FOOD MARKETING INSTITUTE

COMPETITION AND PROFIT

Net Profit Less Than Two Pennies On Each Dollar of Food Sales

The intense competition among food retailers for the consumer dollar is best demonstrated by profit margins that continue to be less then 2 cents on each dollar of sales. For fiscal year 2006-07, the industry's after-tax net profit was 1.46 percent, according to FMI's *2006-2007 Annual Financial Review* (see Figure 1). This figure averaged 1.22 percent over the past 10 years

The level of competition is also reflected in the fact that six companies have fallen from the top 10 since 1987 (see Figure 2).

The competition is not limited to food retailers. In their quest for convenience, consumers are increasingly buying meals at restaurants — particularly fast-food outlets — which account for nearly half of food sales. For more information about competition trends, see the FMI Backgrounder *Food Retailing in the 21st Century — Riding a Consumer Revolution* (www.fmi.org/media/ bg/).

Retailers Rely on High Sales Volume, Not Mark-up To Generate Profits

How can supermarkets survive with profits that leave so little margin for error? To earn a dollar, supermarkets would rather sell a $1 item 100 times, making a penny on each sale, than 10 times with a dime markup. Low markup to stimulate high volume is the fundamental principle of mass merchandising, which the supermarket industry introduced to the marketplace in the 1930s.

Measures of Profitability

When measuring profitability, three ratios help provide an overall picture of the financial health of food retailers:

Net profit margin — net income as a percentage of sales that remains after paying all expenses, including product costs, taxes and the realization of any extraordinary gains or losses. This measure has remained in the 1 percent range throughout the industry's history, following the business model to make money on volume rather than high markups.

Return on total assets (ROA) — net income divided by total assets, which measures the ability of a company's combined equity and debt capital to generate profits. This reflects the profit generated from the firm's asset base, regardless of how it is financed. In 2006-2007, the industry's ROA was 5.85 percent, up from the previous year's figure of 4.62 percent.

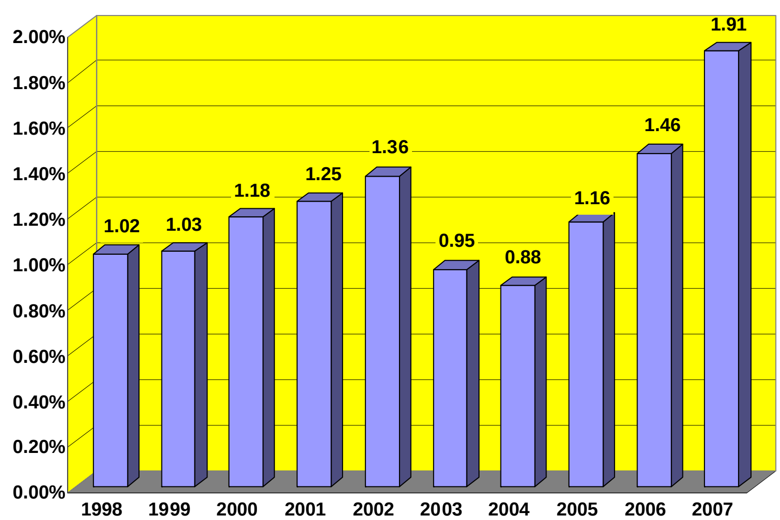
Return on equity (ROE) — net income as a percentage of the owner's equity. This relates company earnings to the resources provided by its owners. It shows how well the firm employs leverage, e.g., funds acquired from outside sources by issuing debt securities. In the most recent fiscal year, the industry's ROE was 16.79 percent, up from 14.65 percent.

The Meat Margin

The public frequently asks why a large spread exists between the per-pound price of a live animal and the retail price of meat. Practical experience in the marketplace, however, shows that government beef "spread" data — the difference between farm prices for live animals and food retail prices for beef — are based on questionable assumptions.

U.S. Department of Agriculture (USDA) measurements assume that supermarkets sell beef in a whole-

Figure 1. Net Profit as a Percentage of Sales



Note: Data are for fiscal years ending March 31 in year listed.
Source: *FMI Annual Financial Review*

carcass form on the same day they purchase it from the farmer. Actually, weeks elapse from the time the animal is processed to the day the meat is displayed in the meat case as retail cuts. The same day that the farmer's selling price is beginning to decline may be the very day the retailer receives a beef shipment bought several weeks ago at a higher price.

This time lag in the processing and delivery cycle of various food items may create the erroneous assumption that retailers are not passing along declines in farm prices.

In addition, USDA data measure "choice" grade beef in whole-carcass form. Although numerous stores merchandise "choice" beef, many have adopted their own grading standards, emphasizing lean beef. The mix of retail cuts sold in the marketplace, therefore, is quite different from a statistician's assumptions. Government indices also fail to reflect adequately the impact of supermarket price specials on beef products. In fact, retail gross margins for all meats have fallen slightly over the past decade.

The farm-to-retail price spread is also affected by all the processing and labor-intensive preparation in the store, not to mention transportation from the packer to retailer.

Figure 2. Top 10 U.S. Food Retailers by Sales

1987	1997	2007
Safeway	Kroger	Wal-Mart*
Kroger	Safeway	Kroger
American Stores	Wal-Mart*	Safeway
Winn-Dixie	Albertsons	Costco
A&P	American Stores	SUPERVALU
Lucky Stores	Costco	Publix
Albertsons	Winn-Dixie	Ahold USA
Supermarkets Gen.	Publix	Delhaize America
Publix	A&P	H.E. Butt
Vons Companies	Food Lion	A&P

*Includes Wal-Mart Supercenters and Wal-Mart subsidiary Sam's Clubs.

Source: Business Guides, *Directory of Supermarket, Grocery & Convenience Store Chains, 1988, 1998 and 2008.*

The greatest factor in the price spread from the farm to the retail meat counter is that less than half of a steer is edible. This weight loss has a dramatic economic impact on retail prices.

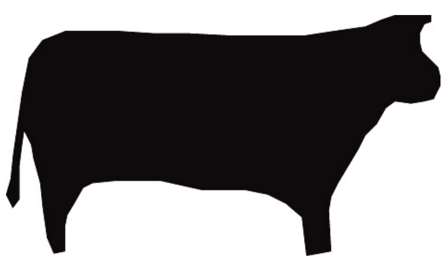
For example, a rancher sells a live animal weighing 1,200 pounds. At a net farm value of $1.98 per pound, the rancher would receive $2,376 for the animal, according to 2007 USDA Economic Research Service data (see Figure 3.)

The price per pound, however, fails to reflect the fact that only 570 pounds of the carcass is edible. If the cost of the edible portion is calculated, the price per pound rises to $4.17.

Of the 570 pounds of edible product, only 500 can be processed into retail cuts. The retailer can earn only a few cents a pound on the remaining 70 pounds of bone, fat and waste. This leaves the retailer with 500 pounds of high-grade product for the original $2,376 payment, increasing the cost to $4.75 per pound.

These calculations do not take into account a host of additional costs that retailers incur for transportation, warehousing, labor, refrigeration, processing, computerized checkouts, administrative support, packaging, taxes and overhead. When all the costs — and a penny of profit — are added, the price spread becomes quite small. ■

Figure 3. The Meat Margin



Cost per pound of $2,376 steer

1,200-pound live weight	$1.98
570-pound carcass	$4.17
500 pounds of retail cuts	$4.75

Source: USDA Economic Research Service, 2007 Choice Beef Values and Spreads and the All-Fresh Retail Value

FOOD MARKETING INSTITUTE
2345 Crystal Drive, Arlington, VA 22202
T 202.452.8844 F 202.429.4519
fmi@fmi.org ■ www.fmi.org