Per unit costs			
	National brand manufacturer		Controlled label manufacturer		National brand manufacturer		Controlled label manufacturer	
	In percent				In cents per unit			
Revenue		125.0		105.0		136.5		105.0
Disc. and allow.		25.0		5.0		27.3		5.0
Net revenue		100.0		100.0		109.2		100.0
Cost of goods Sold								
Labor	8.2		9.5		9.0		9.5	
Materials	28.4		32.5		31.0		32.5	
Packaging	25.6		27.0		28.0		27.0	
Other	4.6		5.5		5.0		5.5	
Total		66.8		74.5		73.0		74.5
Gross margin		33.2		25.5		36.2		25.5
Freight	4.6		6.0		5.0		6.0	
Marketing	12.8		3.0		14.0		3.0	
R & D	0.9		0.5		1.0		0.5	
Administration	5.5		8.0		6.0		8.0	
Depreciation	1.8		2.0		2.0		2.0	
Total		25.6		19.5		28.0		19.5
Net margin BIAT		7.5		6.0		8.2		6.0
Interest		0.9		1.0		1.0		1.0
Net margin BT		6.6		5.0		7.2		5.0

Source: Industry personnel.

Consumers were encouraged to buy national brands through heavy advertising and promotion by the manufacturer. NBMs advertising heavily rarely lost market share; the losers tended to be those manufacturers which did not. In addition, NBMs used premium quality packaging to capture consumers' attention in the store. This was important given that 66 percent of consumers' purchases were unplanned.

The costs of NBMs were influenced by several factors. Building and maintaining brands was expensive, even for larger companies. Many NBMs were multi-nationals so were able to lower these costs by sharing activities and experience across various national markets. They also spent heavily on producing new products that matched changing consumer interests and that took advantage of technological innovation. They were able to ease the entry of their new products into the market by putting their well-known brand names on them. The volume produced by NBMs gave them a shipping advantage over smaller manufacturers; they could ship full truck loads of product to customers while smaller manufacturers could not.

Controlled Label Manufacturers (CLMs) worked to produce satisfactory products at the lowest possible cost. While their direct manufacturing costs were similar to those of NBMs,

Appendix Exhibit 3
Sales of food in Canada by type of retailer, 1989

	Chains	Independent	Total
	Millions of dollars		
Food stores			
Combination*	18,581	10,702	29,283
Grocery, confect. & sundries**	2,139	6,237	8,376
All other	337	2,823	3,136
Total	21,057	19,762	40,819
Department stores			339
Total food sales			41,158

* Supermarkets.
** Convenience and specialty stores.
Source: Statistics Canada.

their indirect costs were lower. How much lower particular costs were depended on how each company differentiated itself. Most differentiated themselves by specializing in a limited range of products. This, together with their smaller size, meant that many were not well known by potential customers. The CLMs often gained their credentials as a reputable manufacturer by producing products for a dominant and respected retailer. This created a relationship with the retailer that other retailers sometimes saw as an allegiance, discouraging them from buying from the particular manufacture because they "did not want to support someone who was working with a competitor." Another concern was whether a manufacturer would be able to supply the large volume needed by a retail food chain.

Occasionally the largest retailers and wholesalers manufactured their own controlled label products. In recent years, however, they had preferred to buy products from manufacturers. Retailing had become so competitive that retailers felt they needed all available funds to upgrade their own retailing operations.

A few companies sold national brands and also manufactured some controlled labels, such as E. D. Smith (EDS). Producing controlled labels helped cover overhead and provided a market for surplus product. Sometimes the only difference between the national brand and controlled label was the packaging. But for the manufacturer who tried to meet unique product specifications requested by the customer, manufacturing was more difficult. Some companies manufacturing controlled label products also sold products to NBMs.

2. Customers

Customers of grocery product manufacturers included retailers, food services and other manufacturers (See Appendix Exhibit 3). Analysts predicted that there would be fewer combination food stores in future because the industry was over-stored. Each market would be left with two or three retail food chains and fewer independents. The number of grocery, confectionery and sundries stores would also decline as combination stores lengthened their store hours. The biggest competitive challenge to combination stores appeared to be warehouse clubs.

Appendix Exhibit 4
Canadian sales by type of food stores by [rovince, 1991

	Chains*	Independents		Total
		Voluntary groups**	Unaffiliated	
	Millions of dollars			
Maritimes	2,545	796	724	4,065
Quebec	2,396	7,606	2,049	12,051
Ontario	9,066	4,281	1,116	14,463
Manitoba	1,170	261	178	1,609
Saskatchewan	767	405	160	1,332
Alberta	3,074	949	131	4,154
British Columbia	3,566	1,717	254	5,537
Total	22,584	16,015	4,612	43,211

* Four or more stores under a single owner.

** Independents (1–3 stores per owner) operating in a major or secondary way under a wholesale-sponsored program. Typically they shared a common banner with other independents.

Source: Canadian Grocer.

2.1. Food retailers

Food sales varied by province (See Appendix Exhibit 4) while within each province sales were dominated by a few chains which benefited from centralized buying and distribution (Appendix Exhibit 5). Each company sought to maximize volume by supplying multiple "banners." For example, George Weston and Co.'s retailing division, the Loblaw Companies., had stores in Ontario under the Ziggy's, Mr. Grocer, Fresh Mart, Value Mart, Fortino, Loblaw, and Zehr banners. The Great A&P Tea Company supplied stores under the A&P, Miracle, and Dominion banners. Each banner had a different marketing mix which appealed to a particular segment of consumers.

Food retailers sought to maximize sales dollars per linear foot by carefully controlling the 15,000 or so items carried in the standard supermarket. Point-of-sale terminals and products marked with universal product codes greatly assisted them in this effort. Any product that did not provide sufficient margin or sufficient turnover to generate the desired profit per linear foot of shelf space was soon replaced. This approach made it increasingly important that a new product be unique to be attractive to retailers.

In recent years, food retailers had become more reliant on price competition. This had made them increasingly sensitive to the cost of goods sold as their gross margin averaged 20 percent of sales and their net margin averaged only 1 percent of sales.

Retailers carried both national brands and controlled labels. Controlled labels were more important in Western Canada than in Ontario. They were also more important in Canada where they accounted for 20 percent of the grocery product sales than in the United States (US) where they accounted for only 14 percent. Their importance was increasing in both countries and was expected to grow faster in the US.

Appendix Exhibit 5
Provincial market shares of major food retailers, 1992

Company	Banners used/served	Mar.*	Que.	Ont.	Man.	Sas.	Alb.	B.C.
	Number	In percent						
Distributors								
Canada Safeway	2	–	–	–	33	19	28	20
Federated Co-ops	1	19	–	–	10	27	18	–
Great A&P Co.	3	–	–	18	–	–	–	–
Loblaw Cos.	11	18	–	25	21	30	12	9
Metro-Richelieu	5	–	33	9	–	–	–	–
Oshawa Group	6	10	13	10	5	7	11	3
Overwaitea	2	–	–	–	–	–	7	34
Provigo	2	–	23	–	–	–	–	–
Sobeys	2	35	–	–	–	–	–	–
Warehouse Clubs								
CostCo	1	–	–	–	4	4	6	4
Price Club	1	–	7	3	–	–	–	1
Other		18	24	35	27	15	18	27
Total		100	100	100	100	100	100	100

Source: Compiled from industry sources.
* Mar. means the Maritime provinces of New Brunswick, Prince Edward Island, Nova Scotia and Newfoundland.
"..'' means no market share in that area.

3. Use of national brands

Food retailers carried national brands because consumers expected stores to have them. Retailers did not feel obliged, though, to carry all national brands. Robert Chenaux of Loblaw said, "A retailer is only going to carry a national brand which is number one or two in market share for its product category." The decision about which national brands were stocked was tempered in several ways. Large retailers generally preferred to deal with a few large manufacturers who had full lines of products as this reduced transactions costs. Sometimes retailers would carry national brands with weaker market shares if their manufacturers were willing to make greater price and non-price concessions. The retailer gave the most significant national brand it carried in each product category the most and the best shelf space. The retailer's controlled label, if it had one, would be located close by.

Food retailers continually pressured NBMs for lower prices. If the manufacturers were unwilling to lower prices overall, retailers asked for products at low prices for approximately six promotions a year. Retailers typically overbought products at the promotional prices and later sold them at the regular prices. Industry sources estimated that 50 percent of the product retailers bought at promotional prices was later sold at regular retail prices. Retailers also tried to get as many non-price benefits as possible, including liberal delivery and return policies.

Food retailers charged NBMs for merchandising activities they performed for the national brands. For example, they charged manufacturers for in-store product displays when retailers allowed them and for placing product in superior shelf locations such as at the end of aisles. Retailers also charged manufacturers for the privilege of having the product included in the retailer's newspaper advertising. Furthermore, food chains typically charged NBMs a "slotting fee" of approximately $20,000 to add a new product to a store, though the fee varied depending on the bargaining power of the manufacturer. Some retailers also charged a failure fee if the product proved unsuccessful. Manufacturers treated these charges as allowances and discounts from sales revenue which had been valued at list prices.

Retailers' demands for benefits and allowances were offset by the manufacturers' own direct advertising and promotion. Retailers asked for fewer discounts the more a manufacturer spent on its own, promoting and advertising its national brand.

4. Use of controlled labels

Food retailers viewed controlled label and national brand products as substitutes. Typically the products were similar in quality but controlled label products were sold at lower prices. Retailers hoped that consumers would come to the store because of the national brands but, after comparing them with controlled labels, buy the latter. Retailers were able to sell controlled label products for less than national brands because the net wholesale price of national brand products was approximately 9 percent higher. Thus the net price of a similar product to the retailer would be $1.00 from the CLM and $1.09 from the NBM. This meant that retailers received higher margins on controlled label products and, if the consumer liked them, the controlled label developed consumer loyalty to the store.

The owner of the controlled label bore responsibility for product development, label design, product quality, and product promotion. Substantial volume was necessary to justify these activities. Those who lacked the volume needed to support these activities internally relied on manufacturers to perform them.

Over the past decade, retailers had tested alternative approaches to controlled labels. In the early 1980s generically labeled products of lower quality were offered at prices significantly lower than national brands. This approach had proved unsuccessful. More recently Loblaw Cos. had tried the premium label approach with its "President's Choice" label. Loblaw, through its Loblaws International Merchants Division, had developed a range of "President's Choice" products along with a merchandising program. The products carrying this label were superior in quality but sold at prices similar to national brands. By 1992 Loblaw was selling $750 million each year of "President's Choice" products. It had more than 1,000 of these products in Canada and half as many in the US. Other retailers were starting to copy Loblaw's premium label approach. Analysts expected that 1 or 2 chains in each market would successfully copy Loblaw's approach.

Loblaw had decided to build on its success in Canada and in the US Midwest where it owned the National Supermarkets. It started licensing US food retailers by geographic area to carry it products and use its merchandising program. By 1992 it had signed up Lucky Supermarkets in Southern California and Tom Thumb in Texas. The products that carried the "President's Choice" brand were made by grocery product manufacturers according to Loblaw's specifications. Under the licensing arrangement, however, manufacturers worked directly with the licensed retailers while Loblaw collected a fee on all the business. Loblaw's success in the US was intriguing because traditionally the controlled label customers there wanted generic copies of successful national brands.

4.1. Other retailers

Other retailers were selling more food products in order to maintain growth in maturing retail markets. These retailers included warehouse clubs (Price Club and Costco Wholesale), mass merchandisers (K Mart), and deep-discount drug chains. All were selling grocery products at prices below those of food retailers. Warehouse clubs appeared to offer the most serious competitive challenge to food retailers. In 1991 they accounted for only four percent of Canadian retail sales. In the US, where they had been established for five more years, they accounted for 14 percent. By the year 2000, 20 percent of US food sales were forecasted to go through these stores.

Warehouse clubs offered top selling national brands, on average 4,000 items, at lower prices per unit and sometimes in larger packs than traditionally available at food retailers. They used minimal promotion, relying instead on word of mouth. Warehouse clubs had annual sales of $1,000 per square foot versus food retailers sales of $450 per square foot but operated on a retail markup of only 10 percent. Food manufacturers anticipated that clubs would carry controlled labels as well as national brands in future.

The economics of warehouse stores were different than regular supermarkets because they operated differently. Their real estate costs were lower because they built their facilities on land zoned for industrial rather than retail use. They were able to do this because they were "clubs," limiting membership and charging each member an annual membership fee of $25. Their operating costs were lower, in part, because their stores were large (100,000 square feet), austere facilities in which they provided few services. In addition, they bought the merchandise they sold at low prices, typically paying "dead net" prices–prices which excluded all rebates, discounts, and allowances that manufacturers normally provided. Warehouse clubs tried to reduce price further by arguing that sales representatives did not have to call on them.

Food retailers were concerned by the growth of warehouse clubs. They felt that manufacturers were selling to clubs at "incremental prices." As a result, retailers commonly asked manufacturers to justify the prices retailers paid versus the prices clubs paid. If retailers were not convinced that manufacturers were practicing "fair" pricing, they could retaliate with actions ranging from reducing merchandising support to dropping the nationally branded product from their stores.

4.2. Food services

A great variety of food service businesses bought products from grocery product manufacturers. Some bought nationally branded products such as jam and butter in portion-packs so they could put the same brands in front of the customer that most bought for home consumption. These businesses also bought many controlled label products in larger containers or as unbranded product in bulk which were used in commercial kitchens. The smaller food services often bought from food wholesalers who provided credit and service. The larger food services, such as Pizza Hut and McDonalds, bought directly from processors and were more interested in low prices, product that met their specifications, and delivery when needed.

4.3. Food manufacturers

Large food manufacturers bought some products from specialized manufacturers. These products were usually bought in bulk and were then used in manufacturing value-added products (for example, jam was bought to be used as filling in pastry items). These manufacturers bought based on price and meeting specified quality requirements

5. Consumers

Consumers liked branded products because they were assured consistency in quality and value. But consumer preferences were changing in other respects. They were showing less loyalty to retail banners. They also wanted new and different products. This was reflected in their growing interest in ethnic foods, for example pasta and Mexican foods. In addition consumers wanted food products with fewer additives (preservatives, artificial flavors and colouring agents), less fat, less sodium, and fewer calories. Consumers also wanted more products compatible with their meal needs. This included products which could upgrade their home cooking, allowing them to substitute meals at home for meals out. Finally, they wanted products that made meals easier to prepare, serve and clean up after.

Consumers were showing increasing interest in prices as well, according to a survey done for the Canadian Grocer. Seventy two percent of consumers said price had become their most important consideration while 45 percent gave better prices as the reason they had switched stores. Manufacturers' perception of consumers' interest in prices was that they suffered from a "high price-high deal syndrome." Consumers, they said, expected to be able to buy major brands periodically on sale at significantly lower prices. They were less interested in every-day lower prices. A segment of consumers, though, was willing to pay higher prices for unique products of higher quality.

A recent phenomenon that concerned retailers was cross-border shopping. Many consumers were driving from Canada to the US to do their shopping because prices there were cheaper–a comparison of selected food prices appears in Appendix Exhibit 6. In 1992 the National Task Force on Cross Border Shopping reported that Canadian retail food prices were higher than in the US because of higher wholesale prices of food products entering the retail system rather than inefficiencies in the Canadian distribution system.

6. Suppliers

6.1. Inputs

Ontario food manufacturers bought most fruits and vegetables from Ontario farmers under conditions which were heavily influenced by marketing boards. These boards were legally

Appendix Exhibit 6
Comparison of prices for selected grocery products between Canada and the US, May 1991*

Product	In Canada	In the US
	In Canadian $s	
Basket of food items	225.55	202.65
Kraft Miracle Whip salad dressing	3.47	2.77
Heinz ketchup	3.41	2.59
Hunts Thick N Rich tomato sauce	1.93	1.48
Alymer whole tomatoes	1.63	1.46
Kraft strawberry jam	3.90	2.60

* US prices were converted at the prevailing rate of exchange, $1 US = $1.18 Canada. All appropriate taxes were included. Similar product sizes.

Source: A.C. Nielsen Co., *A Comparative Study of Grocery Prices in Canada and the US*, Prepared for Agriculture Canada, May 1991.

sanctioned by the provincial government to represent farmers and to help provide "orderly marketing" of their produce. Their views were facilitated by government regulations that restricted Ontario processors from importing foreign produce and that imposed tariffs on imported food products.

Under marketing boards, all farmers growing produce in Ontario received the same price. Each processors had to post a bond each year before the harvest to ensure that farmers would be paid for their produce if the processor was to have financial difficulties. Each processor also had to sign contracts with farmers in the spring of the year setting the amount of produce the processor would buy. Farmers had to be paid upon delivery of their produce to the plant. The net effect of marketing boards was that produce cost processors 15 percent more in Ontario than in the US.

Processors outside Canada were able to buy fruits and vegetables from farmers under more flexible terms of sale. This meant that processors elsewhere had to pay more attention to market conditions when buying. They could also buy in both the northern and southern hemisphere, getting a new crop every six months.

Canadian companies were able to buy sugar at the world price. This was as much as 50 percent below the price of sugar in the US. US manufacturers, however, were able to use sugar bought at world prices if the products made using it were exported.

6.2. Packaging

Manufacturers of grocery products used cans, plastic containers, glass jars and cardboard cartons. Canada had few manufacturers of these products because of strong competition from US manufacturers. As a result, prices were similar in both countries. The size of the customer influenced prices, with larger customers paying as much as 20 percent less than smaller customers.

6.3. Processing equipment

The industry producing food processing equipment was an international one in which few Canadian manufacturers competed. Developments in food processing technology were few and were usually developed by the equipment manufacturers. Once a new machine was developed, its manufacturer tried to sell it to food processors around the world. Ontario companies had ready access to this equipment and tariffs on it were waived if similar equipment was not made in Canada.

7. Impact of the free trade agreement

The industry's competitive situation changed following the signing by the Canadian and US governments of the Free Trade Agreement in 1988. Under this agreement, barriers restricting trade between the two countries were eliminated. Tariffs on finished goods were eliminated immediately while those on raw products were to be eliminated over 10 years. Immediately following the signing of the Agreement, many Canadian customers of Canadian manufacturers went to US manufacturers and got price quotes. Then they told their Canadian suppliers they would have to match the US prices (as much as 20 percent lower) or lose their business. Not all Canadian manufacturers were affected at least in the short run. Those unaffected either had licensing agreements for the Canadian market or had corporate product mandates for particular products and markets.

The change in the geographic boundaries of the market due to free trade had additional implications for manufacturers who had traditionally sold in only one of the countries or were multi-national corporations. Canadian companies who had sold across Canada found that their "national" brands were now regional brands in the North American context. Meanwhile, US manufacturers such as Knott and Smuckers who had never been in Canada started marketing there. They focused on the Toronto and Montreal markets because they did not want the expense or bother of launching brand names and building distribution across Canada. Finally, multi-national companies with operations in both countries rationalized production on a North American basis where economics favored doing so.

The ability of Canadian manufacturers to compete in the larger North American market was mixed. They did not appear to suffer significant cost disadvantage, though there were differences in costs. With respect to inputs, Canadian manufacturers continued paying higher prices for Ontario farm produce and the lower world price for sugar. Canadian manufacturers of some products with high sugar content obviously benefited because of their access to the US market. With respect to operating costs, the story was also a mixed one. Canadian plants had been built to supply the smaller Canadian market. This meant that, by US standards, they were smaller and more flexible because the production run for any product was much smaller. Consequently, they lacked the economies of scale of the large specialized plants common in the US but had costs advantages when producing the volumes required to satisfy niche markets in the US.