"Look Back in Anger

David Lang

Where Next For Baking ?

During May's Federation of Bakers graveyard spot I kept thinking I sounded like a broken record.

Each time I talk to the industry, I deliver the same 'End Is Nigh' sermon ... yet the world hasn't ended, the audience remains much the same, and it's always in rude health.

Perhaps I'd got it wrong and needed to think again.

So ... this time around ...I've taken a fresh look to see if I can see forward rather more clearly.

Cutting to the chase, my conclusion is that Toffler's right ... This Is The Future.

It exists and it's working

And it's still not too late to aboard.

To explain why, and how, I've set a three piece agenda.

First I'll try to explain why the

industry is still destroying value.

Second I'll talk about the big changes currently taking place.

Finally, I'll tell you where I think things are headed.

Are you sitting comfortably ? Then I'll begin...

1) Why Are Baking Returns So Bad ?

It's axiomatic that quoted companies return the average cost of capital.

Theory continues that profitability converges to the average.

Thus, extraordinary profitability attracts competition to drive down returns ... and as Groucho Marx once remarked... *'the*

opposite is also true'.

Where returns are below the cost of capital, market pressures drive them back up to the norm.

With plant baking, convergence theory just hasn't worked.

Life's a lot better than it was. As I just mentioned, however, profits remain below the cost of capital.

After deducting a charge for capital, last years economic loss was around £20m...much value is being destroyed.

Store minus £20m for later ... first let's look back a bit.

Plant Baking hasn't always been a graveyard.

When I started out, the major bakers prospered despite declining volumes and excess capacity.

Edward Heath's dash for growth put a stop to all that. Money supply explosion ushered-in hyper-inflation, hotly followed by price controls.

Crucially for baking, the arcane Price Code included a productivity deduction.

Companies could recover only half their increased wage costs in higher prices.

Integrated Miller Bakers, adapting to dramatically higher EC wheat, maxed flour prices to justify the biggest possible recovery of labour intensive bakery costs.

This helped create a structure similar to the Swedish paper industry of the time.

Expensive pulp, but cheap paper, diverted profits to the raw material end of the paper chain ... and the same thing happened in Milling & Baking.

With bread consumption headed remorselessly south, a vicious discount war raged. Already weakened financial results were made even worse by disastrous strikes.

The combination did for Spillers French.

Afterwards, independent bakers were encouraged to fill the vacuum ... but the economics remained the same.

Flour was ultra expensive and milling earned nearly all the industry's profit. Garry Weston explained that Milling & Baking was cyclical.

ABF attempted to exert market discipline.

Leadership, however, was usually undermined by independent expansion as profitability improved.

Periodically, Allied's patien snapped and discounts soar as it attempted to impose orde

Prompted by Mr Westor comments, I tried to track t. cycle. Sure enough, indust returns seemed to have a natui rhythm.

Sometimes, the downward 1 ended in a major bust li Spillers or Pridays. Sometime things eased back into balan through attrition.

Some of the cyclical uptur were impressive ...particular the 1983-9 boom whip coincided with a good time f food chain profits generally.

Others were short and brutish like post Spillers 79/80.

The upshot's been the weo evidence of convergence theoi mentioned earlier.

Almost always, Milling & Bakin returns have undershot the ca of capital ... with Wrapped Brea permanently EVA negative.

Fundamental reasons for th disappointing picture aren hard to find.

Viewed against Porter's Fi~ Forces Competitive Frameworl the structure is badly flawed with fragmentation overcapacity, very strop; customers, low barriers to entry and high exit costs.

Moreover, the industry's eith been privately owned ... or ne to it. As a result stock mar discipline, which typically driv convergence, has been in sho supply.

So what's different now?

2) What's Changing

While the financial picture has been evil ... it's not set in stone. And, as I said at the start, there are opportunities to get out from under.

I'll come to those later ... first let's look at three drivers of fundamental change ... starting with Bread.

The 1980's food industry profits boom, was brought to an abrupt halt by 1990's disinflation.

In the UK, the catalyst was hard discounter arrival and belated supermarket retaliation.

British Bakeries ... which had been selling share to salt profits ... was lured into the fray in Autumn 1991.

Prices began to melt.

To bash the discount chains, top line supermarkets were busy displacing manufacturer brands with value bread.

Pride.

And Warburtons was going from strength to strength.

So while the chains were degrading wrapped bread, consumers were showing a fresh appetite for quality, variety and innovation ... an encouraging trend confirmed by double digit Breads Of The World growth.

VD day ... or victory over the hard discounters...came in 1996

For bread, however, the win was Pyrrhic with values continuing to decline despite a new upscale brand emphasis, and the gradual withdrawal of the value-brand hypodermic.

Eventually, Wal-Mart got stuck in ... new alliances were established, category management started to bloom, and the tide began to turn.

Bread brands flourished, while own label slumped into doubledigit free fall.

franchise ... my second major structural change driver.

You'll remember the Price Code shifted integrated company profits from bread to flour. Milling insulation was reinforced by abstinence from supermarket buyer intercourse. Coke does the same with its bottlers.

Not surprisingly, independent millers ... sometimes operating at below 100 hours a week ... were happy enough to go along with the deal, and to take their pricing cue from Allied.

The problem was Harry Kear had other ideas. In 1987/8 he got Pridays to break ranks.

The initial beachead was repulsed when Priday folded after Black Wednesday. A second more durable attempt followed, however, and Finedon's resurrection scuppered ABF's 1995 leadership initiative.

Sales began to drop at 5% a year, and more than £250m was wiped off wrapped bread market value.

Almost the entire value chain's profits were excised ... from the farm gate to the checkout and nearly all stops in between.

All that remained in surplus was ring fenced milling ... and the private label specialists who were making hay.

For brands, the paradox was that new upscale Kingsmill and Hovis were starting to replace devalued Sunblest and Mother's

We aren't privy to retailer DPP information.

Rudimentary back'oth'fag packet sums, however, suggest that supermarket branded bread profitability has been transformed.

Current branded fixture operating margins could be in the mid teens....five years back we doubt the number was much better than break-even.

Supermarket branded bread profit restoration, has been accompanied by the demise of the flour

Subsequent market pressures have forced Rank and Allied to bring flour transfer pricing into line with a dramatically lower free market price.

The effect has been to reduce the milling industry to primary processor commodity status...and to create a more even distribution of Milling & Baking earnings

Reflecting permanent change, Allied bagged RHM's long term Milling & Baking blueprint and sold its free market business to ADM. The new independent leader has a clear appetite for more mills.

That's another story ... suffice to repeat that, the last five years have seen flour milling change out of all recognition.

Rationalisation has brought capacity more or less into balance.

Over time industry should start to earn its cost of capital. Anything more than that seems doubtful given the danger of capacity creep ... or, worse still... sucking in marginally costed imports.

What is patently clear is that the franchise system is over for good.

Finally, there's been massive bakery rationalisation ...my third major dynamic.

The UK motorway network may be a pain ... but roads are still light years ahead of the 1960's. The result is you don't need three bakeries in every centre of population and there's been severe contraction.

Bakery operating hours increased hand in hand with the closures ... culminating in an effective move to 24/7 after Sunday opening.

Rationalisation has seen a 35 year drop in the total number of UK bakeries from 230 to 56.

A vast amount of slack capacity has been taken up ... a little more remains to go... but perhaps the effective surplus is now down to around 10,000 sacks.

The result has been that Baking Industry efficiency has improved out of all recognition ... especially at lagging Allied.

Together with the other major change drivers...

- excellent brand growth

- permanently lower flour prices

The combination has transformed wrapped bread profits which are now worth more than three times my 1997/8 estimate.

Along the way, value has shifted from grain procurement and processing through baking to the supermarket companies and consumers who are getting better value ... in the broadest sense... than ever before.

While baking's doing better, however, those awake at the start will recall that the industry still doesn t cover its cost of capital.

Industry economic profit is concentrated in the brands ... or, more particularly, in one major brand. The contrast with loss making Private Label baking couldn't be starker.

The deficit poses serious questions for hybrid Allied and BB.

I'll deal with that issue in my conclusion ... first I'll give you a bit longer to puzzle out the chart.

3) **Where's It** All **Headed**

Like professional soccer players, stockbrokers aren't famous for reading books.

I read occasionally ... but prefer it if you don't mention to any of my colleagues back at Investec.

BTAIM, to suss the compal follow, I dip into the work c management gurus who with them.

Apart from Porter, this m involves McKinseyite toms stuff from Stern Ste' Marakon etc.

Generally, the argument's whether it's the wicket, o the batsman that matters most

On one hand there's Porter, reckons that returns are all with the state of the pitch, that structure is paramount

On the other ... there's Resourced-Based theory o: Prahalad and Gary H which says profit's all to do internally based **Competences.**

Either way, markets discussed like a war zone.

Companies are in life and (zero-sum, struggles with competitors, customers, suppliers.

That's the way that I've t(to look at Milling & Baking

Expecting private label ca excess to reach br(point... anticipating increase failure ... and wait an event to turn things are

As I said at the start. moved on.

Rather more powerful

might be at work than those simply explained by opposing Porter and Prahalad & Hamel theories.

The thought came to me while I was re-reading Arnoldo Hax's Delta Project in a new attempt to work out where Unilever's going.

Hax doesn't refute Porter or Prahalad & Hamel. Instead, he builds on their analysis to illustrate the growing importance of network.

In effect Hax says it's not just the pitch and the team that dictate success, it's the entire system ... including the, the umpires, the spectators and the sandwich makers.

Creating a network that harnesses the expertise, creativity and capital of partners in a total bonded system, is what makes all the difference.

Hax uses a Pyramid ... or Delta symbol... to illustrate the existence of three distinct competitive positionings:

i) **Best Product:** Where competition is based on a product mind set ... either low cost or differentiated. Here the focus is internal and on the company's competitors. **With BP price is key, and business is war. relationships. With TCS, business is love.**

iii) **System Lock-In:** Where competition is based on total system economics. Here customers remain central but external complementors come into the extended value chain. **With SLI, bonding locks in the customer and locks out the competitor.**

It's a moat and drawbridge approach... Walls had it, Coke has it, and mighty Microsoft is defending it for all it's worth.

With SLI business is secure and highly profitable.

The next chart shows returns increase as you progress around the triangle and bonding increases.

Fundamentally, Hax reckons that **Best Product** companies inhabit a winner takes all, smokestack time-warp.

By contrast **Total Customer Solutions** create a positive feed back loop to reinforce success and provide a springboard to increase bonding towards the holy grail of System **Lock-In.**

To get a feel of how all this applies to a consumer products company, read P&G's Annual Report about its Market Development Organisation.

With 18% of its sales from WalMart, Procter indexes way above share in the US's biggest retailer ... check out its 27th October Q2 results to see the benefit

The Delta Project could start to explain what's going on in bread.

Branders are winning, because they provide **Total Customer Solutions.**

Wrapped bread volumes are in gentle decline, so the only way for supermarkets to grow profits is through margin. Brands provide this through premium pricing, consumer relevant innovation and high service levels.

My earlier ABC pot shot shows that branded wrapped bread growth, innovation and pricing power has transformed fixture profitability.

The more brands displace value bread and private label, the better for supermarket earnings.

It's a virtuous circle.

Meanwhile, branders are gearing to harness complimentor expertise and cash.

Part of Warburtori s success is its use of outside milling expertise.

ii) **Total Customer Solutions:** Where competition on based on **customer** economics. Here the aim is to reduce customer costs or increase their profits. The strategic focus is outward with deep understanding of customers and supplier

Procter was one of the first to camp next to Wal-Mart's Bentonville HQ and it introduced EDLP dozen years ago. P&G has a 300 strong global team working on the account ... with 200 stationed in Arkansas alone.

ABF has added flour to its existing world class ADM oil refining partnership.

Once it's comfortable, it wouldn't surprise us if it reduces vertical integration further. 1

With distribution... the second biggest cost item ...BB's Dagenham RDC is finally playing out of its socks. It was bound to take time to bed down ... but now it's a template for revolution.

And if RHM doesn't push ahead nation-wide, someone else will bag its plan ...the prize looks too big to miss.

Finally, co-packing could become a long term competitive strategy rather than a short term expedient.

Like Allied pulling out of flour completely, and outsourced distribution, contract baking might seem far-fetched.

Take a look, however, at what's going on elsewhere in fmcg.

Co-packing is a great way to benchmark costs and quality, and to reduce risk and investment levels.

But while many of the likely components needed to create bonded **SLI Baking** already exist ... the bakery network of the future is still a long way from creation.

More immediately, there's still a lot of sunk capital ... fixed, working and emotional, locked up in Best Product strategies. Unfinished business remains to be dealt with the time honoured body count.

For a read of how things might turn out here, compare two versions of UK market share.

The first shows unprofitable Private Label as a clear No 1, with British Bakeries brands second, Allied third and with Warburtons a distant fourth.

Next take a look at life where Warburton competes. Here the brands at one, two and three, with private label fourth and the rest too small to mention.

Warburtons' clear lead is Total Customer Solutions based. It provides retailers with the highest margin and asset turnover, backed by excellent quality, innovation, consumer connection and near perfect service levels.

For Hovis and Kingsmill the threat couldn't be plainer.

If Warburton repeats in Southern England what it's achieved up North, there will be a radical real estate change.

Branded bread is a huge, growing £800m market and there could be room for three national brands.

Some wonder, however, that, if Warburton achieves national supremacy, will

the supermarkets really want to stock three similar branded ranges ?

The question opens an interesting debate.

Not least there's the issue mentioned earlier as to whether Allied and BB will continue to have a foot in both camps.

Experience shows that hybrid branded/private label businesses aren't usually the Best of Both worlds.

If Warburton wins in London things could be black for Private Label.

Far fetched?...well its happened North of Chorleywood...and it's message from current double digit dob decline.

Private label appears to ha Best Product anchored thinking

Competition is essentially about price.

Value bread is contracting prices are up ... but it's costing retailers a bomb.

My sums ... which do the bra a capital efficiency disservice suggest that regular priv label's a waste of space as well

Selling brands instead of dob' no-brainer... usually it's other way around. Reta brands typically have a 500/1 basis point gross mar advantage.

Hax says don't base strategy what your competitors doing.

Instead, you should studying your customers a your customers' customers. The way you move around profitability triangle.

Taking the analysis towards conclusion suggests that t only way to prevent priva label melt-down is to prove the chains what they rea want ... more profit and ev more delighted customers. That's all about quality, innovation and premium pricing and trading the consumer up like the brands.

I detect attempts to crack the problem ... interesting new upstage private label products are starting to emerge. Long-life shows it can be done.

Having got that off my chest, it's time to pull my themes together and summarise my key points.

First ... Why Are Returns So Bad? ...Well the answer's partly structural with substantial private control insulating companies from the full rigor of the stock market. That the big two are hybrids doesn't help. Most of all, however, returns are bad because a lot of private label baking is locked in an out-dated Best Product mentality.

Second... What's Changing Is ... that there's a value chain profits shift from Milling to Baking and the Supermarket Checkout. The change is permanent and it benefits bakers.

Third ... Where It's All Headed ... is towards a networked system. Powerful fresh ordnance for radical new Industry models already exists. Increasingly, this firepower will be brought to bear

As life South of Chorleywood evolves, new dynamics could help you build the healthy, economically profitable, returns you all so richly deserve.

Finally, This Is The Future ... and because it's new ... it's not too late to leap-frog aboard.

Question: Clive Bole, Maidstone

How do our European friends compare, say if you took Germany ?

Answer:- Yes, I was looking at the camps numbers which were absolutely dreadful but under new ownership its starting to make sense again, Camps is starting to improve, there aren't too many significant companies in Europe for me to follow and I can't get at the subsidiary account information like I've got year of in England, but I follow the American numbers which I expect you've been watching the results from people like Sara Lee recently and from Flowers which are all pretty ghastly, there is a lot of grief in the baking industry in American not helped obviously by what was going on with Atkins but the UK is I think looking dramatically better, it is a much healthier picture here than in the States or Europe.

Question: Ross Warburton

Can I just ask you about morning goods in the context of what you have just been saying, 800 gram bread that sounds pretty complicated to me but very sensible, the morning goods market is growing and most of it is through private label, I just wonder what your feelings are about the morning goods market and the shape of it in the future ?

Answer:- That's a tremendous question because I think what happened was a vast morning goods capacity build half a dozen years ago and the markets just got too much capacity in it, I think that Greencores have a little bit of a blaze and I sense that they are not going to rebuild and that helps a little bit and also there are much better

attempts by the branded companies to innovate and to provide the consumer with more variety and quality, I think there's a great opportunity for the brands there and it comes back down to looking at what the customer and the customer's customer wants and basically the customer wants returns and its wants happy consumers and I think it's a great opportunity for the brands to provide that in the way they've done it with 800 gram bread.

Question: John Lindsay, Chester Do you think the Instore bakeries add value to the retails or do you think the retails would be better off selling the like of Ross's product ?

Answer:- Well I think they need a smell but I think that can be piped in. I think that the numbers I've seen, the returns are pretty dreadful, as I've said I'm not privy to the DP analysis from the stores but I think that the retailers I've spoken to in the past said that the economics are poor. There's the problem with shelf life that's been identified earlier as well and I think it's a difficult area for the supermarket companies and they've started to handle the situation differently creating a greater opportunity for the brands to sell the wrapped product so I think Instore has probably peaked and that the threat is declining and were companies are being managed for profit then clearly its not going to be an area which is going to attract a lot of new capital I think.