

# Outlook

Retail & Consumer  
Outlook | Australia  
2007 | Changes in play

3rd Annual Edition | May 2007

# Foreword



I am pleased to introduce Retail & Consumer Outlook 2007.

This 3rd edition contains chapters from PricewaterhouseCoopers' thought leaders on key challenges faced by companies operating in Australia's retail and consumer goods sector. Issues such as the retail grocery supply chain, private label and franchising continue to impact our ever-changing landscape. New this year are chapters focusing on emerging challenges and influences such as private equity, the environment, innovation and retailing on the web.

Our theme is 'changes in play' and as always each chapter includes *The Way I See It* – an independent, first-hand commentary from those who are out there in the industry experiencing the issues first-hand.


I trust that you will find our views both informative and thought provoking. The *Outlook* sections and *Take action* recommendations are especially designed to provide you with insights and practical guidance.

A handwritten signature in black ink that reads "Mike James". The signature is stylized and written in a cursive-like font.

Mike James  
National Leader  
Retail & Consumer Goods Sector  
PricewaterhouseCoopers

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# Key issues, trends and changes

## Economy – the year gone by and a look to the future

The resilience of the Australian consumer has again been demonstrated. Despite three interest rate rises in 2006 and a steady rise in interest paid as a percentage of housing and consumer spending, retail spending has continued to grow.

Retail turnover grew 5.6 per cent for the 2006 year, and 2007 started with a massive increase of 0.9 per cent in January and 0.9 per cent again in February.

Consumer sentiment is buoyant. Westpac's consumer sentiment index has climbed steadily to its highest point since the 95-point low in November 2006. The drop in consumer confidence after the May, August and November 2006 interest rate hikes was short lived and sentiment rebounded quickly to current record levels.

Consumer confidence remains volatile, however, and is predicted to dip again slightly before the end of 2007. At the time of going to print (April 2007), there were concerns that the Reserve Bank would again lift interest rates to counter potential inflationary pressures in the economy. No doubt this would have a negative impact but the duration of any loss in consumer confidence will depend on the economy's ability to sustain low levels of unemployment while driving wage growth. These two indicators are critical to growth in household incomes and underpin resilience in sentiment. Given predictions for continued growth in employment and wages, it is likely that consumers will be able to withstand potential increases in interest rates and fuel prices.

In 2006 we predicted that forecasting customer demand would remain a challenge for retailers. The good news is that there have been fewer profit downgrades from retailers in 2007 compared to 2006. This could be attributed to businesses improving forecasting capabilities but it is more likely that continued economic prosperity is making life just a little easier.

## Consumers and their spending patterns

Consumer spending on retail goods has shown strong increases over the past two years, in actual dollars and in real terms. Actual growth at September 2006 was 5.5 per cent (6.2 per cent seasonally adjusted) whilst in 2005 the corresponding growth was 2.6 per cent (2.3 per cent seasonally adjusted).

However, this presents only half of the picture, as the retail share of total household consumption expenditure has decreased alarmingly over past years. In 1966, retail spending represented 41 per cent of total household consumption spending, whereas today the figure is 24 per cent. While the percentage has remained at around 24 per cent for the last five years, the trend line remains negative.

Some of this decrease can be explained by the simple fact that household disposable income has been rising at a rate faster than retail sales. However, consumers are spending more of their disposable income on services such as household cleaning, lawn mowing and past-times such as online gambling.

The challenge for retailers is to retain and regain their share of consumer wallet. From the retailer's point of view, price deflation and cost pressures have squeezed margins. From the consumer's point of view, increased household costs – whether they be rent, interest rates or fuel prices – are putting significant pressure on retail spending.

## Ageing population

Australia's population is ageing at a rate greater than other equivalent Western economies. The Baby Boomer bulge is moving into retirement with the first wave now in their 60s. We are also living longer and retiring earlier. The average age of retirement is now 58 for males and 47 for females, with both groups living to 78.5 years and 83.3 years respectively.

All this is causing a major shift in the composition of our workforce and an increase in the number of older retirees. The impact of the recent generous changes in government superannuation rules will not kick in for many years, and meanwhile an ever-expanding pool of retirees will rely on some form of government pension. Currently, there are 5.25 people in the (potential) workforce for every person aged 65 or more years. By 2050-51, this will have fallen by more than a half, to 2.2.<sup>1</sup>

It is predicted that the GDP impact of such a cost blow out will be around 3.5 per cent of GDP by 2046-47.<sup>2</sup> Unless there is a major policy shift by government soon, it is estimated that our taxes will need to rise by over 10% to fund it.

The only sustainable way of addressing the problem is to extend the working life of all Australians. Some employers have already picked up the wind of change and are focusing on how they can attract and retain older workers and how to take advantage of older consumers' spending patterns.

While an ageing population will present huge challenges for the Australian Government, what is more worrying is the impact it will have on Australia's competitiveness in global trade. Other countries in our region have population age demographics which are moving in the opposite direction, compounding our competitive disadvantage.

<sup>1</sup> *An ageing Australia: small beer or big bucks?*, Gary Banks Chairman, Productivity Commission, April 2004.

<sup>2</sup> *InterGENERATIONAL REPORT 2007*, Circulated by The Honourable Peter Costello, MP Treasurer of the Commonwealth of Australia, April 2007.



## Fuel prices

The retail price of petrol peaked in Australia in June 2006 with metropolitan prices reaching around \$1.38 per litre. While the price has since moderated it is unlikely to return to its previous low levels and prices will continue to fluctuate because supply remains unstable. In effect, we predict the fuel price rollercoaster is set to continue.

Although fuel costs represent only 4 per cent of CPI, the impact of any price rise is profound and it's not just the immediate 'back pocket' reaction that is of concern. In the longer term, the price of fuel causes a flow-on increase in transport costs and we have already seen this reflected in increased prices of goods and services. Ultimately these increases in commodity prices put pressure on the inflation rate leading to further pressure on interest rates.

In light of the sustained increases in fuel prices over the past five years, the surging demand for oil from emerging economies and the expectation that the world's supply of oil cannot increase indefinitely, it is unlikely that most Western economies will see any consistent fall in petrol prices in the future. The implication is that retailers will see a shift in consumer discretionary spending over the long term in response to fuel price changes.

## The emergence of private equity players

Since the 2006 edition of *Retail & Consumer Outlook*, private equity has emerged as a major influence and is turning up the heat on retail and consumer goods companies. Values are high and purchase price multiples are at unprecedented levels. There are few bargains left, and the challenge to realise value from targets has led to the development of aggressive growth strategies.

While the impact of a strategy to cut costs and improve systems cannot be ignored, it will not drive realised prices to the levels desired. Management is crucial to the ultimate delivery of value, as is the focus on acquiring talent and aligning performance to the growth value driver.

Even if your company is not susceptible to a hostile private equity attack, the bar has been raised. The competition for market share, recruitment and retention of scarce talent and the opportunity to grow by acquisition has suddenly become a whole lot more expensive.

**Chapter 2 Private equity | Retail therapy works** covers this issue in more detail.

## Environmental and social issues

Corporate social responsibility (CSR) is still driving change. Every year we see more companies embracing CSR and using it to build their brand with consumers, their employees and the community.

Many sceptics see CSR as a 'nice to have' or something that is disposable when the market turns and profits come under pressure. However, to view CSR only as a cost is to ignore the significant benefit that can flow from building awareness of a company's brand and the corporate values that underpin it. Both employees and consumers are becoming more inquisitive about where products come from, if they support fair trade and how they were derived from the environment.

In an effort to address these questions, we predict major retailers will put pressure on suppliers to comply down through the supply chain. Internationally the move to embrace CSR principles is gaining pace, with the standout benchmark being Marks & Spencer in the United Kingdom. Marks & Spencer has implemented a 100-point suite of CSR principles which it refers to as "Plan A" covering climate change, waste, raw material sourcing, fair partnerships and healthy eating.

The issue of CSR is covered in more detail in **Chapter 1 Environment | Do you want to be a green grocer?**



## E-retailing

Most retailers have vivid memories of their love affair with electronic commerce during the dot-com boom of the 90s and the cost of what was a failed experiment. Most pulled back from engaging in e-commerce, some severed their relationships completely and those that stayed with it did so with limited enthusiasm.

But e-retailing is making a comeback overseas, and the trend should not be ignored by Australian retailers. Things have changed considerably over the past five years and there are different drivers influencing the market. The technology platform has changed, with the cost of computer software and hardware continuing to decrease as capacity increases. Advances in connectivity are also driving increased use of the internet among most age groups.

While the change drivers in e-retailing cannot be denied most retailers in Australia are still weighing up the costs and benefits. We can see that overseas e-retail sales are increasing at a rapid pace. Will Australia mirror the trend? We think so despite Australia's significantly different population demographics.

**Chapter 4 Retailing on the web | Passion driving technology fashion** covers this issue in more detail.

## Private label

Over the last three years, PwC has tracked the move by Australia's two major grocery retailers to increase the penetration of private label products on their shelves. We are now seeing the impact of these changes, not just on the products that are appearing in supermarkets but in the way customers and suppliers are reacting.

The private label strategies in Australia are essentially modelled on grocery retailers in Europe and the United Kingdom. Initial targets for private label penetration in Australia were modest when compared with levels reached in the UK, but were set at rates nearly double the existing penetration.

PwC's analysis this year shows that more private label products are on the shelves and the retailers remain committed to their strategies. What we have not seen, however, is any significant move in the sale of private label products. Nevertheless we remain bullish on our prediction that grocery retailers will succeed in their private label strategies even if it is taking longer than planned to implement.

Our analysis of the status of private label in Australia is covered in **Chapter 10 Private label | A year on...**

## Innovation to grow and differentiate

Increasingly we hear from CEOs in the sector that innovation is the foundation of their growth agenda. This is the mindset of fast moving consumer goods (FMCG) companies responding to the threat from private label products.

Also retailers attempting to grow market share in markets with little difference in core product offerings need to watch out for the undifferentiated mid-market squeeze. Be clear on your value proposition and the markets you wish to serve.

**Chapter 6 Innovation | Innovate to differentiate** examines the innovation agenda of companies and puts the view that innovation is more than new product development. If innovation is to flourish in a company it must encompass products, services and the whole way a company does business. It has to be driven from the top and embrace all levels and employee rewards needed to achieve the innovation agenda.

## Skills and talent shortages

Every day in the newspaper we see some mention of the skills shortage in Australia. With an election coming up this year, the two major parties will go head to head on policies of education, skills and attracting older workers back to the workforce.

No doubt the Australian Government considers it is in a no-win situation. On the one hand it is justifiably proud of its success in employment growth and the record low unemployment rate of 4.6 per cent. On the other, a strong economy, perhaps underpinned by a resources boom, has put incredible pressure on our skilled labour force.

As a short-term fix, it appears employers are pushing the government to reconsider its approach to permanent immigration and temporary visas for guest workers. All this is needed but until the benefits come into effect, many Australian businesses will be forced to find other ways or operate at sub-optimal levels – a situation the sector and country cannot afford.

**Chapter 7 Franchising | The war for talent** looks at this issue for that segment.

## Supply chain transformation

The potential break-up of one of Australia's major retailers and other forces over the past 12 months have curtailed what was expected to be a year of metamorphosis in the retail grocery supply chain.

Threats and opportunities materialised: there has been the consolidation of primary freight; the stalling of collaborative planning, forecasting and replenishment; and the emergence of private equity as a force. There were also fits and starts for programs such as shelf ready packaging, regional supply hubs and radio frequency identification technology.

**In Chapter 3 Retail grocery supply chain | Strengthening the chain**, we analyse eight major issues that we believe will impact investments by retailers, suppliers and service providers to the grocery retail sector over the next three to five years. It should be a dynamic time.

Our predictions for the future of the industry suggest that both retailers and suppliers should continue to be proactive as they respond to ongoing change.



# 01

## Who wants to be a green grocer?

Business leaders will remember 2006 as the year in which environmental affairs became a matter of strategy rather than compliance. The unparalleled public concern over issues such as water scarcity and climate change created significant new risks and opportunities for business, yet only a handful of Australian companies moved to capture them.

The consensus is that this shift in public sentiment on the environment is permanent. PwC's engagement with executives, at a personal level and through formal surveys,<sup>1</sup> confirms that business expects the issue to grow in significance. Moreover, governments have responded to changing public attitudes with new regulations and policies that promise to keep environmental issues at the forefront of consumer debate and increase the pressure for corporate action.

This development is international; however corporate Australia has been slower to respond than its overseas peers. In 2006, six of the world's 10 largest public companies by market capitalisation – BP, Citigroup, GE, HSBC, Shell and Wal-Mart – were explicitly pursuing competitive advantage through improved environmental performance. In Australia, by contrast, only one of the 20 largest ASX-listed companies has taken this approach and the retail and consumer goods sector is lagging.

It would be surprising if this gap did not narrow over the coming year. We expect to see more Australian businesses, particularly those in the retail and consumer sector, develop offerings that respond to the call for improved environmental performance. The business case will be straightforward and compelling – as Marks & Spencer puts it: "We're doing this because it's what you want us to do. It's also the right thing to do. We're calling it Plan A because we believe it's now the only way to do business. There is no Plan B."<sup>2</sup>

<sup>1</sup> *Carbon Conscious*, PwC, December 2006, and *Business Insights Survey*, PwC, March 2007.

<sup>2</sup> <http://www2.marksandspencer.com/thecompany/plana>

### The outlook

- The public concern about dwindling water supplies and climate change will deepen, forcing governments at local, state and federal level to introduce more and stronger regulations on business.
- Senior management will have to not only engage with these issues but also demonstrate leadership, especially on water use and energy efficiency.
- Severe penalties – individual and corporate – will await those executives and companies who ignore their environmental obligations.
- A company's attitude to sustainability will directly affect the mood of investors, the integrity of its brands and the health of its share price.
- Big players will move on environmental issues and in doing so change the rules for the entire sector.
- Employees, consumers, suppliers and clients will all demand better corporate social responsibility performance from companies, who will respond by instigating environmental initiatives to enhance their positioning with these various audiences.
- Information about environmental performance will become a matter of public record and a competitive issue for businesses.
- Competitive pressure will drive rapid change and sharpen companies' focus on improving environmental performance.

## The international experience

Globally, measurable improvement in environmental performance is becoming a core element of retail and consumer companies' approach to market. Retailing businesses in the United Kingdom have been particularly active in this arena, driven by broad community concern about environmental issues that have created the opportunity for them to compete on green performance. The leading players have developed a wide range of environmental initiatives. Common themes to emerge have been programs aimed at reducing waste to landfill, improving energy efficiency, lowering greenhouse gas emissions and sustainable sourcing (see Figure 1). Intense competitive pressure is driving continual innovation and improvement.

In January 2007, a new round of programs were launched by major grocery retailers in the UK. Tesco announced its intention to become

“a leader in helping to create a low-carbon economy”<sup>3</sup> through a range of measures, including carbon-cost labelling on every one of its 70,000 products, and significant reductions in greenhouse gas emissions. Around the same time, Marks & Spencer launched ‘Plan A’, a 100-point plan focussed on improvement in five areas: climate change, waste, raw materials, fair trade and healthy eating.<sup>4</sup>

In the United States, environmental initiatives in the retail sector are being driven less by vigorous competition and more by pace-setting behaviour from market leaders such as Safeway and Wal-Mart.

<sup>3</sup> “You’ve checked the price and calorie count, now here’s the carbon cost”, *The Guardian*, 19 January 2007.

<sup>4</sup> [www.marksandspencer.com/plana](http://www.marksandspencer.com/plana)

Figure 1: UK retailers' environmental initiatives

<p><b>Asda</b></p> <ul style="list-style-type: none"> <li>■ Plans to have no waste going to landfill sites by 2010.</li> <li>■ Has invested €40 million (A\$60 million) in new recycling facilities at distribution centres.</li> <li>■ Has increased use of biodiesel fuel in its transport fleet.</li> <li>■ Has redesigned its own-brand range to reduce the weight and volume of packaging by at least 10%, including designing thinner bags for pre-packaged salads and biodegradable packaging on all organic food by March 2007.</li> <li>■ Moving towards sourcing seafood only from sustainable fisheries.</li> </ul>	<p><b>Sainsbury's</b></p> <ul style="list-style-type: none"> <li>■ Has spent £14 million (A\$35 million) on energy-efficient projects since 2002, with another £5 million (A\$12.5 million) to be spent in 2006/07.</li> <li>■ Aims to roll out state-of-the-art recycling facilities to 347 stores.</li> <li>■ Has redesigned packaging, and plans to pilot fully compostable packaging and phase out PVC plastic.</li> <li>■ Aims to reduce carbon emissions by 20% of 2000 levels.</li> <li>■ Aims to source 70% of organic food that can be grown in the UK from the UK.</li> </ul>
<p><b>Tesco</b></p> <ul style="list-style-type: none"> <li>■ Launched a £100 million (A\$250 million) environment fund in April 2006.</li> <li>■ Switched to biodegradable-only shopping bags from September 2006.</li> <li>■ Aims to reduce the number of bags distributed by 25% in two years.</li> <li>■ Aims to reduce energy use by half in its stores over the 2000–10 period.</li> <li>■ Has committed to reducing the number of truck deliveries to its convenience stores and to make the trucks quieter and more fuel-efficient.</li> <li>■ Aims to introduce regional counters in stores to promote local produce.</li> <li>■ Introducing carbon-cost labelling across entire product range (70,000 items).</li> </ul>	<p><b>Marks &amp; Spencer</b></p> <ul style="list-style-type: none"> <li>■ Launched 100-point ‘Plan A’ in February 2007, with five key aspects: <ul style="list-style-type: none"> <li>– Climate change: UK and Ireland operations to be carbon neutral by 2012.</li> <li>– Waste: zero waste to be sent to landfill by 2012.</li> <li>– Raw materials: key raw materials to be sustainably sourced.</li> <li>– Fair partner: will manage labour standards in supply chain and expand range of fair trade products from tea and coffee to include bananas, jam and sugar.</li> <li>– Healthy eating: will help customers and employees choose a healthier lifestyle, including making all food from non-GM ingredients and using only free-range eggs.</li> </ul> </li> <li>■ Rated best UK retailer in supporting sustainable fishing by the Marine Conservation Society and Greenpeace.</li> </ul>

Source: *Food Business News*, June and September 2006; [www.j-sainsbury.com](http://www.j-sainsbury.com); [www.marksandspencer.com/plana](http://www.marksandspencer.com/plana)

Safeway has put significant effort into improving its energy efficiency and sourcing an increasing percentage of its power from renewable sources.<sup>5</sup> Though its targets are not as ambitious as those being developed by UK companies – Safeway’s engagement strategy is focused more on reporting what has been achieved than setting future targets – it is the first retailer to join the Californian Government’s Climate Action Registry.<sup>6</sup> This registry gives companies a robust and credible framework, through which they can disclose greenhouse gas emissions associated with their activities and obtain independent verification.

Wal-Mart has developed a more comprehensive environmental program. Its chief executive, Lee Scott, has set about transforming the world’s number one retail company into an environmental leader. The company has ambitious goals to:

- increase the efficiency of its vehicle fleet by 25 per cent within three years, and double overall efficiency by 2016
- eliminate 30 per cent of the energy used in stores
- reduce solid waste from US stores by 25 per cent in three years
- invest US\$500 million (A\$640 million) annually in sustainability projects.<sup>7</sup>

While these goals are significant in themselves, the corporate change program Wal-Mart has designed to achieve them is even more compelling. Company executives are being encouraged to embrace the sustainability thinking pioneered by the Rocky Mountains Institute in *Natural Capitalism*, the controversial and groundbreaking book that claims the next industrial revolution will be driven by a scarcity of resources.<sup>8</sup>

For example, Lee Scott advocates that the business changes the way it looks at waste: “If we throw it away, we had to buy it first. So we pay twice – once to get it, once to have it taken away. What if we reverse that? What if our suppliers send us less and everything they send us has value as a recycled product? No waste and we get paid instead.”<sup>9</sup>

This approach reveals two things. First, Wal-Mart is looking to develop environmental improvements that pay for themselves through revenue generation and cost reduction, rather than adding a cost component to the marketing overhead. If it succeeds, the environmental gains will become embedded in core business activities rather than something that is propped up by budgets that may be cut when times are tough. This approach is good for the environment and for the business, and is the hallmark of a leader’s attitude to green growth.

Second, it demonstrates that when big players move on environmental issues, they change the rules for the entire sector. It is clear that a key part of the greening of Wal-Mart will be a reengineering of its supply chain to better suit the corporate objective of reduced environmental impact. The company’s suppliers will be asked to generate less waste and help find new uses for the waste material that cannot be stripped out of the process.

## The local context

As noted at the outset, the fundamental driver for improved environmental performance in the retail and consumer sector, and Australian business generally, is the growing public concern about dwindling water supplies and climate change. While there has been a basic community awareness of these two issues for some time, they shot to prominence in 2006 and seem set to dominate public debate in the lead-up to the federal election in late 2007. This will affect businesses by:

- accelerating changes in employees to expect more of their employers
- producing new government policy and regulation
- generating concern among investors about share price impacts
- creating the potential for competitive differentiation and shareholder value creation.

<sup>5</sup> “Safeway leads retail sector in fighting greenhouse gas emissions”, *Business Wire*, 26 January 2007.

<sup>6</sup> [www.climateregistry.org](http://www.climateregistry.org)

<sup>7</sup> <http://walmartfacts.com/Factsheets/1292007Sustainability.pdf>

<sup>8</sup> *Natural Capitalism: Creating the Next Industrial Revolution*, Paul Hawken, Amory Lovins and Hunter Lovins, 1999.

<sup>9</sup> “The green machine”, *Fortune*, 7 August 2006.

## Employee expectations

A growing body of evidence indicates that the traditional view of what motivates employees, such as salary and benefits, is only part of the story. An increasing number of studies have documented the influence that corporate social responsibility (CSR) factors, such as environmental performance, can have on employer selection and employee loyalty (refer Graphs 1 and 2).

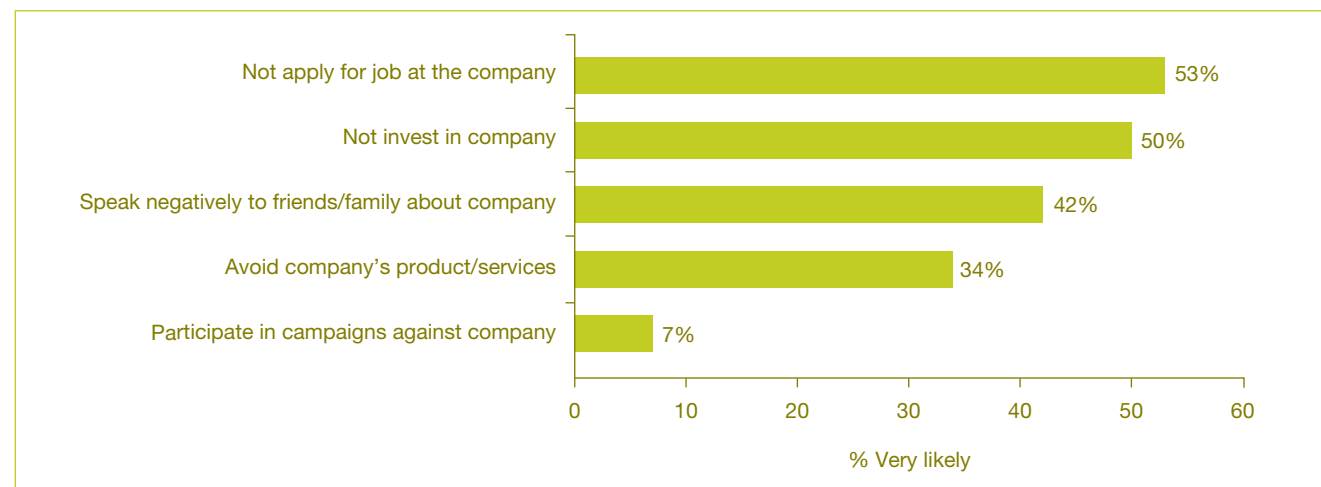
It is to be expected that in the current social climate, environmental performance will feature highly in employees' assessment of their employers' CSR performance and impact the number of employees who give a company consideration. Given the concerns of many businesses that an inability to

secure the right people will hinder future growth, we expect to see increasing numbers of retail and consumer goods companies looking to position themselves as employers of choice through environmental initiatives.

## New policy and regulation

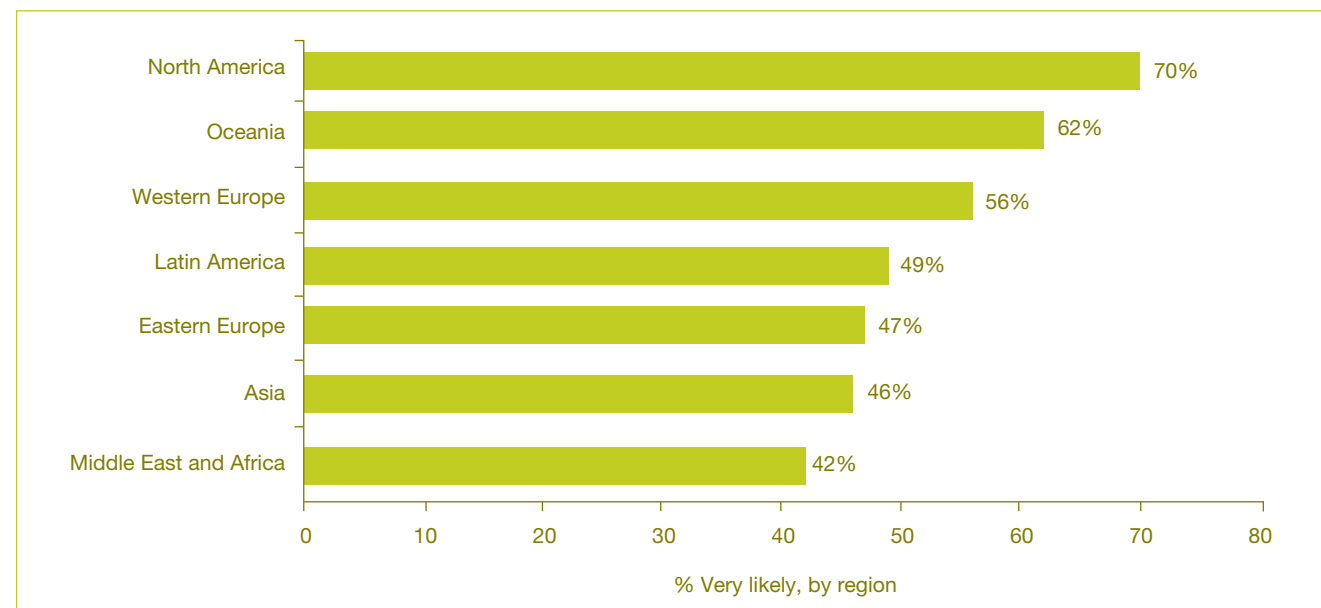
Heightened concern about climate change and water is driving significant regulatory effort at both the federal and state levels. The flagship is the federal *Energy Efficiency Opportunities Act 2006* (the EEO Act), which will name Australia's top-250 energy users – defined as those companies using more than 0.5 petajoules of energy a year – and force them to publicly disclose ways in which they can reduce energy consumption (refer breakout on next page).

Graph 1: Impact of corporate social irresponsibility on student behaviour



Source: Globescan/World Business Council for Sustainable Development, 2005.

Graph 2: Not applying for a job at company because of social irresponsibility



Source: Globescan/World Business Council for Sustainable Development, 2005.

## The Energy Efficiency Opportunities Act 2006

This act aims to address the concern that many businesses are not identifying and implementing cost-effective energy efficiency measures, a concern first expressed in the 2004 white paper *Securing Australia's Energy Future*.

The cost of this problem to the economy is significant. The explanatory memorandum produced at the time the legislation was introduced into Parliament suggested that taking only half the opportunities available to improve energy efficiency could deliver \$975 million in economic benefits, while also reducing greenhouse gas emissions.

Companies that adopt energy efficiency measures are expected to save 10–30 per cent on their energy bills, without reducing productivity.<sup>1</sup>

The act has five key elements:

1. Registration with the Department of Industry, Tourism and Resources (DITR). Once registered, companies will be listed on a government website, [www.energyefficiencyopportunities.gov.au](http://www.energyefficiencyopportunities.gov.au)
2. Submission of a plan outlining how energy efficiency will be assessed.
3. Implementation of the plan to assess the energy efficiency opportunities (EEOs) of a business.
4. Reporting publicly on the outcomes of the assessment.
5. Compliance and enforcement procedures.

The plan must outline how assessments will be conducted within the various parts of a company over a five-year period. During this time, at least 80 per cent of operations must be assessed. After the plan is approved, the company must implement it.

A key outcome of the assessment will be an EEO report that must be sent to DITR and will form the basis of public disclosures. The public reports will need to include details of EEOs – including the percentage of energy that can be saved with paybacks of up to four years – and information on the business's energy performance.

Companies affected by the act must submit an assessment plan within 18 months of the end of the financial year in which they first used 0.5 petajoules of energy. The first companies affected – those with this level of energy consumption in 2005-06 – will have to submit plans by 31 December 2007 and report publicly by 31 December 2008.

The EEO assessment must be conducted in accordance with a framework set out in the regulations made under the act. The framework comprises six elements:

1. Demonstration of leadership support for energy efficiency within the company.
2. Involvement of a wide range of people in the assessment process, particularly those that have the ability to influence energy use.
3. Accurate data collection and information gathering.
4. A comprehensive process to investigate and analyse the identified opportunities.
5. Defined decision making where the company must determine how to respond to the identified opportunities.
6. A process of public reporting and disclosure of results.

It seems the architects of the legislation appreciate how the information disclosed is likely to be used. The regulations allow companies to produce a summary of the public report for the financial community. If it does so, the company must include this summary in its annual report.

The act and regulations leave open the question of how EEO assessments will be verified. However, records must be kept for a minimum of seven years and authorised officers are empowered to inspect sites and enforce submission of documents.

Non-compliance with these provisions attracts civil penalties of up to \$110,000 for corporations. In addition, individuals responsible for compliance with the EEO Act may commit a range of offences. For example, where filings made under the act are misleading or deceptive, the executive signing them off may face a penalty of up to 12 months imprisonment.

<sup>1</sup> Explanatory Memorandum to Energy Efficiency Opportunities Bill, 2005.

This new focus requires senior management to engage with the issue and demonstrate leadership on energy efficiency. It also requires that the chairperson, chief executive or managing director sign off on the opportunity assessment reports that must be submitted and made public under the EEO Act.

The penalties for non-compliance are significant. For individuals, such as the executive signing off filings made under the EEO Act, 12 months imprisonment may be imposed under the *Criminal Code Act 1995* if a document is misleading or deceptive. Other breaches may attract civil penalties of up to \$110,000.

At the state level a number of similar initiatives are under way. The Victorian Environment Protection Authority (EPA) is expected to introduce a program to impose energy and water efficiency assessments on Victoria's top 250 users of each resource in 2007. Legislation empowering the EPA was passed in the second half of 2006. However, regulations setting out the detail of how such assessments will work in practice are still being developed. Also mooted for Victorian business are price increases for water and the introduction of a tiered pricing structure designed to create greater economic incentive for efficiency improvements.

In NSW, legislation introduced in 2005 empowered the Department of Energy, Utilities and Sustainability (DEUS) to gather data and then publicly identify NSW's top 200 water and energy users. These companies were all required to file detailed action plans directed at improving energy and water efficiency by the end of June 2006, however many are still outstanding. While the names of the top 200 energy and water users are public – and include many companies across the retail and consumer value chain – actual consumption levels and companies' ability to improve efficiency are not in the public domain. Interestingly, this lack of disclosure has attracted less debate than in Victoria, though there is growing public concern about the delay in production of the action plans.

A feature of these initiatives is the fact that they make energy and water use more transparent. There is clear demand in the public domain for this information. In Victoria, for example, the media has applied considerable pressure to the Victorian Government to release details of the state's top 200 water users. It is understood that this data has already been collated and will feature in the annual

reports issued by Victorian water authorities at the end of 2007. In March 2007, Victorian Premier Steve Bracks announced a mandatory requirement for the top 1,500 industrial water users to develop individual water savings plans.

Some Victorian businesses, including the operators of major retail centres such as Chadstone, Highpoint, Southland and Melbourne Airport, have responded to the pressure for disclosure by revealing that they are in the top 200. These expositions have sparked comparisons of company performance within the media. It is clear from this development that as robust data about the environmental performance of iconic Australian brands becomes widely available, competitive tension will almost certainly follow.

Some early adopters are already positioning themselves to respond well to these new pressures. Orion Springfield, which is located on the Brisbane fringe and one of Australia's newest and largest shopping centres, incorporates a number of environmental features. It uses recycled water in the toilets and water features, incorporates solar panels to generate electricity, and has been designed so air-conditioning is required for only three months of the year. The owners of the centre predict that these design features will translate into a 42 per cent reduction in electricity use and 68 per cent reduction in water use as against business as usual.

Of course, not all retail and consumer companies will be caught by these new requirements. However, it is clear that many major businesses will be drawn in across manufacturing, distribution and retailing. In the case of manufacturing, the large fast moving consumer goods producers all use significant amounts of water and energy through their production processes and extensive use of refrigeration.

For logistics businesses, fuel use and refrigeration are key components of their energy profile, while for retailers, consumption is driven by the need to light the stores and keep food cool and fresh. Finally, the operators of the large retail centres attract attention for their high levels of water use, often related to reliance on evaporative cooling for air conditioning.

### Investor concerns

Growing numbers of investors are linking improved environmental performance to improved share prices as a result of a growing body of empirical evidence. Graph 3 shows that the Dow Jones Sustainability Index (DJSI) World – comprised of the top 10 per cent of sustainable companies within the world's 2,500 largest public corporations – has tracked and outperformed the Morgan Stanley Capital International (MSCI) World Index by 4.8 per cent over the five years since August 2001.

This has sparked increasing interest within the investment community about the apparent connections between specific environmental issues and share price. A particular focus has been energy use, due to the direct correlation between energy consumption and greenhouse gas emissions. As governments seek to address rising greenhouse gas emission levels through pricing, either by introducing new taxes or trading systems, investors have become increasingly concerned about the potential for stranded assets and structural adjustment on the businesses they invest in. Similar inquiries will be made into water use if governments respond to scarcity with pricing initiatives.

A leading example of the approach to energy use/greenhouse gas emissions is the Carbon Disclosure Project (CDP). This began in 2003, supported by institutional investors with US\$4.5 trillion in assets under management, and has grown rapidly. In February 2007, the asset backing of the institutions supporting CDP was US\$41 trillion.

The CDP works by sending an annual information request to some of the world's largest companies.

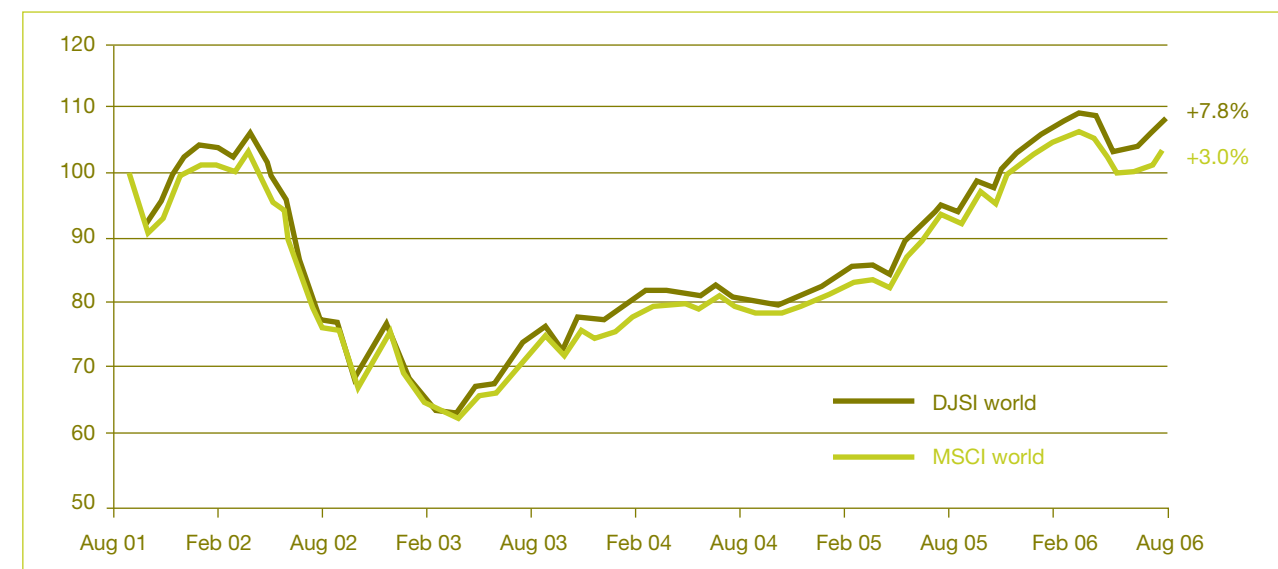
In 2003 the request went to 500 companies. This year, this number had grown to 2,400. The request seeks data on the likely business impact of proposed greenhouse gas regulation and predicted changes in climate. The responses are analysed and made public ([www.cdproject.net](http://www.cdproject.net)).

While the CDP has been remarkably successful in articulating the likely business impact of climate change and greenhouse regulation, a weakness is its voluntary nature. The CDP cannot compel companies to respond to its information request, and it is not in a position to verify the accuracy of any disclosures. Moreover, it is unable to force companies to disclose in a common format, meaning that the data that is obtained can be difficult and time-consuming to compare.

For this reason the data that will be made public through the new legal requirements, particularly the EEO Act, is likely to be examined closely by market analysts interested in the risks of climate change and greenhouse gas regulation. The energy use information that will be disclosed can be readily translated into greenhouse gas emission data, within a statutory framework that provides significantly less room for spin. As investors gain a greater understanding of the water risk also embedded in existing assets and business models, we can expect water disclosures to be analysed more closely.

Companies that rate poorly on energy use compared to their peers can expect to find it harder to raise capital as they fail to qualify for funds that are seeking green assets for their investment portfolios.

Graph 3: DJSI world Vs MSCI – performance. Five years Aug 01 – Aug 06, EUR, Total Return Index



Source: Dow Jones Sustainability Indexes 2006.

## Competitive differentiation and shareholder value creation

The increased prominence of environmental issues has set the stage for retail and consumer companies to compete on environmental performance in a number of areas. Whether it be in the war for talent, consumers or capital, strong environmental positioning will enhance a business's attractiveness.

Currently, Australian retail and consumer companies are lagging behind their international peers. This position is untenable in the medium term, so there is some catching up to be done. The rise of government-mandated disclosure of environmental performance measures will meet a marketplace of customers hungry for information and solutions, and drive competition on environmental performance. The only question is whether retail and consumer companies will drive the agenda, or simply respond to a market shift generated by government regulation and consumer demand.

Internationally, many retailers have already seen a rapid change in consumer sentiment regarding the environment and felt a resulting impact on their brands. Consumer concern for the environment and the move towards healthier eating has driven a material change in the merchandising practices of major grocery retailers as they expand offerings of cruelty-free, organic and fair trade products.

Many international grocery retailers are developing large organic ranges, especially in fresh produce, finding that consumers are willing to pay higher prices for products that are environmentally friendly and healthier. Early results in Europe have indicated that merchandise ranges that are both environmentally friendly and healthy have strong sales and increase profits. As retailers embrace more environmentally friendly merchandise, consumer goods companies will need to ensure they have the products available at the right price to meet the demands of retailers and consumers.

## What does this mean for the retail and consumer sector?

Change is inevitable and the major grocery retailers in the Australian retail sector can be expected to use their size and market power to force the supply chain to accommodate their objectives. The process used to improve energy and water efficiency is likely to be similar to programs such as the push on shelf-ready packaging. Both product suppliers and service providers to retail companies will feel these changes.

Product suppliers to major retailers can expect to be asked to provide more data on their own energy and water use and that embedded in their products. This information will need to be delivered in a way that fits with the systems upstream and downstream, so accurate data can be delivered at the point of sale. Property groups will need to be much more conscious of the energy and water consumption locked in by premises design, and can expect to be asked to accommodate, if not assist with and fund upgrade works.

Once the data collection systems are established, analysts will not be far behind. Expect to see retailers start comparing products, suppliers and entire supply chain components to identify areas where environmental savings can be made. Wal-Mart is beginning this process in 2007, with the launch of a packaging scorecard that will be issued to all 60,000 of its suppliers, and used to drive a global packaging reduction of 5 per cent by 2013. It would not be surprising to see the major players in Australia adopt a similar approach and set improvement targets, forcing process changes and requiring any cost savings achieved to be passed through.

Beyond the operational and supply chain issues, environmental competition will create traps for industry stakeholders, especially at the outset. Existing strategies may have unexpected environmental dimensions and will need to be re-thought. A vertical integration strategy, for example, may bring with it risks and opportunities associated with direct responsibility for a greater portion of the value chain's energy and water use. This may clash with the company's desired environmental positioning, particularly where sections of the chain have fundamental issues that cannot be solved within an appropriate time frame.

On the flipside, seemingly obvious environmental initiatives may fail for traditional reasons. A good example of this challenge is the difficulty Unilever faced after the introduction of a concentrated, highly efficient and biodegradable washing detergent into Wal-Mart stores. While the product was perfectly aligned with Wal-Mart's environmental strategy – sales of concentrates reduce packaging waste, transportation costs and emissions, and save on shelf space – it was unable to meet sales targets because its small size meant it did not have the same shelf prominence as competing brands.

Perennial legal concerns such as trade practices issues, particularly misleading and deceptive conduct, should not be forgotten either. Competing on environmental performance will raise the bar for industry leaders and the retail and consumer sector generally. Greater focus on the issue will increase the level of understanding among consumers and regulators, creating new dangers for those that continue to approach environmental performance as a soft issue.

On the investment side, shareholders are showing an increasing willingness to call directors to account for inaccurate financial documentation. It is only a matter of time before someone tries to tie a major loss back to the failure to consider or disclose environmental risks or opportunities. It may well be one of the increasingly aggressive plaintiff law firms, backed by the growing and ambitious litigation funding industry.

On the retail side, the Australian Competition and Consumer Commission (ACCC) has recently increased surveillance of companies making statements about the environmental attributes of their products and services. Proceedings have been brought against companies that have made imprecise, misleading and even false environmental claims. Few businesses realise that an international standard on environmental claims (ISO 14021:2000) has been developed and is likely to be used by regulators to assess the reasonableness of environmental product statements.

This is just one of many new measures Australian retail and consumer companies should brace for as concern about the environment finally translates to real regulatory action.





**Peter Slator**  
Chairman  
Unilever Australasia

Unilever is one of the world's largest consumer goods companies, with an annual turnover of about €40 billion (A\$66 billion) and more than 200,000 employees. The company has operations in more than 100 countries and markets 400 brands, among them iconic names such as Lipton, Dove, OMO, Flora and Rexona.

Globally, Unilever has a long history of embedding corporate responsibility into its operations and brands. The company recognises that any CSR activity will not be sustainable unless it is part of the way we do business.

While the company has always viewed itself as an integral part of the communities in which it operates, with a strong social conscience and comprehensive social programs to support this, the explosion of political and consumer interest in environmental matters over the past few years has introduced us to a new reality and new challenges. Behaving sustainably requires us to look beyond continuous improvement, compliance and reporting and towards making environmental leadership part of the Unilever story.

Already, we have made good progress. Unilever is a co-founder of the Marine Stewardship Council and the Roundtable for Sustainable Palm Oil, among others.

It is a member of the Sustainable Packaging Coalition and has been included every year in the Carbon Disclosure Project's Climate Leadership Index. In 2006, Unilever placed first in its category in the index. We were also the food industry category leader in the Dow Jones Sustainability Indexes for the seventh year running, and have been named in the Global 100: Most Sustainable Corporations in the World ([www.global100.org](http://www.global100.org)).

Beyond these larger strategic initiatives there are ways in which we tackle the issue at a brand or category level that are also making a difference. In partnership with Greenpeace, we have developed solar-powered ice-cream freezer cabinets that are chilled by hydrocarbons, rather than chlorofluorocarbons (CFCs). These cabinets are now being rolled out globally.

Laundry detergent, a huge part of our business, is also an area where we are not only improving our operations but playing a role in educating consumers. By taking ownership of the way in which our products are used, we can have a significant environmental impact. Developing laundry products that wash well in cold water is just one example. The number of inquiries we are receiving about issues such as grey water use is increasing, which tells us that consumers are looking to us for information on how they can live more sustainably.

For manufacturers and retailers, the mind shift to environmental leadership requires us to see commercial opportunity in behaving in an environmentally responsible way. Real examples illustrate the benefits of this shift: in France, the Skip Actigel laundry tablet has become the fastest-growing of our home and personal care brands since we decreased its chemical composition by 20 per cent, and the size and weight of its packaging by 5 per cent.

Our focus at Unilever is applying this thinking across our entire portfolio of brands, and in leveraging our size and scale to provide positive influence both up and down the supply chain and ultimately, to the consumers that use our products. Unilever in the USA is partnering with Wal-Mart in a suite of initiatives around water, packaging and chemical reduction, among others, and the effectiveness of this partnership is providing Unilever globally with a model for similar initiatives.

Here in Australia and New Zealand we have converted the cars which our sales representatives use to LPG. This is not just good environmental practice: it saves us money as well. We need to support global initiatives and focus locally on everyday opportunities in our business to live up to the challenge issued by our consumers and employees.

## Conclusion

There is no force more powerful than a knowledgeable and energised public backed by government mandate and regulations. The dual spectres of climate change and water shortages are now constants for businesses around the world. They are propelling the issue of businesses' environmental performance out of the background and into the spotlight, creating new risks and opportunities.

Business now has no choice but to adapt to this new paradigm, employees demand their employers be more environmentally responsible; governments

continue to generate green policies and regulations; investors track a company's environmental performance with the same zeal as closely they watch its share price; and leaders seize the zeitgeist to create competitive advantage.

Once Australia's retail and consumer giants chart their own courses to meet these imperatives they will drag the entire industry along with them. The momentum is building and it will soon become irresistible.

## Take action

- Senior management must heed the public's growing concern over the environment, engage with the issues and show leadership on matters such as water use and energy efficiency.
- Small-to-medium retail and consumer goods companies should prepare for the self-interested actions of larger companies that will re-engineer supply chains to suit their own approach to reducing environmental impact.
- Launch environmental initiatives to enhance your standing with employees, consumers, suppliers and clients who will all demand better corporate social responsibility performance.
- Prepare initiatives to transform the new transparency of environmental performance information into a competitive advantage.
- Get up to speed with new and proposed regulatory requirements that affect your business, your customers and suppliers, and prepare strategies to meet and take advantage of them.

*The insight in this chapter has been provided by Sean Lucy, Director, PwC Legal.*

*Sean has a broad range of experience in environmental matters and regularly assists clients develop environmental strategies and governance frameworks as well as with transactions and litigation that contain significant environmental aspects. Sean also contributes to the ongoing public debate surrounding sustainability, renewable energy and climate change through his work on the Board of the Australian Business Council for Sustainable Energy.*

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# 02

## Retail therapy works

Domestic and global private equity firms are engaging in a level of ‘retail therapy’ never before seen in Australia. Numerous high-profile retailers have been acquired by private equity firms, often at unprecedented valuations. Examples such as the department store leader Myer and the interest in giants like Coles also show that size doesn’t matter.

The boom is good news for those looking for capital to expand, restructure or exit their businesses, but will also have far-reaching consequences for the entire industry. Private equity-backed retailers will become more aggressive in the marketplace and offer management teams significant incentives to outperform their peers. Private equity managers will also leverage their expertise and contacts in Australia and overseas to make their companies more successful. Retailers that fail to respond to this new level of pressure will see a significant decline in value and may become potential acquisition targets.

Management teams need to consider carefully the impact of private equity on the retail industry. The choice is whether to maximise value in the short term through a full or partial sale of shares in the business or to prepare strategies to prosper in an even more competitive marketplace. Failing to act will destroy significant shareholder value, meaning that for most the status quo is not an option.

### The outlook

- There have been (or are pending) a number of high-profile private equity-backed transactions in the retail sector. Size is no object and more are likely to come.
- US and European private equity firms are looking at investment opportunities in the relatively immature Australian market. Coupled with more aggressive lending practices from banks, this is leading to increased investment at all levels.
- Private equity firms will drive efficiency and competition in the marketplace.
- Private equity investors will continue to target companies with good brands, growth prospects, quality management, defensible market positions and strong cash flows.
- Competition for funds between traditional fund managers and private equity will continue to intensify, with more private equity-backed transactions being blocked by fund managers.
- While valuations are high, companies will need to focus on their competitive position to maintain and grow this value in the medium term.

## Rise in M&A activity

While merger and acquisition (M&A) activity in the retail sector is not new, the current levels and valuations are. According to mergermarket, between 2005 and 2006 the total value of M&A transactions within the Australian retail sector was more than \$6 billion. In comparison, retail initial public offerings (IPOs) raised approximately \$650 million over the corresponding period.<sup>1</sup> This disparity highlights the importance of M&A as the preferred growth and/or exit avenue for Australian retailers.

Not only has there been a dramatic increase in the level of activity, there has been a change in the drivers. Traditionally, transactions between retailers were driven by strategic reasoning, with prices reflecting the value of the strategy and the synergies and savings that could be extracted from merging businesses. More recently there have been more transactions involving financial investors seeking high returns than strategic or trade buyers seeking acquisitions or investments.

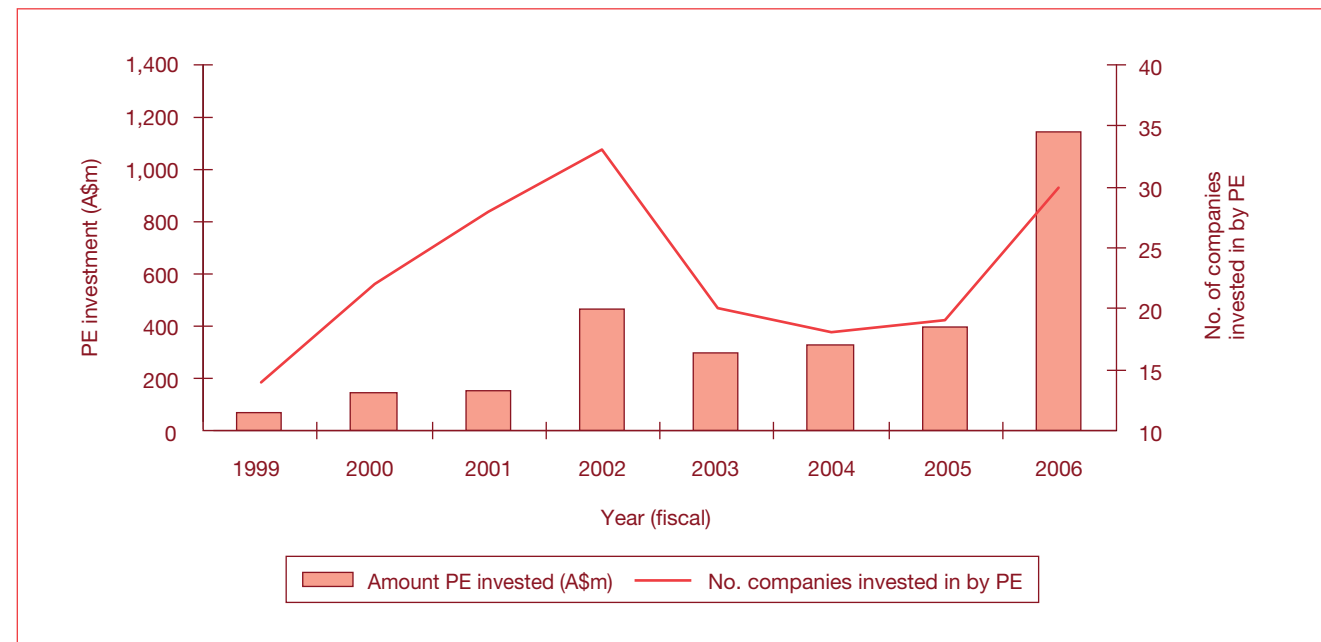
Graph 1 shows the value and number of consumer-related (including retail) transactions involving private equity (inclusive of venture capital) investors over

the past eight years. The clear trend is that the level of private equity investment activity is increasing; a trend that looks set to continue in the short and mid-term. Consumer-related transactions captured \$1.2 billion, or 51 per cent, of total private equity funds invested in 2006. This came from domestic as well as large overseas funds.

The increased activity, which is a function of significant in-flows into private equity funds, coupled with a finite number of suitable targets, is driving higher valuations. Graph 2 shows the historical earnings before interest, tax, depreciation and amortisation (EBITDA) multiple implied by a number of private equity transactions involving retail targets. The highest multiple paid for a retailer was for Godfreys, in 2006. Four of the highest multiples occurred in the 12 months to September 2006, with some sizeable retail private equity transactions pending.

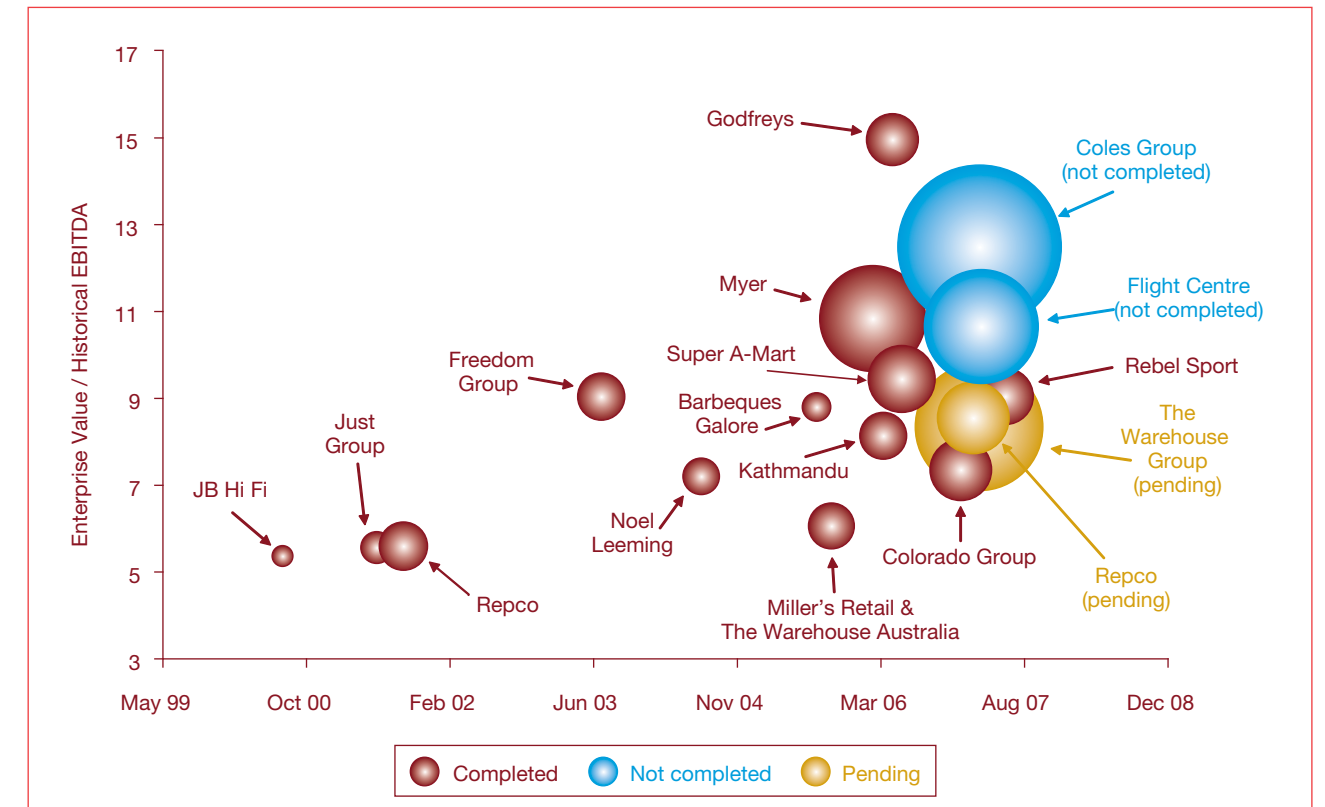
<sup>1</sup> Source: PwC Survey of Sharemarket Floats, for the calendar years 2005 and 2006.

Graph 1: Consumer related private equity investment in Australia



Source: Thomson Financial & Australian Private Equity & Venture Capital Association Limited Survey, Fiscal Year Ended June 30, 2006.

Graph 2: Historical EBITDA multiples for retail assets



Source: Public announcements, presentations and PwC industry knowledge; size of circle is proportional to enterprise value. Multiple = midpoint of circle.

The level of activity and high valuations are most likely at or very near a peak. Over the next 18–24 months, we expect to see valuations plateau as the availability of high-quality retail candidates moderates. This is particularly true in the public company space as the pool of obvious first stage buyout targets is being depleted as traditional fund managers oppose more private equity-backed public-to-private transactions (eg the proposed buyout of Flight Centre was defeated by Lazard Asset Management in February 2007).

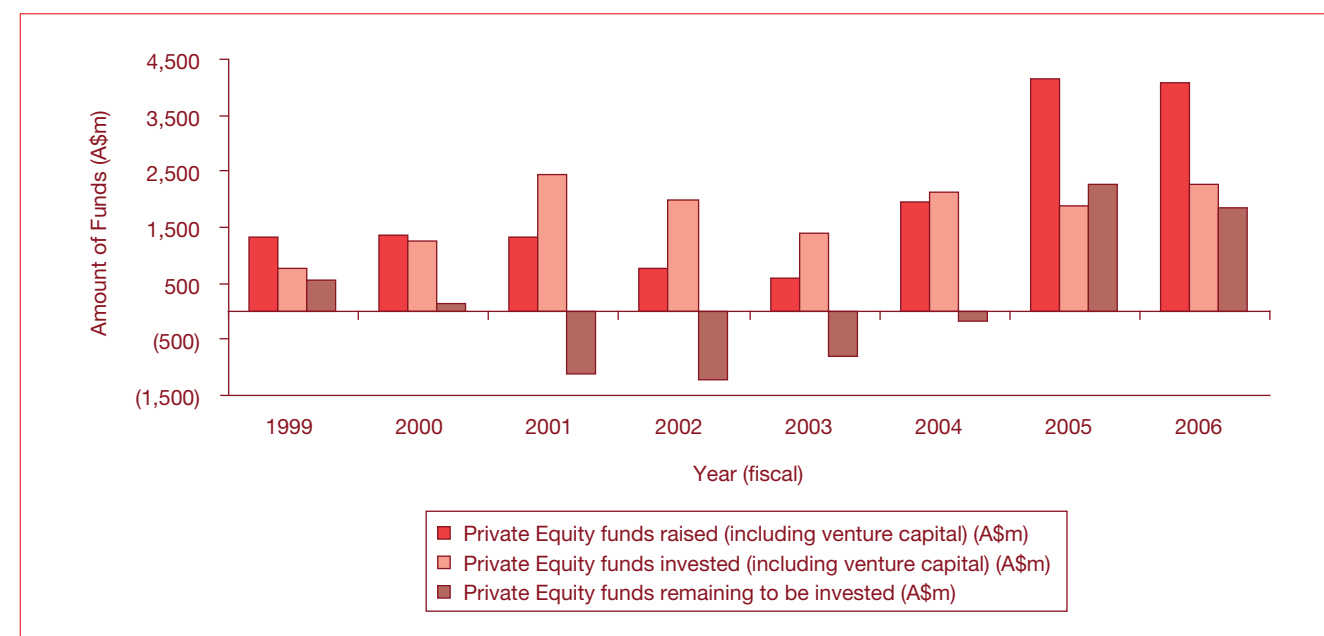
## Why retail?

The increased level of private equity investment in the retail sector is being driven by financial market conditions and the specific attributes of retailers. On the financial side, there is an abundance of private equity funding available coupled with increased liquidity in debt markets and more aggressive lending practices.

The reasons vary from company to company but retail businesses are particularly attractive to private equity investors due to:

- the ability to grow through an aggressive store rollout plan, both domestically and overseas
- the potential for operational improvements (eg improving the supply chain efficiency, IT and/or finance function effectiveness of a business)
- gaining value uplift via the sale and leaseback of significant property assets
- the ability to release cash through improved working capital management
- the potential to improve distribution and product diversification by acquiring two or more retailers in similar sub-sectors.

**Graph 3: Private equity funds raised in Australia**



Source: Thomson Financial & Australian Private Equity & Venture Capital Association Limited Survey, Fiscal Year Ended June 30, 2006.

Graph 3 shows the level of private equity funds (including venture capital) raised and invested over the past eight years. Also shown is the approximate level of funds yet to be invested. In the five-year period to 2006, the amount of funds raised almost trebled. The graph shows there is a significant level of private equity funding yet to be invested but what isn't immediately obvious is that much of this must be invested soon.

Most private equity funds have a life of seven to 10 years. That is, funds are raised, invested and returned to investors within seven to 10 years. Given the holding period of most investments (approximately three years) the majority of the funds raised need to be invested in the first three to five years of the fund's life (allowing sufficient time to exit investments and wind up the fund). Accordingly, a large portion of the uninvested funds available will need to be invested over the next two years, making most private equity managers particularly hungry for good deals.

Similarly, debt providers are ready to finance quality businesses and are engaging in more aggressive lending practices. Historically, senior debt facilities were secured almost entirely against the assets of the business and would represent maybe two to three times EBITDA. More recently, senior debt levels on private equity-backed deals have been reaching up to five to six times EBITDA, with banks more willing to lend against cash flows with limited recourse. There has also been significant growth in the subordinated debt markets, taking total debt on some transactions up to eight to nine times historical EBITDA.

A need to invest funds in a relatively short timeframe, coupled with high gearing levels, is increasing the competition for assets, further pushing up business valuations. The situation is also affected by the increased level of interest in the Australian market by overseas investors. With European and US private equity markets being relatively mature, many large funds are now seeking investments elsewhere and see Australia as an attractive proposition.

### Mechanics of a typical private equity transaction

Private equity, which can be defined as investment in primarily unlisted companies accompanied by a degree of investment participation by management, is not a new concept. However, the Australian private equity industry has grown considerably in prominence and size over the past decade. There are 46 Australian private equity firms registered with the Australian Private Equity & Venture Capital Association Limited (AVCAL). This excludes a significant number of seed venture capital funds and private family groups. New funds (private equity and venture capital) formed in 2006 averaged \$415 million in size, up from the average fund size of \$74 million in 2001.<sup>2</sup>

<sup>2</sup> Source: Thomson Financial & Australian Private Equity & Venture Capital Association Limited Survey, Fiscal Year Ended June 30, 2006.

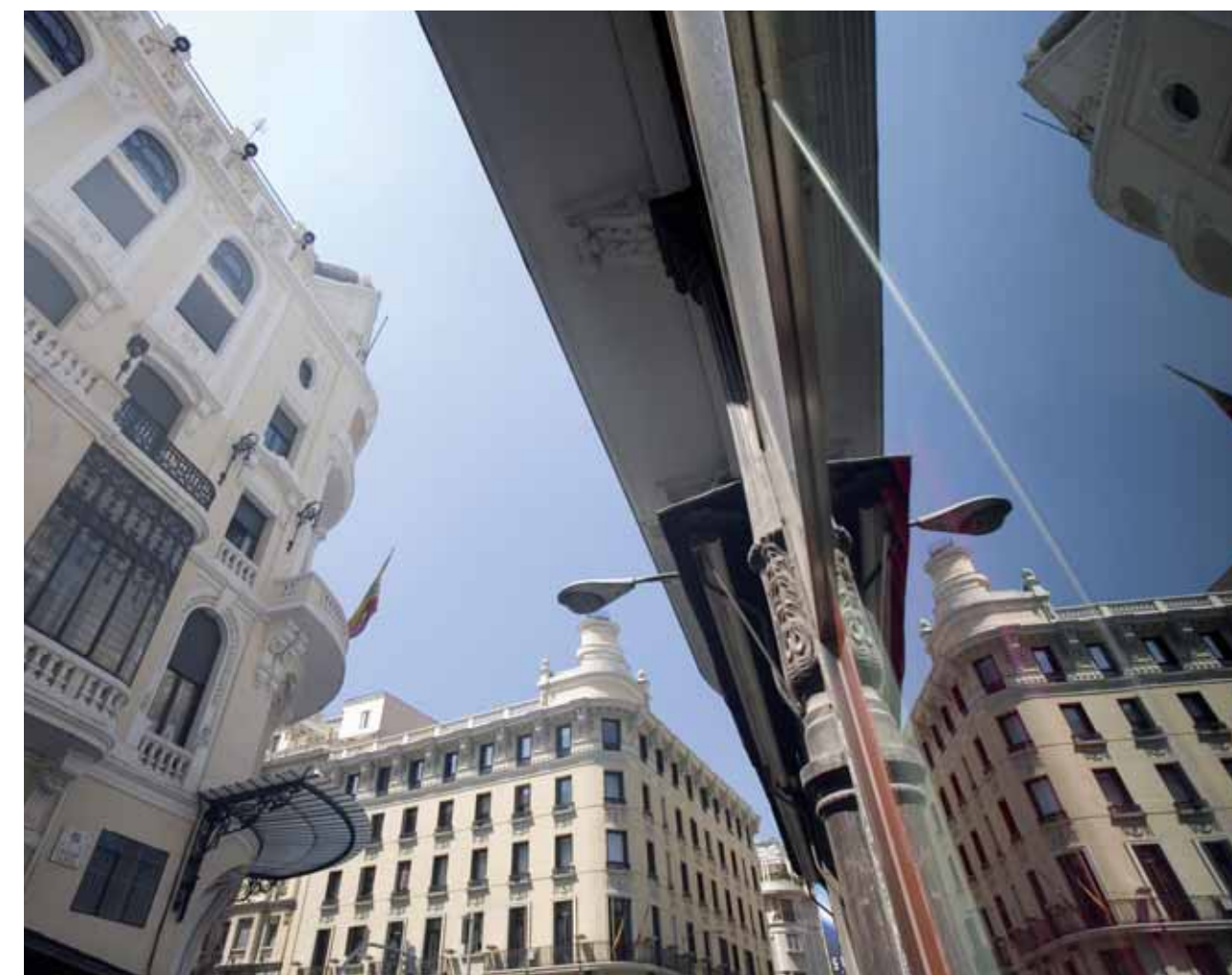
While funds focus on different market sectors and investments of different size, the basic mechanics of a private equity transaction are the same. The private equity fund manager makes an investment in a private company, or a division of a listed company or of a conglomerate with a view to making a suitable return over three to five years. Traditionally, the basis for this return was price or multiple arbitrage, with investors seeking undervalued assets, introducing a series of performance improvement initiatives, and exiting at a higher earnings multiple. Such returns were further enhanced by clever financial engineering made possible by the 'four pillars' of a good private equity target:

- a lazy balance sheet or conservative capital structure
- strong and maintainable cash flows with which to pay down increased debt
- an attractive growth outlook to drive future earnings
- a strong incumbent management team.

While these attributes remain essential criteria in the selection of private equity targets, undervalued assets are increasingly difficult to find.

The competitive auctions accompanying many recent sales show that good quality businesses are scarce. This new level of competition has significantly reshaped the private equity landscape, with investment returns now largely determined by the operational improvement capability that private equity brings to the investee company, instead of multiple arbitrage or financial engineering.

In effect, multiple arbitrage has been replaced by performance improvement arbitrage, whereby private equity managers work meticulously to apply superior methods to review and ensure rigorous alignment of operational strategy, specific and measurable key performance indicators (KPIs), and powerful management incentives. It is this well-planned, thorough and detailed approach that unleashes the true earnings potential of the target company and, if managed correctly, engages key management stakeholders from entry to exit by way of trade sale, second stage buyout or IPO.



**Table 1: Indicative structure of a PE transaction**

	Existing business <sup>1</sup>		Entry		Exit			
	\$'m	%	\$'m	%	3 years		5 years	
					\$'m	%	\$'m	%
Forecast EBITDA <sup>2</sup>	12.5		12.5		15.7		18.4	
EBITDA multiple (entry/exit)	8		8		8		8	
Enterprise value (EV)	100		100		126		147	
Ordinary equity:	70		20		63		94	
Management – upfront equity	n/a		1	5%	3	5%	5	5%
Management – performance equity			n/a		6	10%	14	15%
Private equity	n/a		19	95%	54	85%	75	80%
Preference shares <sup>3</sup> (private equity)	n/a		10		14		18	
Total equity	70		30		77		112	
Debt <sup>4</sup>	30		70		49		35	
Leverage ratio (Debt/EV)		30%		70%		39%		24%
Envy ratio <sup>5</sup>				1.5:1				
<b>Exit metrics:</b>								
Dollar returns (\$'m) - private equity					38.5		64.1	
IRR <sup>6</sup> - private equity					33%		26%	
Times money in <sup>7</sup> - private equity					2.3		3.2	
Dollar returns (\$'m) - management					2.1		3.7	
Times money in - management					3.1		4.7	

**Notes/Assumptions:**

- 1 = Prior to acquisition by private equity. Entry and exit structuring and outcomes are post acquisition by private equity.
- 2 = Under private equity ownership EBITDA is forecast to grow at 8% p.a.
- 3 = Preference shares attract an annual coupon of 12.5%, which is rolled annually and paid out on exit.
- 4 = Half of the outstanding debt principal and interest is repaid evenly over five years.
- 5 = The ratio between the price paid by private equity and management for their respective initial equity stakes.
- 6 = Internal rate of return, post corporate tax, pre investor tax.
- 7 = Times money invested is the proceeds to private equity (and management) on exit divided by its investment amount on entry.

Table 1 provides an example of the mechanics of a private equity transaction at both entry and exit:

- Prior to acquisition by private entity, the enterprise value of the business in this example is \$100 million (or eight times forecast EBITDA), comprising \$70 million in equity and \$30 million in debt. The assumed existing lazy balance sheet and strong operating cash flows, enables private equity to increase the leverage ratio from 30% to 70% on entry. Under this revised capital structure, total equity comprises \$20 million in ordinary shares and \$10 million in preference shares. The latter attracts an annual return coupon (payment-in-kind) of 12.5%.
  - The management team’s equity participation involves an upfront co-investment of \$1 million (or 5% of the ordinary equity at entry), and a performance component potentially equal to a further 15% that is tied to pre-agreed KPIs and is dependent on the time of exit.
  - A substantial proportion of management’s co-investment amount is sourced from its own net worth. The envy ratio, which can be defined as the ratio between the price paid by management and that paid by private equity for its respective total equity share, is 1.5:1. An envy ratio of greater than 1:1 is designed to deliver a greater portion of management’s equity stake upfront, rather than in three or five years’ time.

Following acquisition, private equity seeks to lay the foundations that will enable it to maximise returns by significantly improving the overall administration and operation of the investee company. A key output of the lengthy due diligence process (typically conducted by a team of private equity analysts and advisers) is a detailed strategic plan which directs all activities towards this goal. In particular, it is aimed at realising identified sources of value, implementing relevant KPIs to proactively manage performance and introducing the incentives necessary to ensure management’s objectives are aligned with those of the investor. In putting this plan into action, private equity will incentivise management to implement cost reduction programs, streamline operations and grow revenues through product and market expansion. Investors will also focus on the balance sheet (in particular working capital) to ensure efficient cash management. While private equity will assist management to set the strategic agenda, it relies heavily on the experience and ability of the incumbent management team to drive the strategy on a day-to-day basis.

On exit, the particular return indicators that are adopted depend on whether the investment is being viewed through a private equity or management lens. Traditionally, private equity investors focus heavily on the required internal rate of return from the investment. This is dictated by its investment mandate and is usually set at more than 25 per cent, although recent competition for scarce assets has brought it closer to 20 per cent. Another important indicator for such institutions is termed ‘times money in’. This means that many private equity firms aim to triple their initial investment – their ‘money in’ – within the holding period of three to five years. From a management perspective, however, absolute dollar returns are paramount. As a rule of thumb, management expects the transaction to accelerate its net worth to such an extent that retirement becomes a realistic option.

**Implications of private equity for shareholders and managers**

The large amounts of available capital, the level of deal activity and the traditional private equity operating model are having significant effects on the whole retail sector. Over the next three to five years, successful retailers will be those that improve operational and financial efficiencies and can keep costs (particularly inventory costs) under control. This will require clear strategic vision and a strong, highly motivated management team.

Retailers should critically assess their businesses and formulate clear strategic targets for the next three to five years. They should implement a

performance management system that accurately tracks performance against those targets and ensures management’s objectives are aligned with those of shareholders. While many complete such reviews regularly, it is important this analysis is undertaken with the increased private equity activity and the various objectives of shareholders in mind. To that end, any review should cover current or future exit plans, operational performance management and incentives for key managers.

**Current and future exit plans**

Owners of retail businesses (both public and private) need to carefully consider the timing of an eventual exit and plan accordingly. The current level of activity will have an impact on retailers seeking an exit in today’s market and into the future.

Relative valuations are high and are expected to remain so in the short term. This is coupled with a high level of liquidity, making a divestment of all or part of a shareholding in the current market an attractive option. While shareholders of both public and private companies are able to realise significant value for their investments, an exit may not suit personal investment objectives.

In the medium to longer term, such high valuations are likely to stabilise. As the current group of private equity investors look to realise a return on investments, a number of retail businesses will be sold either to trade buyers or the public via IPO. This is likely to result in a cooling-off in current valuation trends, particularly if it coincides with a period of higher interest rates and reduced consumer spending.

Holding on to a business may enable further growth or improved profitability. However, new levels of competition from private equity-backed companies could make this more difficult. An assessment needs to be made of the value of the business and the value that the expansion strategy could deliver. If the expected growth does not adequately compensate owners for the risks of ownership, exit plans should be brought forward.

Public company shareholders face a different dilemma, particularly if the company is underperforming. In the short term, the company may become the target of a takeover, allowing shareholders to extract a premium. However, in the absence of a takeover or a change in management, the underperformance may continue or even accelerate as the market becomes more competitive, resulting in the loss of significant shareholder value.



### Operational performance management

One of the positive aspects of private equity involvement in the retail sector is that competition from sophisticated private equity participants forces other retailers to 'raise the bar' in terms of performance. In addition, companies under private equity ownership provide a range of invaluable lessons for other retailers. Principal among these is private equity's approach to establishing strategic objectives for investee companies and the measures employed to track performance against these objectives.

A 100-day plan that sets out private equity's strategic intent for the business – for example, strategic growth options, cost reduction opportunities and product or market expansion options – is typically developed during the due diligence period before a deal is consummated. Knowledge of the product market and business itself gained during this period serves as the basis for future performance objectives. The rigorous nature of this process adds credibility to these objectives and ultimately helps management accept them.

A critical element in managing the delivery of the strategic plan is benchmarking performance through indicators that reflect industry best practices. KPIs identified in this manner introduce the independence required to accurately assess the performance of the business. Private equity is creative in identifying KPIs – looking beyond traditional internal performance measures such as income statements, cash flows and balance sheets to identify leading (external) indicators that will help predict customer demand/trends and therefore performance. For example, an electrical appliance retailer might look to leading indicators such as planning applications for large residential property developments to determine future demand and in turn locations for new stores.

In applying a similar approach, astute retailers will significantly enhance the likelihood of superior performance. According to IBISWorld, merchandising, wages and rent represent almost 90 per cent of a retailer's cost structure in Australia. Failure to manage these costs can have a significant impact on the value of the business. For example, comparing wages costs to industry averages may highlight poor management of this cost element.

Identifying such underperformance should trigger management to assess store rosters in light of customer demand and associated shopping patterns. Remedial action prompted by such benchmarking should lead to improved staff optimisation, eliminating unnecessary rostering in off-peak times.

Creativity is certainly important in selecting performance benchmarks but it is important not to throw the baby out with the bathwater. Retailers should keep an eye on traditional measures such as comparable store growth, overheads, operating cash flows, inventory turns and days payable.

### Key management incentives

Management capability is critical to the success of any private equity investment and can be a significant contributing factor in investment decisions. While private equity investors will sometimes bring outside management to the businesses in which they invest, more often than not they will rely heavily on the incumbent managers to drive growth.

Another valuable insight to be gleaned from private equity is its ability to align its interests with those of management. Under private equity ownership, senior managers are required to put 'skin in the game', thus ensuring the company is owned and managed by like-minded people who share a stake in the business. In such a highly incentivised environment, management is motivated to outperform operational KPIs. Such motivation is further sharpened by the discipline typically associated with a highly leveraged vehicle.

Recognising the correlation between motivated employees and performance makes it critical that

retailers identify key management and staff and put in place a range of incentives to ensure the best possible performance across each level of the organisation. Regardless of whether shareholders plan to exit in the short term or hold and grow the business, the right management and incentive programs will have a significant impact on value.

While attempting to replicate private equity-style incentive programs makes sense in theory, there are practical difficulties for both public and private businesses. In a public company setting, the market may not view large equity payments favourably, particularly if the business is not performing well. Similarly, private company owners may find the option of diluting their equity unappealing, especially if ownership is highly concentrated.

Faced with these issues, public and private businesses can still do much to align the objectives of owners and management. For example, public companies can offer generous performance-based options that are closely aligned with carefully defined KPIs and hence shareholder objectives. Privately owned retailers may look to franchising arrangements as a viable alternative for providing key employees with a stake in the business. It is important to note that individual and team-oriented cash bonuses are effective motivators only if properly aligned with corresponding KPIs and executives have control over the required outcomes.

In borrowing management incentive ideas from private equity, it is important not to lose sight of the fact that not all managers are motivated by rewards such as money. For many, intrinsic rewards, such as better work-life balance and career development, are a more powerful and sustainable source of motivation.



**Eric Morris**  
**Chief Executive Officer**  
**The PAS Group Pty Ltd**

We have a simple motto at The PAS Group: “We do what makes sense.” I am sure this is a common goal, but it has become much easier within a private equity-backed business.

The PAS Group was formed in 2004 to pursue a roll-up strategy of acquiring quality businesses in the Australian wholesale apparel market. Our companies include Yarra Trail, Breakaway, Designworks, The Hopkins Group, Review, Capelle and Fiorelli, whose products are sold through thousands of retail outlets across Australia.

The primary private equity owner is DB Capital Partners, which holds the majority of shares of the business through its managed funds, with The PAS Group management holding the balance.

I’ve worked in the retail, wholesale and licensing industries for more than 25 years in a range of senior roles. These included managing Myer’s Private Brand division and being Asia Pacific regional director for Reebok based in Hong Kong. Even with all this experience, I believe the private-equity backed approach we are using at The PAS Group is the best business model for operating and growing a business like ours.

Private equity is enabling us to build scale in a fragmented sector and to grow both organically and through acquisitions. The group’s annualised EBITDA has climbed from \$5 million in our first year to \$14 million in the second, and in 2007 we are on track to do in the region of \$30 million.

Companies that we acquire can expect to change. Smaller businesses in the highly competitive world of apparel tend to run on minimal resources and business infrastructure. Managers work in the business and have little information about the wider market. They also have few peers to share ideas with.

The first thing we do after acquiring a company is enhance its reporting systems and support. The most crucial step here is to improve financial controls, in some instances installing a financial controller for the first time. Then we work with managers in the business by taking a helicopter view of their operations and market opportunities, and by assisting in the creation of business plans.

With these plans in place, we are investing for growth. At Capelle, we created new product divisions. We have enabled Designworks, which provides private label clothing to department stores as well as its own branded products, to expand its customer base to Jay Jays and Myer. The Hopkins Group has introduced a new brand that has been picked up by David Jones and Myer. I’m pleased to say that we have added jobs across the group since our foundation, contrary to the common perception of private equity ownership.

Notably, we haven’t rushed to replace the information technology systems at our group companies, preferring to stick to the idea that “if it isn’t broken, don’t fix it”. Indeed, a key part of the private equity ownership model is that the investment horizon is relatively long compared to that in the public market and you can concentrate purely on what is right for the business.

For companies considering working with private equity investors, I think it is important that the managers of the business and the investors find their appropriate space. In our case, we rely on DB Capital Partners for its knowledge of leveraged finance and transactions. A representative is also on the board and we talk regularly about events and opportunities. Over time we would expect DB Capital to exit, most likely through an IPO or a trade sale.

Day-to-day management of the business rests with The PAS Group team and the individuals leading our businesses. We are fortunate to be supported by an experienced board including chairman Bob Dalziel, formerly at Mayne Group and Coles Myer.

I believe the key to the private equity model is the board and the management team that is running the organisation. The strength of our business is the aligned board, with each board member providing valuable input in their respective areas.

I don’t see the growth of private equity slowing down in the Australian retail and consumer sector. The presence of duopolies tends to lead to complacency and create opportunities for private equity managers. The fragmentation of other parts of the market is also an opportunity, as we are realising with The PAS Group.

## Conclusion

Private equity’s interest in retail businesses highlights the enormous potential of the sector. However, it should also serve as a warning sign that the competitive landscape is changing fast. Owners and their management teams need to capitalise on the high valuations of retail businesses or actively improve their operations to ensure they remain competitive in a more aggressive and efficient marketplace. Those that do nothing will suffer the consequences.

Whether shareholders are seeking an exit or simply looking to maximise the value of their holdings, management needs to review a range

of business issues. Focusing on areas such as corporate structure, capital structure, supply chain systems, cash flow, working capital, management and growth strategies will not only maximise value during a transaction but also help the business cope with more aggressive private equity-charged competitors. Carefully assessing the options and developing a clear strategy will provide significant value to current and future stakeholders.

## Take action

- Update the strategic plan covering the next three to five years.
  - Review existing operations and improve efficiencies, particularly around working capital and logistics.
  - Consider growth and exit options, including seeking a strategic private equity investor to partner growth prospects.
  - Streamline the corporate structure and formalise procedures including franchise arrangements.
- Know your value and communicate it to shareholders.
- Employ sufficient debt funding to optimise your capital structure and maximise shareholder value.
- Closely align KPIs with your strategic plan and management incentive programs to ensure superior performance.
- Identify key managers and give them incentives to remain with the business.

*The insight in this chapter has been provided by Greg Keys, Partner, Corporate Finance and Lorcan Barden, Associate Director, Corporate Finance.*

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# 03

## Strengthening the chain

While many expected 2006 to be a year of great change in Australia's grocery retail supply chain, the potential break-up of one of our major retailers combined with other forces to temper the transformation.

In some respects, the past 12 months have been dynamic, with opportunities – and threats – becoming more evident. The year provided moments of truth as the reality of some major supply chain initiatives launched by the big retailers started to bite. Primary freight arrived as a strategy and is now embedded as a standard way of doing business with major retailers. Evidence suggests some retailers are moving away from collaborative planning, forecasting and replenishment (CPFR) as a supply chain enabler. Private equity emerged at the highest level of Australian grocery retail, raising questions as to whether one major retailer will follow through on supply chain initiatives already launched. And although retailers' distribution networks are starting to unfold, they are different than initially proposed.

To analyse these issues and describe the grocery retail supply chain of the future, we will examine eight issues that may have deep implications for investments by retailers, suppliers and service providers to the grocery retail sector.

### The outlook

- Distribution networks servicing independent retailers will not only survive but grow stronger.
- The execution challenges and commercial reality of scan-based trading will reduce its appeal to companies in the Australian grocery retail supply chain.
- Regional, off-shore based supply hubs will become standard practice for multinational consumer packaged goods companies within the next three to five years.
- The rate of CPFR adoption will slow and for some retailers cease, creating downstream issues with retailers' new generation distribution channels.
- Except for fresh produce and selected shelf-stable lines, the uptake of shelf ready packaging in the Australian retail grocery industry will be limited in the short-to-medium term.
- Local grocery retailers will maintain their 'wait and see' position on radio frequency identification (RFID) technology in the short term but it will eventually become an important technology.
- Progressive retailers and manufacturers will drive the pursuit for carbon consciousness in the Australian grocery retail supply chain but carbon neutrality is a long-term journey with significant associated costs.

## The survival of independent networks

The independent grocery retail market comprises independently owned retailers and banner groups outside the two major grocery chains, for example IGA, 7-Eleven and Foodworks. Recent indications reveal a strengthening of the independent channel at the expense of the larger retailers in specific geographies, including Western Australia. This has been fuelled by the Metcash acquisition of Foodland's legacy stores and the growth of the convenience grocery market, which is dominated by franchise operators such as 7-Eleven. This market has enjoyed average revenue growth of 9.4 per cent over the last five years as opposed to more modest growth of 5.5 per cent in the major grocery segment.

The development of wholesalers and third-party logistics providers will be critical to support these independent retailers and other non-grocery channels, such as food service. Without viable operators in this space, the independent channel will struggle to compete on price and on-shelf availability. Wholesalers need to be able to consolidate demand and third-party logistics providers need to be able to offer manufacturers viable channels to market, such as route trade services.

There are significant challenges. For example, only a few third-party logistics providers are able to offer effective route trade services. This has been the domain of independent distributors who often charge up to 30 per cent of the value of the product to deliver

into store. In addition, distributors typically own the customer relationship, which creates further barriers to entry for consumer packaged goods suppliers when trying to launch new products or increase sales volumes in key geographies.

If third-party logistics providers can overcome such barriers and continue to invest in the necessary technology and capital, there will continue to be steady growth in the independent grocery and non-grocery food service market. Ultimately, the consumer will benefit from innovation and a range of choice. However, failure will mean further growth of the larger supermarket chains, resulting in lower costs but a more standardised customer offering. A recent example is the consolidation of the Bi-Lo brand into Coles, with the standardised pricing and stock keeping unit (SKU) range that this brings.

We believe the independent retail supply chain will grow stronger. Improved infrastructure will enable a lower cost and higher service proposition. This will come about as a result of price pressure and supply chain transformation by the major grocery retailers. Consumer packaged goods companies are seeking a higher-margin channel to market. Independent retailers and convenience stores offer such a channel so consumer and packaged goods companies will look to develop and exploit this route to market.

Also, growth in franchising, particularly in convenience and independent grocery retailers, will continue to support this channel to market.

Third-party logistics providers are starting to recognise the margin potential for high-service, multi-drop distribution contracts such as TNT's contract to support BP's new retail and convenience store distribution strategy.

The Coles sale process may also create opportunities for other independent retailers, such as IGA in Western Australia and Queensland, to build critical mass in key markets, further developing and strengthening the independent retail supply chain.

### Should retailers own inventory?

As retailers search for new ways to reduce inventory and transaction costs throughout their supply chain, scan-based trading (SBT) may emerge as the Holy Grail of retail supply chain management. However, we believe the execution challenges and pure commercial reality will stymie SBT in the Australian grocery supply chain.

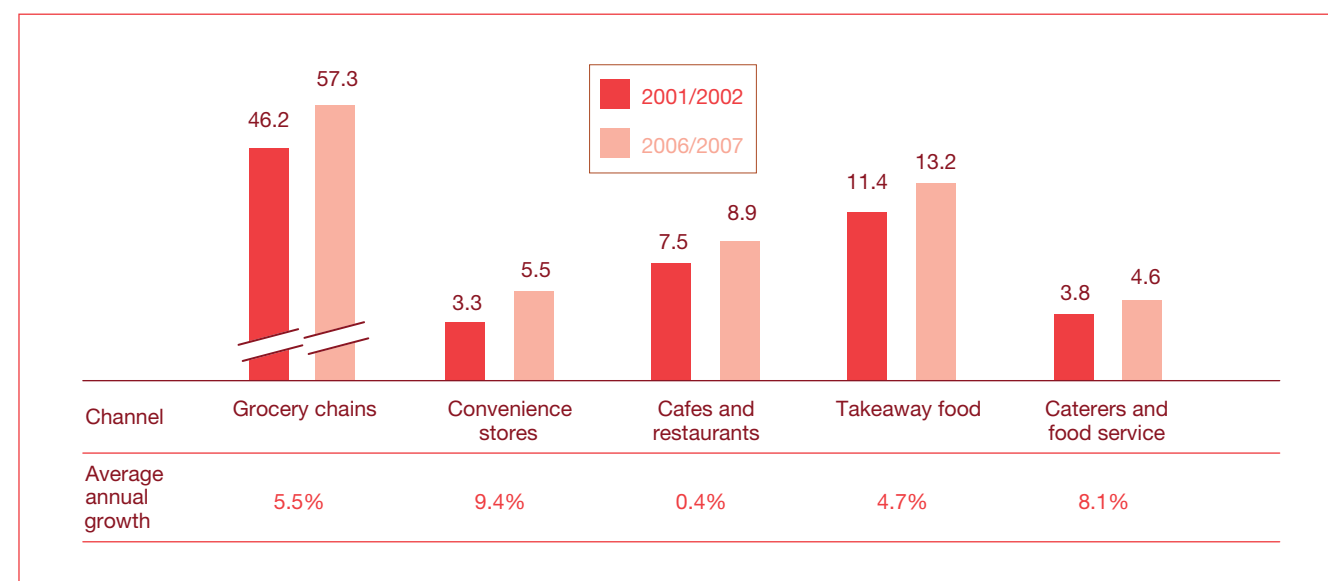
The key difference with SBT is that suppliers retain ownership of their inventory right up until the point of sale and are only compensated based on the point-of-sale scan of the item. Conceptually, this creates the opportunity to reduce administrative costs by simplifying the goods receiving processes and reducing query handling due to data

discrepancies. Improved inventory management is another proposed outcome, with consumer packaged goods companies taking even greater responsibility for optimising the supply chain from raw material supplier to consumer.

In theory, SBT centralises the point of sale for both retailer and supplier, ensuring that both parties are focused on satisfying the end consumer. In practice, it gives rise to a number of issues that cannot be ignored. Many consumer packaged goods companies are concerned about the impact on their working capital because they have to hold channel inventories on their books. Within the Australian grocery retail supply chain there is up to \$2.4 billion worth of inventory that could be transitioned from retailer to supplier. However, by offsetting this with improved payment terms, the net impact may not be so great.

In Table 1 we have illustrated the possible inventory financing implications for the industry if SBT is adopted. SBT would immediately shift the average 22 days of retailer inventory to suppliers – who would pick up a working capital impost of \$2.4 billion as a result. If retailers offset this with improved payment terms – from say an average 21 to seven or 14 days – we may see a net movement of eight to 15 days working capital from retailer to supplier. This would result in increased inventory financing costs to suppliers of up to \$131 million per year.

Graph 1: Australian food retailing – market size by channel (\$ billion)



Source: IBISWorld reports.

Table 1: Scan-based trading inventory financing impacts

Net sales (supplier to retailer)	\$40bn	
Inventory holding moving to supplier (22 days)	\$2.4bn	
Cost of inventory moving to supplier (@ 8%)	\$192m	
Potential improved payment terms for supplier (21 → 7 days net)	\$122m	
Potential improved payment terms for supplier (21 → 14 days net)		\$61m
<b>Working capital increase for supplier</b>	<b>\$873m</b>	<b>\$1,636m</b>
<b>Finance cost increase for supplier</b>	<b>\$70m</b>	<b>\$131m</b>
Increase as percentage of net sales	0.18%	0.33%



Notwithstanding inventory finance impacts, for SBT to work effectively, retailers will have to be willing to give up control of the inventory flowing through their distribution networks. If suppliers are going to own the product up until the point of sale, they will want full control over inventory flow to store. They may even push to exit the retailers' distribution networks and return to direct store delivery. This will create problems for retailers in terms of how they optimise their warehousing and distribution network costs. It also runs contra to how major retailers have designed their new supply chains – which advocate greater control by the retailers.

In addition, if SBT were to catalyse a change in the retail distribution model, it could generate a hornet's nest of trading term issues, particularly given the recent unpopular trading term changes such as primary freight.

Finally, the question of who carries the cost of shrinkage will be another concern for consumer packaged goods companies, although again this should not be a distraction from the more strategic opportunities that SBT presents.

The technology investment required to support SBT (eg fully implemented automated store replenishment systems and planogram standardisation) will be a major barrier to adoption. Major retailers are unlikely to pursue SBT as a strategic priority until their current supply chain transformation programs are complete

and they turn their attention to the next source of competitive advantage. In the meantime, the results of the first pilots internationally will be better understood over the next two to three years.

For now, we have not been able to identify any full-scale operating models of SBT, other than some US-based direct-to-store delivery models. The complexity from both a technology and trading terms perspective is likely to reduce its appeal in the Australian grocery retail supply chain. There are likely to be only two possible candidates – Coles and Woolworths – since Metcash-aligned retailers lack the technology and data uniformity.

Of the two majors, only Woolworths would be close to having the technology to achieve a full operational SBT model in the next two to three years. It is also questionable that SBT actually works for the type of supply chain developed by the two majors, where suppliers no longer provide direct store deliveries and virtually all product is handled through the retailer's distribution channels.

We are unlikely to see a move to SBT in the Australian marketplace any time soon. There is little to compel Woolworths, which is the most capable to execute, to adopt this model when the working capital benefits could more easily be achieved through inventory reduction within its own distribution channels and by driving arbitrage through existing trading terms.

## The case for regional supply chain hubs

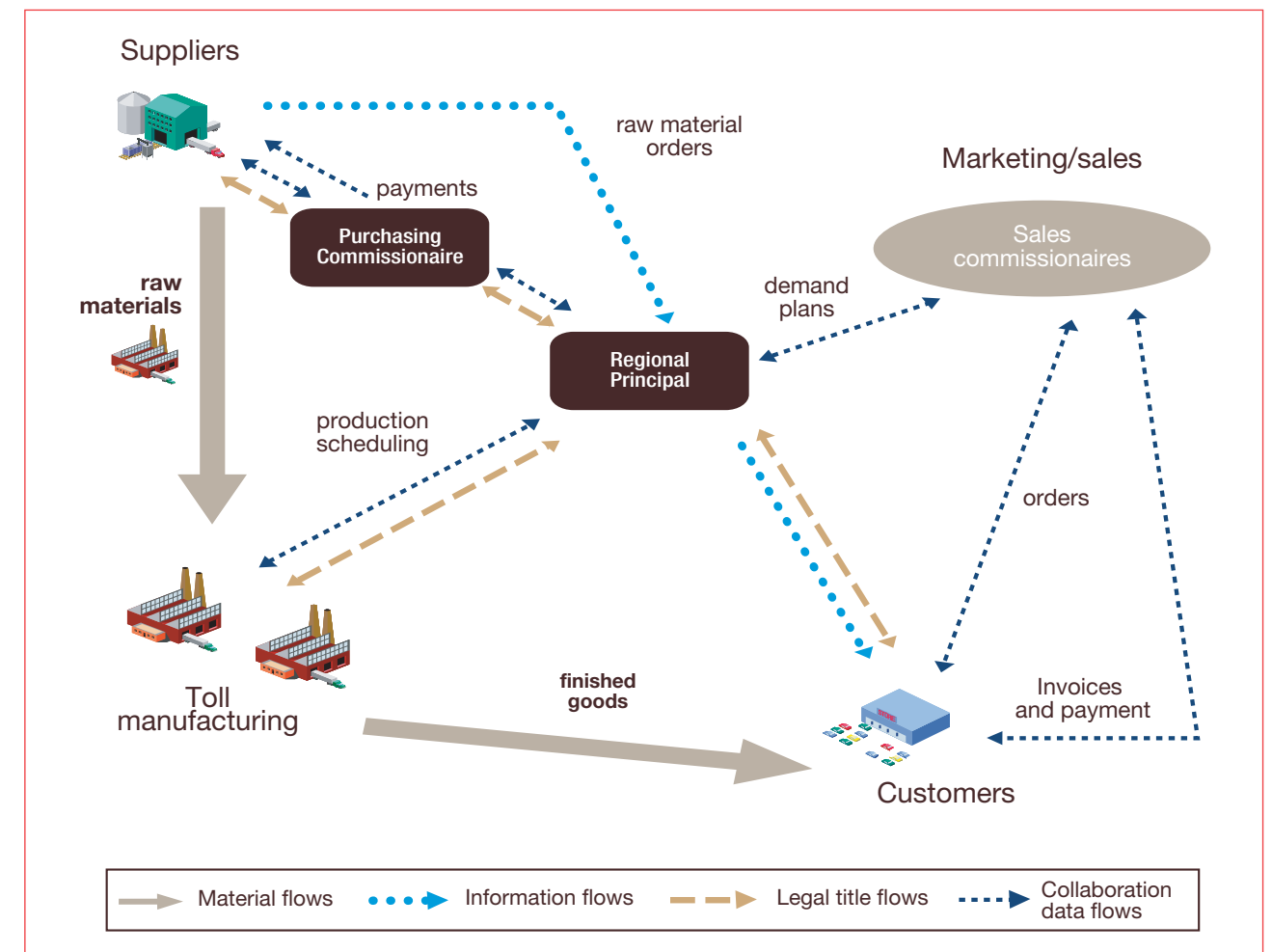
Regional supply hubs will become a standard practice in the Australian retail grocery supply chain within the next three to five years. Adoption will be most widespread for companies with high product costs relative to their transportation costs. Multinational companies will find that establishing an entrepreneurial regional supply management centre can deliver operational and tax savings without the need to change their physical supply chain infrastructure. However, this model won't be for everyone.

Many industries, particularly electronics, have been using supply hubs to reduce inventories and shorten order lead times for years. Multinational companies in the retail grocery supply chain are starting to adopt similar principles on a regional basis.

How widespread will this practice become in Australia and what are the implications for local companies not in a position to leverage a regional footprint?

Regional supply chain hubs create the opportunity for significant cost, transfer pricing and taxation-related advantages. Many companies that have already captured the benefits of low-cost offshore sourcing opportunities are now seeking the next source of competitive advantage through their supply chains. Regional supply chain hubs enable multinational companies to leverage their scale across the region to further reduce their inventory holding costs. Some Asian countries offer significant tax and investment concessions for establishing operations in their countries.

Figure 1: Maximise tax benefits in your supply chain through understanding the related business processes



Many companies operating in the Australian grocery sector may find that the costs of transporting product around the region will outweigh the potential benefits of establishing a regional supply chain hub or even the cost savings from sourcing offshore. Companies with relatively high product costs will be the first to adopt this practice. For example, one leading global alcoholic beverages company recently established a supply hub in Singapore, where product is imported in cleanskins then stored and packed for Asian markets. This has reduced supply lead times to the local markets from 10 weeks to two weeks.

Retail chains, particularly those with private label products, will also establish offshore consolidation centres. The aim is to reduce local transport and logistics costs by consolidating products offshore and delivering directly to regional distribution centres or retail outlets. These practices are already taking effect.

Any company that is importing products from Asia or operating on a regional basis may be affected, although perishable produce suppliers are less likely to be impacted. Locally-based consumer and packaged goods companies may find themselves at a cost disadvantage to their multinational competitors who are able to leverage a regional model.

## To merge or de-merge

There are two primary drivers behind the possible merging or de-merging of supply chain operations from retail operations.

Firstly, major retailers have worked hard to gain control over their supply chains. They are on track to control material portions, from collecting goods from suppliers to delivering them to stores. This now represents a complete package.

The second reason is the strength of a private equity market that is hungry for innovative buying opportunities with significant and market-controlling positions. The recent activity surrounding Coles is a case in point. Much has been talked about with respect to carving up the Coles group. Could the company's supply chain be one of these groups?

A retailer's supply chain operations would be a tantalising asset for a subsequent trade sale to a major and acquisition-hungry third party logistics provider. Look at Toll and Patrick or Linfox and FCL. Alternatively, a new company could be formed, creating a major player in the third-party logistics market literally overnight.

Such a transaction would rely on a long-term contract to continue provision of supply chain services to the retailer at a rate comparable to current costs. The new owner would then have the opportunity to generate margin by streamlining operations and chasing new revenue opportunities. Freed from the constraints of retail ownership, the new business could seek to capture a greater share of the upstream grocery supply chain – gaining primary freight volume destined for all retailers and building consolidation centres to further optimise inbound volume.

Hypothetically, a retailer's supply chain may represent a cost base of about \$1 billion per annum. Assuming a new entity could grow revenue with existing assets by about 20 per cent, and achieve a modest profit margin of 7.5 per cent, a forecast EBIT of \$90 million seems readily achievable. With historical transactions in this industry achieving multiples of seven to 10 times forecast EBIT, we might see a transaction value of \$630–\$900 million.

While the valuation of a retailer's supply chain assets may be compelling, there would be serious issues to address around ongoing service levels to the incumbent retail operation. Declining service or 'dis-synergy' costs may well have an adverse impact on the valuation of the core retail business. The key question is: would the net value of the two organisations equal more than the current value of the merged organisation?

We have seen the likes of Woolworths sell and lease back its distribution centre sites once they had been procured and much of the construction completed. We have a new CEO at the helm of Woolworths and a major private equity process about to unfold with Coles, so it seems the market is primed. De-merging supply chain operations would clearly have an impact on the major shareholders of the retailers if it was to transpire.

If the sale of a retailer's supply chain is to happen, one can only suggest it will take place within the private equity boom in which we currently find ourselves – in the next three to five years. A transaction could only occur with a long-term lock-in between the retailer and the new third-party logistics player and with significant performance-based guarantees. Such a transaction would bring private equity and trade buyers into direct competition, no doubt driving the value of such a deal.

## CPFR in the Australian grocery retail supply chain

CPFR stands for collaborative planning, forecasting and replenishment. It was meant to be a collaborative business process for improving on-shelf availability and reducing inventory levels, but has it failed?

CPFR initiatives have often stalled because of three factors:

- data and process incompatibilities
- difficulties over the choice of technology
- the complexity of communication in a highly-dynamic market.

With one of the major Australian retailers reportedly deciding to disband its CPFR program, the future of CPFR in Australia is bleak.

For retailers, CPFR's failure means many issues remain unresolved. A glass floor will form around key categories with respect to inventory reduction, resulting in a move away from a fully stockless supply chain in some categories. Retailers' newly designed and built distribution centre network may reach capacity much faster than forecast, resulting in overflow or shoehorn solutions across major categories. There will be a limit in the extent to which order frequency can be driven

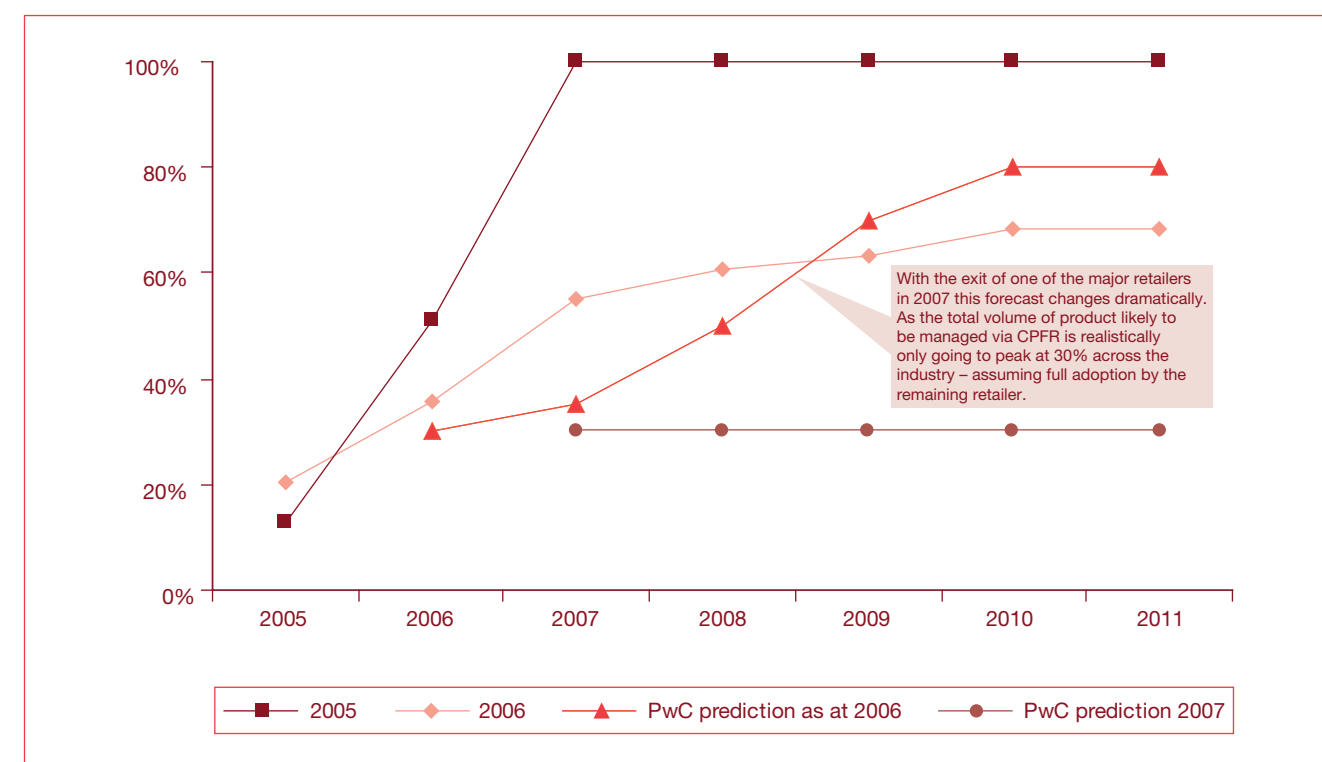
up and full optimisation of on-shelf availability and reduction of out of stocks will also be in jeopardy.

The demise of CPFR means suppliers will need to be proactive and put pressure on the retailers to find workable collaborative trading partnerships. Suppliers will need to invest more than retailers in understanding and planning for consumer demand. They will also need to put pressure on retailers to:

- allow them access to auto-generated forecasts
- find new ways to collaborate with retailers, such as on-site replenishment buyers
- prepare to absorb more inventory
- manage smaller and more frequent orders outside forecast predictions.

When we explored the collaborative planning, forecasting and replenishment issue in detail in our 2006 *Australian Grocery Retail Supply Chain Study* we stated that it was a keystone for the retailers' distribution centre network design strategy. Without CPFR, suppliers and retailers were going to face major issues in fitting a solution for a network that simply was not designed to hold inventory at the levels required to support consumer demand.

Graph 2: Volume of product managed via collaborative planning, forecasting and replenishment programs within the Australian grocery retail supply chain



Source: *Australian Grocery Retail Supply Chain Study*, PwC, 2006.



Given the reliance on CPFR to manage the new distribution channel network, we would anticipate major changes to the configuration of the new distribution channel network. Stockless distribution channels, particularly for chilled product, are now unlikely to become reality. In a worst case scenario, we foresee some of these new generation distribution channels reaching capacity much faster than anticipated, resulting in high levels of disruption to suppliers who will be forced to carry more stock and/or undertake costly expansions to accommodate the inventory needs of the major retailers.

### Shelf ready packaging

Grocery retailers and manufacturers are always searching for ways to improve how they identify and recognise their products, as well as increase the efficiency of how they move goods from their stockrooms to shelves.

Shelf ready or retail ready packaging (SRP) seeks to improve both visual presentation and in-store replenishment with one solution. SRP products have an outer case that can be moved directly to the shelf following the one-touch replenishment principle. Although the efficiency advantages of SRP for retailers are evident, suppliers are yet to see the advantages.

The theoretical benefits of SRP are numerous:

- improving product availability
- reducing aisle congestion
- improving in-store replenishment efficiency
- reducing damaged goods
- improving the visual presentation of products.

For suppliers, SRP is associated with additional costs and complexities in the manufacturing process: new equipment investment or equipment enhancement costs; the redesign of primary packaging; planning and implementation costs; and additional complexity in new product development processes. In addition, implementation of SRP in store requires strict compliance to planograms and fixture mechanics to ensure the SRP units fit the shelf.

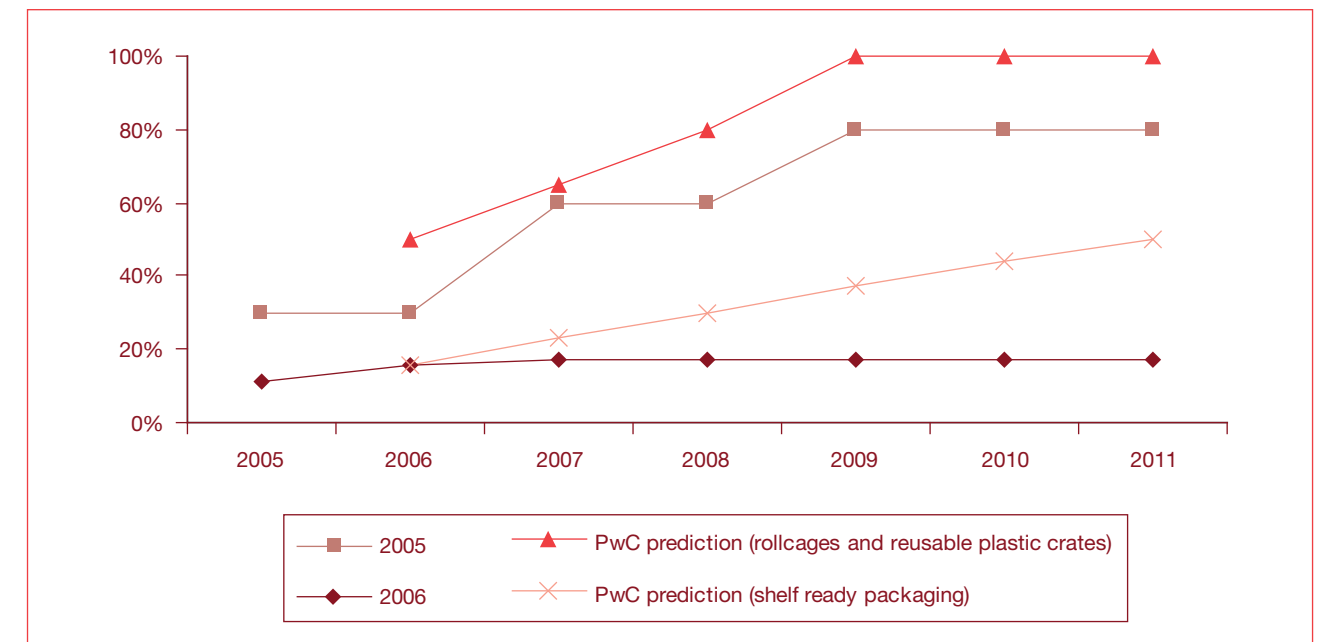
Major players in the Australian grocery stores market have already adopted a number of new SRP initiatives, such as shelf-ready tray replenishments and fresh produce in plastic crates to reduce excess handling of stock.

However, local and international trends highlight the key issues facing grocery retailers and manufacturers implementing SRP. Studies show that shoppers have yet to embrace the new visual presentation of the packaging and there are significant issues with individual items falling over when the SRP unit isn't full. Manufacturers are also highly resistant to implementing SRP as they see limited benefits in the significant additional costs of complying with retailers' SRP requirements.

Except for fresh produce and selected shelf-stable lines, we believe the uptake of SRP in the Australian retail grocery industry will be limited in the short-to-medium term. There is also little incentive for suppliers to pursue a costly SRP solution. We see no major changes to the forecast uptakes from our study in 2006 (refer Graph 3).

Where programs have worked successfully there has been greater control and sophistication across the supply chain in place prior to the introduction of SRP. The major Australian retailers are still establishing the systems and disciplines to enable SRP to work, such as standardised planograms and automated replenishment systems. We would argue that some Australian retailers moved to SRP too soon, without the necessary infrastructure, buy-in and understanding from their category management teams to fully exploit this program with suppliers.

Graph 3: Adoption of store-friendly initiatives within the Australian grocery retail supply chain



Source: Australian Grocery Retail Supply Chain Study, PwC, 2006.

## Will RFID be a major force?

Since the mid-1990s, radio frequency identification (RFID) has been predicted as the next big technology in the grocery retail supply chain, replacing barcodes as the way to identify and track a product throughout the supply chain. RFID tags allow the pallet/case/SKU to be continuously tracked via radio transmitters, without having to physically handle the product as is the case with barcode scanning. RFID was predicted to replace point-of-sale labour, freeing staff to focus on replenishment and customer service. Despite the apparent benefits of RFID technology, by 2007 there have been no significant implementations in the Australian retail grocery market.

There are three major obstacles to overcome before we will see practical application of RFID technology throughout the grocery retail supply chain:

- **Unit price** – although prices for RFID tags have decreased significantly, the current price of 15–20 US cents is eroding the value proposition of implementing RFID in the grocery retail supply chain. At this price, RFID tagging at the case level would add about one per cent to the cost of goods for the major retailers in Australia.
- **Accuracy** – the accuracy of current RFID technology in the harsh warehouse environment – eroded by metal structures and water pipes – is well below that required by retailers to track inventory positions and also below the accuracy currently achieved by scanning barcodes on pallets or cases.
- **End-to-end technology for tracking tags** – implementing RFID technology on an industrial scale requires significant investments throughout the supply chain, from the supplier to the store. Currently, the benefits of RFID do not outweigh the significant costs of implementation.

In the short term, local grocery retailers will maintain their wait and see position to implementing RFID technology. The value proposition for RFID within the Coles/Woolworths duopoly is not strong enough, with Coles resources dedicated to its major supply chain transformation program and the company distracted by the uncertainty around its ownership structure. Competition is not providing the incentive for Woolworths to fast-track the adoption of RFID, so both retailers will continue to monitor the RFID trials at Wal-Mart in the US and Marks & Spencer in the UK.

Longer term, RFID will become an important technology in the grocery retail supply chain. A hybrid solution with the use of both traditional barcodes and

RFID tags is the most plausible. Barcodes will still be used at the individual SKU level for point-of-sale scanning and so on, while RFID will be used to track cases, returnable packaging crates, roll cages and pallets in and out of factories, distribution centres, stockrooms and individual stores. Furthermore, progressive adoption of GPS and/or mobile networks used to track trucks and containers will enable real-time tracking of products from factory to shelf.

## The carbon conundrum

With increasing awareness of the impact of carbon emissions on climate change, progressive companies have begun to ‘go green’ to differentiate themselves and gain advantages from improved customer perceptions.

For example, Tesco recently established a £100 million (A\$250 million) environmental fund that includes a plan to introduce carbon labelling on all products. This labelling is intended to surpass the commonly referenced food miles – a measure of the distance food has travelled from its source – to record the amount of CO<sub>2</sub> emitted during production, transport and consumption.<sup>1</sup>

Similarly, Marks & Spencer has announced a £200 million, five-year plan to make their business carbon neutral. This ambitious plan will require a dramatic overhaul to the Marks & Spencer supply chain, and will be achieved through a mixture of emissions reduction and carbon offsetting.<sup>2</sup>

These early moves by UK retailers raises the question: How would the Australian grocery industry go about achieving carbon neutrality?

Annual CO<sub>2</sub> emissions from commercial road transportation in Australia total 15.2 million tonnes per year. The end-to-end grocery supply chain contributes about 25% of these transport movements, leaving a contribution of 3.8 million tonnes of greenhouse gases per year in transport operations alone. Purchase of carbon offsets against these emissions at an average price per tonne of \$30 would add \$114 million to the annual transport bill of the Australian grocery retail sector – a significant impost in a very cost-competitive industry.<sup>3</sup>

<sup>1</sup> *Food Business News*, June 2006.

<sup>2</sup> [www.marksandspencer.com/plana](http://www.marksandspencer.com/plana)

<sup>3</sup> *National inventory report*, Australian Greenhouse Office, 2006.

Additional carbon certificates would have to be bought to offset emissions from product manufacture, processing and store operations. In addition, the Australian agriculture sector produces an even larger volume of greenhouse gases (90 million tonnes) that would also have to be offset by purchasing carbon certificates. This could add significantly to the cost of meat, dairy and fresh produce.

While the cost and complexity of addressing these issues may seem daunting, progressive competitors will be keen to position themselves as leaders in climate change consciousness. Even in the absence of emissions reduction or carbon trading regulations, we see three broad approaches for the industry to respond:

- **Company-wide emissions reduction** – the most progressive manufacturers and retailers may seek to reduce carbon emissions across all manufacturing and distribution operations. While potentially costly, there may be significant first-mover advantages for those competitors able to position themselves as the carbon neutral pioneers of the sector.

- **Introduction of ‘green-friendly’ products** – a more practicable option may be the introduction of ‘green-friendly’ products that have low-emission production and distribution profiles, or are sold at a price that includes the purchase of carbon offsets. Either solution allows the climate change conscious consumer to be targeted without affecting the more price-sensitive shopper.
- **Retail sale of carbon offsets at point of sale** – a final option would be for retailers to sell carbon offsets at point of sale. This would require significant investment in emissions auditing to support its credibility, and some investment in systems changes to support the point of sale calculation of carbon offsets. This might be seen as the ultimate market-based solution, allowing consumer awareness and willingness to act on issues of climate change to directly influence industry progress.



**Andrew Reitzer**  
**Chief Executive Officer**  
**Metcash**

Grocery retail is such a dynamic business that there is always something happening. At the moment, there are major forces at play shaping the landscape in this country – and beyond. Just some of the issues include distribution networks, regional supply chain hubs, shelf ready packaging, RFID and carbon emissions. Where do you start?

Distribution networks servicing independent retailers will survive and flourish, but there will continue to be consolidation in certain segments. For example, fruit and vegetable produce operates in a very fragmented distribution system. It is only natural that if independents want to lift their game and adopt the same tactics as the major chains then there will be consolidation in this area. Independent retailers will continue to flourish in Australia, so the distribution systems supporting them will flourish as well.

Another issue is consumer packaged goods companies owning their product until point of sale to the consumer. I don't believe in this. Consumer packaged goods companies will get involved in more vendor managed inventory, but only up to warehouse level. We are already providing a lot more data to manufacturers, including information about such things as warehouse withdrawals and upcoming promotions on particular products.

Then there's the question of supply chain hubs. Multinational manufacturers are under enormous pressure from the two dominant chains in our business. Those chains are focused on their share prices. Manufacturers are getting squeezed for better deals and more rebates. We have seen manufacturers claim that in order to pass on further discounts they would have to move their factory offshore because that is the only way they can lower their costs. Unfortunately, I think this will continue because the two chains have the sort of clout to which a multinational manufacturer, in particular, cannot say no.

That brings us to the notion that a major retailer/wholesaler might de-merge their supply chain operations from their retail operations. There are only two major retailer/wholesalers in Australia. They each have a distribution and a retail business and they need to keep them integrated to achieve the cost savings and synergies they want. For example, an independent retailer will call us and say it wants its order at 3pm. We say, "yes sir", 3pm it is. But when you own your own supermarket, you phone the store manager and say that since he works for you, he will take his order when it suits you. It's those types of logistical benefits that will keep the major retailer/wholesalers as integrated chains. They have no incentive to de-merge their supply chain operations from their retail operations.

Will collaborative planning forecasting and replenishment succeed? I believe it will. Efforts to move towards everyday low pricing have not been as successful as some retailers would have hoped, so I think we're into a high-low, hybrid kind of marketing. The only way to make that work for both the manufacturer and the retailer is to do collaborative forecasting and planning. I don't think it happens anywhere near enough, but it will become the squeaky wheel that gets the oil.

Shelf ready packaging is also a hot topic. It will become more popular and succeed eventually. It's difficult in practice because store layouts are so variable: different racking and space allocations. But it will become more prevalent because we all need to reduce labour costs. For example, we found a good source to import general merchandise from China. It all comes shelf-ready. The products are packed on a disposable pallet, you take it out, break the cardboard boxes and you've got a display. It is definitely something that will grow bigger.

RFID is another area of great interest, but it is yet to become a major force in Australian grocery retail. We have to wait for the rest of the world. RFID at the retail level is progressing slowly because it is too expensive. Companies such as Wal-Mart will determine the speed of RFID adoption. We will all eventually be there, but the price equation must come right. It has massive benefits, but there are so many vested interests. RFID at the warehouse will happen sooner. But RFID at retail – which is the big pay-off – is a long way off yet.

Finally, we've been forced to consider global warming. There is talk that the grocery retail supply chain of the future will be carbon neutral. Maybe so. All I know is that as an industry, we are going to come under pressure and if we are not carbon neutral we are going to pay a tax. It's that simple.

## Conclusion

All parties involved in the Australian retail grocery supply chain have to devise strategies to prepare their businesses for the changes that will shape the industry over the next five years: scan-based trading, regional supply hubs, RFID, shelf-ready packaging and collaborative planning, forecasting and replenishment, to name a few.

Some of the disappointments and false starts of the past year may fade quickly as the Coles issue is resolved and the industry adopts new technology

and productivity measures. While independent retailers can feel confident that they have a bright future, they still have to plan how they will deal with the tectonic forces generated by Australia's two grocery retailing giants.

As always, change is inevitable. Some transformation programs have slowed; others have accelerated. How retailers, suppliers and service providers respond to the industry challenges created by the changes will determine their success.

## Take action

- Independent retailers offer a higher-margin, high-growth channel so consumer and packaged goods companies should seek to develop and exploit this route to market.
- Third-party logistics providers should recognise the margin potential for high-service, multi-drop distribution contracts.
- Prepare for regional supply hubs to become standard practice in the Australian retail grocery supply chain over the next five years.
- Suppliers should be proactive and put pressure on retailers to find workable collaborative trading partnerships post the demise of CPFR.
- Recognise that automated forecasting and replenishment systems are no substitute for well-run collaborative forecasting. Integrate the two and customise tactical collaborative trading partnerships.
- Suppliers should prepare for the gradual increase in inventory pushed upstream by the major retailers.
- Third-party logistics providers should watch carefully the outcomes of de-merger activity, particularly if this involves de-merger of supply chain operations.
- Retailers should re-think their deployment of SRP to quantify its benefits and share them with suppliers to drive adoption.
- Prepare for RFID to become an important technology in the grocery retail supply chain – in the long term.
- Suppliers and third party logistic companies should develop a carbon strategy by first understanding and valuing their own carbon footprint before developing a means of reducing emissions.

*The insight in this chapter has been provided by Oliver Sargent, Director, Performance Improvement.*

*Oliver Sargent is PwC's Supply Chain capability leader in Australia. He consults to a range of consumer packaged goods companies, retailers and wholesalers. In a rapidly changing grocery sector, Oliver advises clients on issues from strategy through to design and supply chain improvement.*

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# 04

## Passion driving technology fashion

It's on again! Internet technology is transforming at a rate not seen since the dot-com boom. *Time* magazine declares its Person of the Year for 2006 is "You" because of the explosive growth and influence of user-generated content such as blogs. Analysts, the media and even former celebrated sceptics such as Rupert Murdoch are claiming that this time, with greater availability of broadband, the web *will* change the way we do business.

Yet in Australia, few retailers appear ready to take advantage of the trends. Late last year *The Australian Financial Review* said it all when it reported: "You won't find any Christmas cheer from the major retailers online, and their respective bosses Bill Wavish, Mark McInnes and Gerry Harvey aren't losing any sleep over it."<sup>1</sup>

Our global insights have shown major retailers in the UK and US are investing heavily in the internet as part of their multi-channel strategies. They are building the required infrastructure in stores and at head office to ensure customer service is seamless and enhances brand values.

This is no passing trend and the time is right for Australian retailers to reconsider using internet technology to drive new growth opportunities with e-business and multi-channel retailing. Our own research into 27 local fashion retailers shows there is still a long way to go. Retailers need to understand the channels their own websites are serving and to effectively harness the passion of the new 'digital natives' to generate a commercial advantage.

<sup>1</sup> *The Australian Financial Review*, 12 December 2006.

### The outlook

- Digital enablement of consumers will continue to accelerate and capturing the fastest growing segment of the internet will mean approaching web sites in new ways.
- While bricks and mortar stores are here to stay, retailers will have to leverage existing investments in their supply channel and analytics to deliver multi-channel offerings that regard the internet as part of the overall service promise to customers.
- As Australian broadband and wireless services continue to improve, smart retailers will look to the UK and US for successful business models.
- Without a compelling business plan that includes an integrated, multi-channel technology strategy supporting your brand, time-poor, internet-savvy consumers will switch to retailers that can offer them what they need, when they need it.

## The time is now

The message is simple: the future of the internet is evolving, yet some Australian retailers are sending loud and clear the message that it didn't work last time so they are not going back. This is a mistake because today's internet is a different place.

Table 1 details some of the old barriers to online success we have explored in conversations with our retail sector clients and how we see the current trends.

The 'digital natives' – people who grew up with digital technologies – are now ruling the online world, spawning newer, more creative and faster ways of interacting than ever before. Maximising success online is about understanding where and how the digital natives congregate in order to capture not only the natives but the 'digital immigrants' who will follow.

We have seen how retailers overseas are harnessing this transformation by linking their product development and strategy to the needs of the digital natives, delivering them sophisticated information and purchasing options, then leveraging their online behaviour to provide information to develop in-store strategies. In fashion, this could mean delivering six different designs online in an early-season release, then using the volumes of sales for the top three products to guide order volumes for stores.

How well do you understand your website? Is it appealing to the digital natives? We have developed a simple model for assessing your web presence

against what we see as five key targeting modes for retailers: tribe, product, sales, corporate and citizenship.

In Figure 1, Level 4 represents leading practice in each area and delivers the level of experience many digital natives expect from a compelling website. We believe three of our five modes will be familiar to retailers. However, citizenship, which looks to corporate social responsibility in an online sense, and tribe, which draws on the emerging "you" phenomenon of the internet, may be new for many.

Our research into 27 fashion apparel retailers found they were reasonably comfortable with the product and corporate modes for their websites, with the average score being Level 2 out of 4 in these areas. However in tribe, the average was only 1 out of 4 and with sales it was zero as the vast majority had little or no web site focus on sales. This supports what we see as the current view of retailers: that e-commerce is not yet an important part of their strategy.

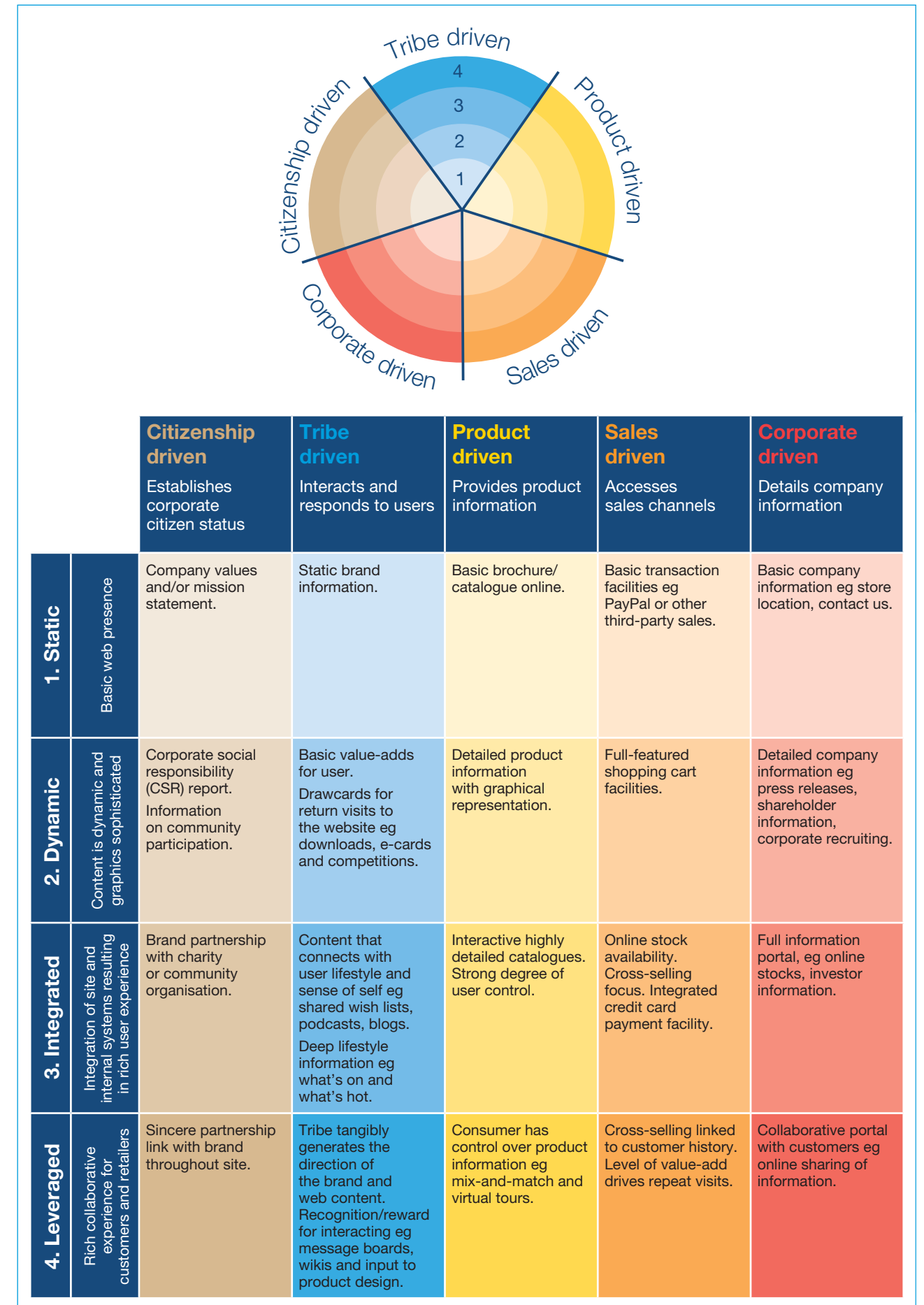
But the news is not all bad. Our conversations with clients have revealed most retailers agree that something new is happening and many of them are revisiting their web presence. However, many are still grappling with how to respond to the increasing presence and drive of the digital natives online.

Table 1: Current view of barriers to online success

Old barriers to online success	Current trend
We already have a compelling web presence.	PwC research suggests this is not generally the case for Australian retailers. Of the five different modes driving retailers' presence on the internet, the average fashion retailer scores less than 50 per cent against our benchmarks. Are you gaining leverage from your online presence?
Our customers want to 'touch and feel'.	For retailers, the new internet is no longer e-commerce only – it's an essential part of their overall strategy with online presence driving in-store visits. See Figure 1, our website profiling tool to understand the roles websites can play in an e-commerce strategy.
People won't buy toasters online.	eBay is the most popular online store in Australia according to ACNielsen, <sup>1</sup> with 57 per cent of online shoppers having purchased through its website. In most cases, these purchases were hard goods, with eBay reporting that an item of women's fashion clothing sold every 13 seconds. People will buy online.
Volumes online are not worth the trouble.	ACNielsen research <sup>2</sup> shows volumes are increasing while resistance to shopping online is declining. This is a consistent trend globally with overseas markets also reporting year-on-year increases in online volumes.
We were burnt in 2000. Why should we look at it again?	There are several factors driving significant change in internet usage and, more importantly, how it is used. Your business needs to understand these drivers and how it will take advantage of them.

1,2 <http://au.acnielsen.com/news/20060918.shtml>

Figure 1: Website profiling tool



## Defining the digital native

Consumers are changing. More specifically, the way they use technology is changing.

Marc Prensky is an internationally acclaimed speaker, writer, consultant and designer in the areas of education and learning. He is the author of *Digital Game-Based Learning* and the founder and chief executive of Games2train, a company whose clients include IBM, Nokia, Pfizer and the US Department of Defence.

Prensky says: "Today's average college grads have spent less than 5,000 hours of their lives reading, but over 10,000 hours playing video games (not to mention 20,000 hours watching TV). Computer games, e-mail, the internet, cell phones and instant messaging are integral parts of their lives."<sup>2</sup>

Prensky coined the tags 'digital native' and 'digital immigrant', popularising the idea that this current era of technology is spawning a difference between the two. The life experience of digital natives has led them to "think and process information fundamentally differently", says Prensky.

So is there an emerging generation of digital native consumers who act – and more importantly shop – online differently from their immigrant parents? Research suggests there is.

Anne Kirah was a keynote speaker at Microsoft Tech-ed 2006 conference in Sydney. As a cultural anthropologist employed by Microsoft Corporation to work on projects from Windows XP to MSN Messenger, she works to understand how people use technology in their everyday lives. Kirah related the story of a 15-year-old European boy and his hunt for a new snowboard.

As a digital native, he used his online networks through forums and instant messaging communities to identify the snowboard he wanted. He then researched it online, found a local store that stocked it and went offline to touch and feel the snowboard. Having confirmed it was what he wanted, he went back online to purchase it – from another country in Europe where he got a better price.

<sup>2</sup> *On the Horizon*, NCB University Press, vol. 9 no. 5, October 2001.



Like the boy in Kirah's story, if you were born after 1980 you probably can't remember life without mobile phones. Your entire secondary school career was dominated by the internet and instant messaging. Gen Y (born 1980–94) makes up the largest portion of these digital natives and represents about 21 per cent of the Australian population (4.1 million). They are increasingly cashed up and retailers that want to attract digital natives dollars need to understand the different ways they want to operate online.

Ultimately, attracting digital natives is about appealing to all consumers. If you capture the natives, the immigrants will follow.

## Hunting the natives

Retailers we spoke with, particularly those in fashion, are unanimous in their view that online is an essential channel to market, even though only five of the 27 fashion retail websites we surveyed supported online sales.

This supports our view that e-commerce is not just about sales: it is increasingly about all the online modes of tribe, product, sales, corporate and citizenship. Without a compelling web presence and strong product information, time-poor, internet-savvy consumers won't even consider spending with you in your retail outlets. Research from ACNielsen Australia shows that for many product categories, "searching the internet" is the strongest influence on purchase behaviour – even when the ultimate purchase is offline.<sup>3</sup>

Engaging the growing number of digital natives online is an essential piece of a retailer's overall strategy that will also ultimately capture the immigrants who follow.

So what are some of the emerging trends that retailers can use to attract the natives? First, they need to understand the habits of the digital natives by looking at how they are using technology.

When talking about digital natives and their online habits, it is difficult to ignore MySpace.<sup>4</sup> Launched as a social networking site in 2003, MySpace had by July 2006 passed Google as the number one destination for internet users in the US.<sup>5</sup> MySpace attracts more than 75 million users and nearly 30 billion monthly page views – the equivalent of 10,593 page views per second.

To consumers, MySpace is literally that: a space to meet, chat with friends, share content and music, post messages and collaborate.

For the retailer, MySpace is an opportunity to meet the digital native in their virtual home. It is a place to interact with a specific target market at their number one destination. While there are successful models overseas – for example Blizzards World of Warcraft, with about 120,000 friends connected to the site – local retailers are also beginning to explore this avenue. Just Group's Jay Jays brand uses MySpace as part of its summer festivals promotion.

MySpace also has a low entry cost and is one avenue retailers should explore to promote the tribe message among digital natives.

Another runaway internet success is YouTube,<sup>6</sup> which allows users to upload and share video clips across the internet. It delivers more than 100 million internet views a day<sup>7</sup> and is the leading destination on the internet for video entertainment. Launched in February 2005, within two years YouTube was acquired by Google for US\$1.6 billion in stock. It is now a cornerstone destination on the internet – and has captured the imagination of major media companies.

YouTube is becoming a de facto standard for advertising commercials as well as video clips. The Warner Bros announcement in September 2006 that it would share music videos with YouTube in return for advertising revenue shows how mainstream companies are adapting and taking advantage of this new medium.

YouTube is also an example of how key digital native destinations are attracting the digital immigrants. A study by eMarketer has shown that 54 per cent of YouTube users are now aged between 35 and 65, while 61 per cent earn more than A\$60,000 per year. These older, wealthier eyeballs will increasingly make YouTube attractive to advertisers, in the process scaring many TV executives.

Another important trend is the cross-channel nature of these emerging sites. For example, hosting videos on YouTube is free and allows retailers to embed movies into their own websites without video hosting infrastructure. At the same time, quality, quirky footage featuring products can appeal in its own right, with YouTube attracting viewers and comments within the site. This spreads the brand message further while also drawing viewers back to the main retail presence.

<sup>3</sup> <http://au.acnielsen.com/news/purchase.shtml>

<sup>4</sup> <http://myspace.com>

<sup>5</sup> Hitwise.com – July 2006.

<sup>6</sup> <http://www.youtube.com>

<sup>7</sup> [http://www.google.com/press/pressrel/google\\_youtube.html](http://www.google.com/press/pressrel/google_youtube.html)

## Capturing the natives

What all the successful new internet ventures have at their core is the reason *Time* magazine calls “you” the person of the year for 2006 – collaboration and user-driven content. When YouTube uploads 65,000 new videos every day, it is users who are driving and creating this phenomenal content growth. MySpace is merely an engine to allow users to create and share pages and messaging, while Wikipedia would not be the world’s largest encyclopedia without the contributions of hundreds of thousands of users.

This raises a challenge for the modern retailer: when users drive communities, as shown by YouTube, MySpace and Wikipedia, and then turn to these communities for their online information, how do retailers influence consumer opinion and spread the right messages about their product?

With some retailers experiencing negative entries on sites such as Wikipedia, this is an issue that needs to be taken seriously. You cannot afford to ignore these communities. The only strategy is to participate – which may include building your own brand within them – before someone else does it for you.

Facing strong user communities with such forthright opinions, retailers need to understand what people are saying online about their product. This is less of an issue with digital immigrants as they tend to research to justify an existing decision and therefore steer towards articles and reviews that support their beliefs. Natives, however, are far more likely to be influenced directly by online opinions because they are researching to decide *what* to buy, not support *why* they are buying a certain product.

Here is a great example of a digital native using Whirlpool,<sup>8</sup> a fully independent community website focused on the state of broadband in Australia, to conduct product research. The grammar and punctuation are the writer’s own: “Hey there peeps, i just wanted to get a fair idea of a good modem for a good price, my budget would be around \$100.”<sup>9</sup>

The first response, within 27 minutes, is from Warcom.com.au, a leading online modem retailer that has grown from start-up in 2003 to have more than 200,000 customers and an enviable reputation among IT professionals today. By participating in online forums, Warcom monitors and influences purchase decisions directly. This is not a strategy to be taken lightly – Warcom participates in the Whirlpool forums and has built a reputation through providing sound advice and supporting the community, even when guiding people to purchase from its own site. For Warcom, participating in online communities is a direct way of guiding consumer opinion.

Technology on the web is enabling old ideas in new ways. Another form of interaction called crowd-sourcing is also gaining momentum. With one of the first recorded studies of crowd-sourcing dating back to 1910,<sup>10</sup> the idea has gained a new audience through James Surowieki’s book *The Wisdom of Crowds* and sites such as Wikinomics.<sup>11</sup> Both explore how large numbers of relatively unskilled people can provide accurate answers – something the internet is well suited to enabling. This raises interesting questions about how businesses can use new ways to take advantage of the power of crowds and collaboration in new ways.

The example Neil Ridgway gives in *The Way I See It* – how Rip Curl constructs online polls to guide its advertising spend on magazines – uses the wisdom of crowds in a very direct way.

An emerging practice among large global retailers, particularly in the fashion and grocery sectors, is to tie investment in their supply chains, data warehouse and analytics to leverage early trends from one channel – such as the internet – and provide realistic volumes in other channels. This is another example of using the wisdom of crowds in providing sales lead information.

## Keeping the natives

While it is too early to say how successful some of the newer business models will be in this area, there are some interesting players that retailers should monitor closely. One example of an online retailer at the cutting edge of consumer-driven shopping is Threadless ([www.threadless.com](http://www.threadless.com)).

Threadless manufactures and sells T-shirts in a unique way. In its own words, Threadless is “an ongoing T-shirt design competition”. Four to six designs are chosen every week from 600-plus submissions. The winning designers receive US\$2,000 in cash and prizes and their designs are printed and sold from the site. Threadless has more than 300,000 users with an average of 3,000 new users every week.

<sup>8</sup> <http://whirlpool.net.au>

<sup>9</sup> Whirlpool Forums, <http://forums.whirlpool.net.au>, 24 September 2006.

<sup>10</sup> *The Wisdom of Crowds*, James Surowieki, 2006.

<sup>11</sup> <http://www.wikinomics.com>

Threadless uses the power of crowd-sourcing to its best advantage. It does not employ any designers yet in return for a chance to win US\$2,000 it receives more than 600 submissions a week. How many businesses can produce more than 600 designs a week? Threadless only prints the designs voted for by the community. From the hundreds of hopefuls, it knows before going into production which ones will sell. Registered users of the site can get free T-shirts by promoting Threadless with links, photos and referral sales.

Threadless also leverages its online community by advertising to them in return for a few T-shirts. Blogs on the Threadless site keep the content fresh, providing profiles and behind-the-scenes information about designers. This in turn drives users to return to the site as it continually changes.

While retailers may be put off by the fast turnaround of Threadless, overseas trends towards fast fashion and shortening of product cycles suggest they should consider these concepts. For example, a strong tribe-driven brand could adopt Threadless’s catalogue model to potentially reduce catalogue production costs, while keeping the tribe engaged and collaborating with your brand online.

In Australia, newspaper publisher Fairfax Media is using blogs to enhance its online coverage of news and articles. Jason Hills is a columnist who specialises in technology and gaming.



He takes advantage of the online community of reporter and participant by both writing the articles, engaging in debates around the blogs and occasionally quoting comments from blogs in articles. All these activities are effective strategies for building a strong online readership, which in turn enhances the Fairfax brand.

## Rules for the hunt

Based on our research on how to hunt, capture and keep the digital natives, here is a simple set of rules to help you entice these most active and profitable of consumers:

- **Rule 1: Participation is paramount.** People must be able to interact with your company and through this interaction provide you with meaningful information. For example, Threadless lets consumers pick the print for their next T-shirt as it gathers market intelligence about which garments will be popular with the target audience. Devise ways in which your customer base can feel it is more involved in what is available to purchase or the direction and power of your brand.
- **Rule 2: Share the success.** Smart retailers give their customers skin in the game. They develop ways to promote their businesses by rewarding their customers for referrals, link-backs, catalogues and even design content. The approach is simple: when customers help you, you reward them. This does not necessarily mean offering money. It may simply mean listening and responding to their concerns in meaningful ways.
- **Rule 3: Communicate with the customer.** Companies around the world have spent billions of dollars on various technologies to enhance their customer relationship management (CRM). CRM is important, but to capture the natives, you need to establish a meaningful conversation with them. Tell the people who buy your products or services what is going on at your company and listen and act on their feedback.
- **Rule 4: Play to your strengths.** Research says bricks and mortar retailers can leverage their market positioning when they combine the shop front with an online presence. The online start-ups may have the advantage of low entry costs but they are at a distinct disadvantage in terms of physical presence and brand. Understand the advantages inherent in your existing channels and know how to leverage them. Use our ‘website profiling tool’ model to understand the aims of your website in supporting your brand and how you are placed. Leverage existing investments in supply chain, data warehouse and analytics to combine information from all channels for powerful insights.

## What about the future?

So you 'get' MySpace, YouTube, Blogs and Wikis and are using them in a rich collaborative experience for your customers, but where is the next MySpace coming from?

One emerging trend generating interest is the 3D internet, also known as the metaverse. Although still in its infancy, major vendors such as Microsoft are releasing development tools<sup>12</sup> that allow creation of 3D rendering on the internet, including people working on 3D stores. More immediately though, the emerging hype is around a product called *Second Life*, which some speculate may even be the true 3D internet of the future.

*Second Life* is a subscription-based 3D virtual world made available to the public in 2003 by San Francisco-based Linden Lab. Founded by a former RealNetworks chief technology officer, Philip Rosedale, the *Second Life* world resides in a large array of servers that are owned and maintained by Linden Lab. *Second Life* provides its users, referred to as residents, with tools to view and modify the *Second Life* world and participate in its virtual economy, which has begun to operate as a real market. The population of *Second Life* is now more than 1.7 million.

*Second Life* is one of several virtual worlds that were inspired by the science fiction novel *Snow Crash* and the cyberpunk literary movement. The goal of Linden Lab is to create a world like the metaverse described in *Snow Crash*, a user-defined world of general use in which people can interact, play, do business and otherwise communicate.

In September 2006, Reuters opened a virtual news agency within *Second Life* to report on events within the virtual world and to provide real-world news. Other big names to participate in *Second Life* include Coca-Cola, Toyota and Wells-Fargo Bank. In Australia, Telstra BigPond opened a virtual island (think store) within *Second Life*. Ninemsn and the ABC are other major Australian companies to create a presence. BigPond's presence is particularly interesting because of the link between its supply systems and the ability to sample product and purchase within *Second Life* itself.

When the US Joint Economic Committee – a group that conducts economic research of policy issues before the US Congress – decided in November 2006 to examine economic activity within *Second Life*, it became clear that the real-world implications of virtual reality are real indeed.

Another trend of interest to retailers is mobile commerce. The move by telecommunications companies into third generation networks is aimed at meeting the demand for faster wireless broadband. On new 3G networks, download speeds are expected to reach at least 10 megabits per second. This is roughly six times faster than the expected average of 1.5 mbps per second broadband (ADSL 1+) connection in 2007 and equivalent to the ADSL 2 wired standard which will now see increasing coverage throughout the next 12 months.

With increased bandwidth and enhanced usability of internet-enabled mobile handsets, sales through this channel are also expected to grow. Mobile handsets offer retailers an almost permanent link between the consumer and the internet. Beyond the obvious opportunity for more purchases to be conducted via mobile phones, these devices are well suited to enable more ad-hoc sales as well as time-shifted purchasing – such as buying a movie ticket as you approach the cinema in order to avoid the queue.

Retailers with a bricks-and-mortar store presence have a strong competitive advantage in mobile commerce. They should look toward emerging location-type services to better leverage their offline presence with location information. These services will allow consumers to combine their physical location with a search such as 'nearest furniture store' to provide information on retailers when and where they need it.

## So where to today?

The jury is still out on the full impact many of these new technologies will have. Undoubtedly, there will be variation from region to region and market to market. However, the consistent view among analysts and the media is something is happening online that is different from before.

Retailers must understand that any investment in online technology must drive their brand, and ultimately must be about selling product or services, either now or in the future.

<sup>12</sup> NET 3.0, previously known as WinFX.

It is clear that overseas retailers are moving to more closely integrate their online and bricks-and-mortar operations. Consumers are demanding a richer, more interactive experience and turning to the internet to research product before deciding to buy. In the UK, consumers are driving the rapid expansion of retailing online as infrastructure such as broadband technology is rolled out. Privacy and security concerns have been alleviated and the service promise has been consistently executed.

The online channel provides unique opportunities for the retailer to gain customer insights in a way that is not possible offline. For example, by providing rich product information online, your consumers are giving you information on what products they are interested in, what features they like and what products they want to mix and match. How can you leverage this to improve such things as your product development, supply chain, stock levels and floor position?

The longer term trend is multi-channel, with e-commerce exploding into a number of options for consumers that can include buying online while collecting the order in a local store on the way to the train – or even buying online, receiving the goods via a central dispatch, then returning defective product to a local store. To implement this kind of system requires sophisticated track and trace mechanisms. Is Australia ready for the type of investment required to make the most of the new consumer?

While developing the tribe component of your website may mean it is relatively cheap to leverage off other website services, the product and sales capabilities will require sophisticated systems to integrate throughout a true multi-channel offering.

Such systems can have implications for your retail business model. Factors to consider include; if you move into online sales, would this undercut other channels? How does the investment justify itself if the direct sales component does not cover costs?

As well as needing the underlying physical IT infrastructure to build a true multi-channel approach, different physical infrastructure in your local market – such as population density, commuting factor, living conditions and accessibility of broadband to your target markets – may also have implications.

Experience in the UK, where many people live in village communities outside the City of London square mile, has driven a model where consumers who commute want to purchase on the web, but pick up at local stores on the way home. This differs from the US, where an engrained model of catalogue sales and mail distribution has led to a generally centralised distribution model for online sales. The impact of long-tail economics differs in these two approaches, with large centralised models better able to take advantage of reduced costs in stocking small sales volume items and generating extra business.

The model for Australia has not fully evolved, but 2007 is the year in which retailers should review their strategies to ascertain whether e-commerce or multi-channel retailing is appropriate for their target customers. If they decide it is, then these retailers need to develop clear and well thought out strategies, just as international retailers have done. They need to consider such things as IT and operational infrastructure, the size of their markets and their brand values.



**Neil Ridgway**  
Marketing Director  
Rip Curl International

To be compelling, websites have to be easy to use. Content should be short and sharp and visually driven to enhance the online experience, otherwise it's just a brochure. With our audience, we also need to provide live vision. You can't be in our markets unless you deliver this as a minimum. Our core market is young and tech-savvy, but older surfers, skiers and snowboarders who have grown with our brand also have a much better handle on how to use the web – and what to expect from it.

The internet allows us to create the first phase of a person's experience with Rip Curl. Visitors to the site can be educated about our products and connect to our brand via a multimedia experience. The tangible experience comes when they go into a store to touch and feel what Rip Curl is, whether it's a surfboard, a wetsuit, watch or clothing.

To generate interactivity we use polls and competitions and ask people their opinion. For example, we might ask: which surfing magazine is the best in the world? We generate a punchy little debate and the answers give us opinions other than our own on where to place our core print advertising. But you can't just take information and run. You must give people feedback. Our web master gets bent right out of shape if we don't respect our audience.

We have had great cut-through with our live webcasting of surf events, reaching hundreds of thousands of people at each event by putting them in touch with the world's best surfers. Our webcasting lets Rip Curl present an exciting live experience alongside information about our brand and products. This allows us to leverage a multimillion-dollar event spend in real time and further connect the Rip Curl brand to elite surfing.

For example, we went to Mexico for the Rip Curl Pro Search in 2006 and it was the surfing event of the last 30 years. We were in the jungle and we beamed footage to a satellite so we could broadcast the event to the world on

www.ripcurl.com and www.aspworldtour.com. We had 600,000 unique views of this multimillion-dollar surfing contest in the middle of nowhere. Such events let your community participate in something unique and it allowed us to add value to what it means to be part of the Rip Curl crew. Some of that audience would use our competitors' products but for a time they were part of our tribe because they watched our event. That's often enough to get them thinking about changing brands because of the experience they had with us online. We want to be known as the ultimate surfing company.

We have 11 brand values: the search, leadership, technology, fun, irreverence, crew, tradition, durability, reliability, respect and belief. We believe that if we stay true to the brand's values our crew will stay true to us. We don't have to use all 11 values every time we do something. If only three or four of the values attach themselves to a product we're designing or a live webcast we're doing then that's fine: it will be indelibly Rip Curl.

Our website plays an integral role in delivering our brand values. In future we will need to divert funding from our more traditional marketing methods and put it into the web. Our task is to take the site from being a centralised branding and content-driven tool to something that can support our international regions and allow them greater flexibility in their local content – without compromising our brand values, existing retail clients and sponsors, or even other regions.

Our customers interact with Rip Curl by experiencing our brand and we know our website plays an important role. However, collecting a huge database of names and information without the intention or means to say something back is a waste of time. This is something we need to focus on. We have many conversations with people, but we're not great at capturing all of them in a way that enables us to respond in a meaningful and personal way where required.

Another challenge is that our site is not sales driven. Our traditional sales mechanism is to wholesale through retail surf stores. We need to think carefully before launching into a sales-driven component online. There is no point offending that core part of our market. We have to do it in a complementary way to continue growth in both areas. Having said that, a great online store would be like a great Rip Curl flagship store: it would lift customer awareness across the board.

The one thing we know here at Rip Curl is that the web is a sharing community and this is core to our brand. The internet is invaluable to this company and it will fight harder for more of our budget because we know it will become more and more effective.

## Conclusion

Internet technology is now enabling a fundamental transformation, where the consumer is driving content and product creation in ways not seen or imagined previously. It is the new way, but where it takes us is still being revealed.

One thing is clear: now is the time to act. Technology strategy can no longer stand on its own. Hindsight would say that it never could.

For the consumer it might be all about "you", as *Time* says. But for retailers, delivering on the expectations of the new consumer and capturing and retaining their business will require stronger integration of corporate, marketing and IT strategies than ever before.

## Take action

- Review your technology strategy in conjunction with your business and marketing strategy. Do they align? Does IT know where the business is going and does marketing appreciate how technology can enable the market?
- Examine how you can leverage the new consumer to provide them deep information and interactivity, while gaining insights into trends that you can use in your business. Plan to integrate web sites into your analytics and data warehouses.
- Play to your strengths by understanding the advantages inherent in your existing channels to market and knowing how the internet complements them. It's not all about e-commerce.
- Look at your business model and analyse the impact of potential e-commerce and multi-channel activities. E-commerce and multi-channel could be part of your future retail growth strategy.
- Analyse the opportunities: understand what the technologies offer and stay abreast of the trends.
- Look to emerging models overseas and examine how they relate to your consumer base, your demographics and your customer behaviours. What is working that might apply to your business model?

*The insight in this chapter has been provided by Tim Bull, Director, Business Solutions Technology.*

*Tim specialises in information technology (IT) architecture and emerging technologies. In an ever-changing technology landscape, Tim is passionate about helping companies plan practical roadmaps for the future using IT as an enabler to deliver real value.*

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# 05

## This time for sure

Convergence is one of the most overused yet misunderstood terms of this new era of communications. The integration of computer, telephone and digital media technologies to allow faster, more flexible ways to communicate, entertain or do business has already seen some false dawns. But this time it's different.

Newer and better convergent technologies are already redefining how retailers communicate and serve their target audiences; technologies that will have profound influence over marketing, sales, distribution and customer service. Ominously for some, convergence will further empower consumers, as the web has already.

For companies ready and able to embrace a convergent future by combining new technologies with fundamental business principles, the opportunities will be significant. For those that pretend convergence is still too far off or about to endure another false dawn, the future will be bleak.

After many years of hope and hype, convergence is real and it is here to stay.

### The outlook

- Convergent technologies and services present retail and consumer companies with new and improved ways of serving and communicating with customers – online as well as in the real world.
- This convergent environment will be one of rapid change and great uncertainty: technology will advance, new business models will emerge and the risk of cannibalisation from new channels will be real.
- Companies will need to understand what they want to achieve with convergent technologies, what their customers want and how best to conduct business to maximise the benefits.

## Convergence defined and demonstrated

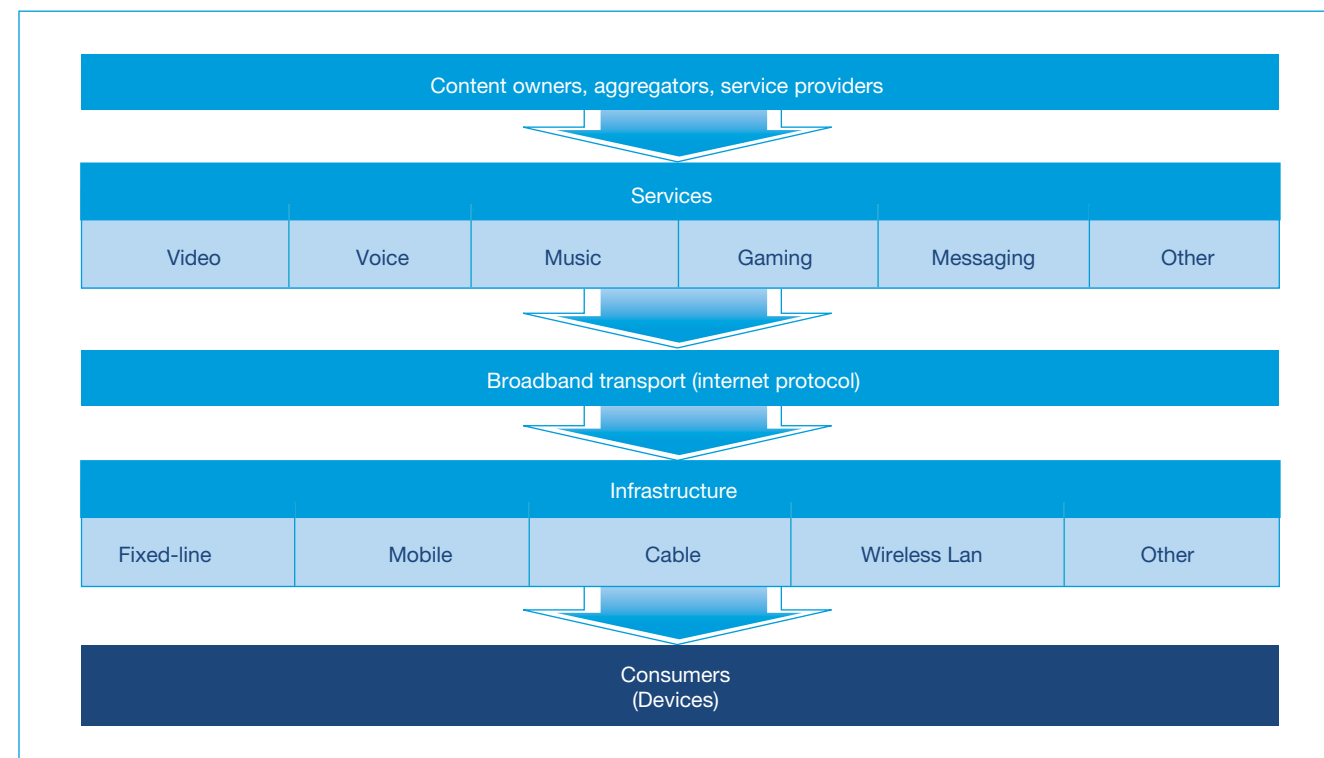
Convergence, enabled by broadband internet, allows a wide range of products and services to be marketed, browsed, purchased and delivered across just about every type of network infrastructure to almost any device. This is illustrated in Chart 1.

Convergence presents Australians with more choices. It gives rise to new products and services. It breaks down geographical barriers, making it just as easy for people to buy from overseas merchants as it is to buy from the local store. More importantly, convergence gives consumers a louder voice. Using e-mail, blogs, instant messages, ratings, reviews and recommendations, customers can communicate with companies that provide products and services, and with friends and strangers from around the world who share similar interests.

This combination of increased choice and a stronger hand in the buying process is shifting the balance of power from those who provide products and services to the people who consume them. Rather than being a futuristic flight of fancy, many convergent products and services are already approaching the mass adoption or saturation phases of their life-cycles. These include:

- digital music devices and services such as iPods and iTunes
- e-commerce sites led by such global giants as eBay and Amazon
- communications devices such as 3G phones, BlackBerries and multimedia PCs
- social networking and community-of-interest sites such as MySpace, Flickr and YouTube.

Chart 1: Convergence illustrated



## Why convergence is real this time

Convergence emerged more than 15 years ago to become one of the buzzwords of the first dot-com boom. At that time, technology was far less developed than our imaginations: we were dreaming in broadband but living in dial-up. In addition, a range of competing priorities and events – such as Y2K, enterprise resource planning and the 2001 dot-com crash – shifted our focus elsewhere. Now, concrete examples of convergence exist. A range of factors has now combined to drive convergence, including:

- **Falling cost of communications.** This includes costs associated with fibre optics, wireless technology and the Internet Protocol (IP). On the consumer side, the prices of PCs, mobile phones, personal digital assistants and associated services have also fallen.
- **Rising broadband penetration.** By the end of 2005, about one-third of Australian internet households had broadband. Penetration will rise to 88 per cent of local internet households by 2010. High-speed internet allows for richer media communications, such as video ads, and easier distribution of digital products and services, such as films, games and music.
- **Rapid technological advances.** In keeping with Moore's Law, computer processor power continues to double every 12 to 18 months. Storage capacities are doubling every six to 12 months and devices are handling increasingly sophisticated multimedia at rapidly reducing prices. As a result, mobile phones and personal digital assistants are more powerful than many older PCs.

- **Adoption of common protocols and standards.** These include Transmission Control Protocol/Internet Protocol (TCP/IP), which manages network communications on the internet, and Voice over Internet Protocol (VoIP). This has allowed content to be shared across more devices and applications than ever before. For example, the same song can now be digitally transmitted to a radio station for broadcast, purchased from an online store and synchronised to an MP3 player, or bought from a bricks-and-mortar store and played on a CD.

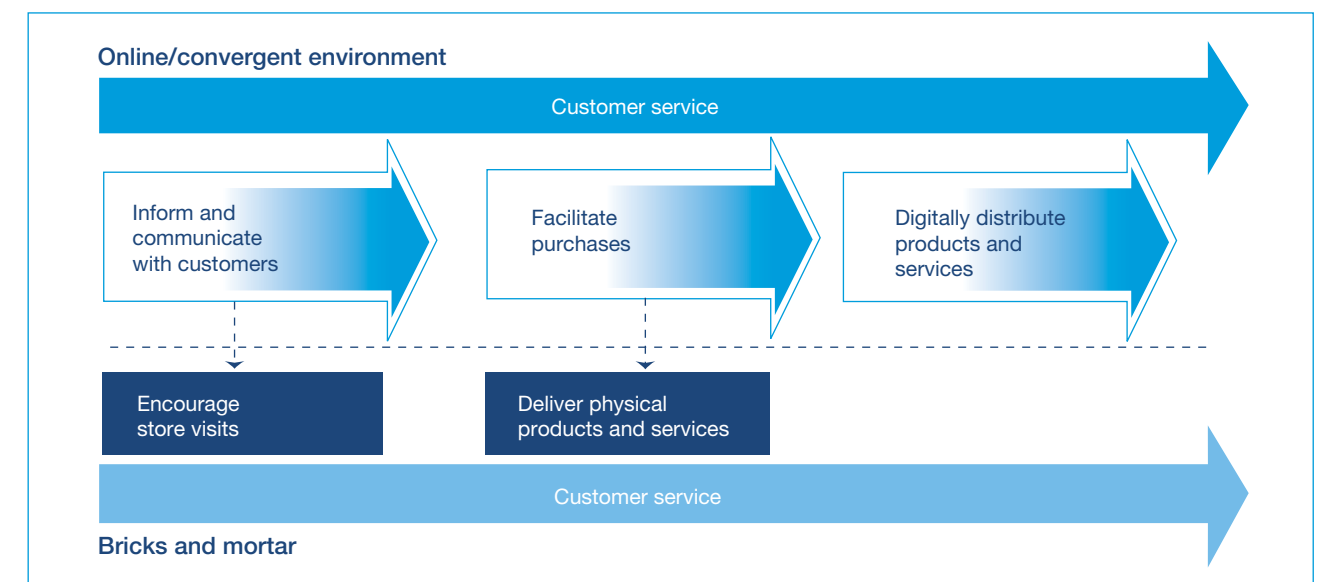
These drivers are combining to make connectivity pervasive across geographies, networks and devices and between individuals. The result is compelling products and services that are encouraging take-up, usage and commerce.

## The role of convergence in the retail and consumer sector

Convergent technologies allow retail and consumer goods companies to serve their customers in ways and at times that customers dictate.

Chart 2 shows that a company's involvement will be across a spectrum and include marketing activities, purchasing and digital distribution. The chart illustrates that this is not an either/or proposition. Convergent technologies can be used for specific online activities or work in conjunction with real-world solutions. The nature of a company's products and services will determine how much of its customer-facing activity occurs online.

Chart 2: The role of convergence in retail and goods companies



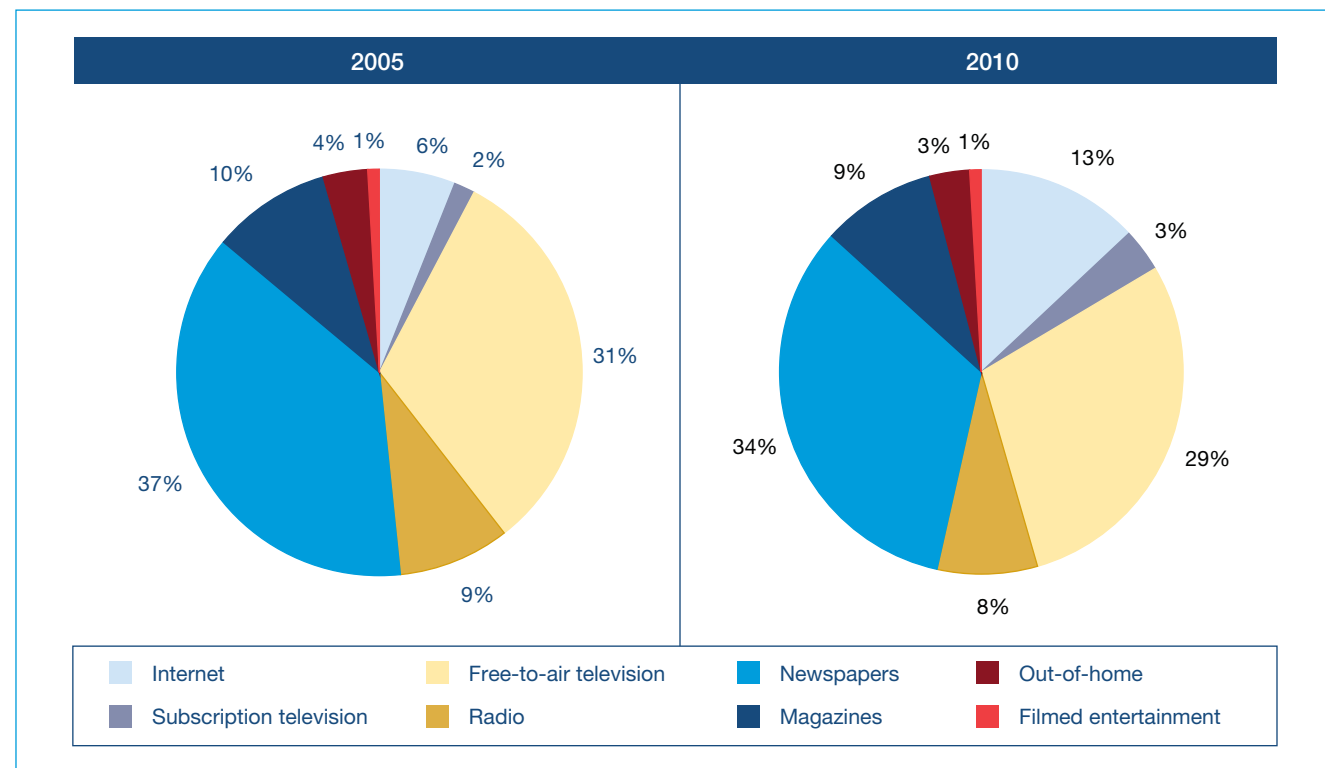
## Inform and communicate with customers

Convergent technologies provide new ways to communicate with customers, enhance accountability and revitalise advertising in traditional media. These new communications alternatives will have a bearing on a company's marketing plans and will ultimately redistribute advertising revenue across different media as advertisers chase fragmenting audiences.

Charts 3 and 4 illustrate the shifting share of above-the-line advertising revenue by medium between 2005 and 2010. During this period, advertising expenditure in Australia will grow at a compound annual rate of 6.0 per cent, from \$10.1 billion to \$13.5 billion.

These charts demonstrate that while newspapers, free-to-air television, magazines and radio will continue to attract the majority of advertising revenue over the next five years, their combined share will fall from 87 per cent in 2005 to 80 per cent in 2010. The only media to increase their share of advertising revenue over the next five years will be the internet (from 6.1 per cent to 13.1 per cent) and subscription television (from 1.8 per cent to 3.4 per cent). They will achieve growth because of rising audiences and an ability to deliver personalised messages in the right context and at the right time.

Charts 3 and 4: Share of advertising by medium



Source: Australian Entertainment & Media Outlook: 2006-2010, PwC.

## Internet advertising and communications

Internet advertising is forecast to grow by 23.5 per cent compounded annually between 2005 and 2010, from \$620 million to \$1.8 billion. By 2010, advertising on the net will be worth more than in any medium except newspapers and free-to-air television. The internet will achieve this growth because it provides:

- New ways of communicating with people.** Search and directory advertising, which comprises revenue from online directory or search engine listings such as Google, ninemsn's My Local, News Limited's truelocal and Telstra's Sensis, is unique to the internet. Search technology is a vital tool for net users seeking relevant information in a sea of content. This benefit, together with the ability of advertisers to measure its effectiveness, has caused the search and directories category to outperform in internet advertising. In 2005, Australian search and directories revenue rose 74.3 per cent to reach \$224 million.<sup>1</sup> Keyword advertising now accounts for 36 per cent of online advertising in Australia.
- Increasingly sophisticated display advertising.** In the early days, display advertising on the internet was mainly in the form of banners and pop-ups. While these forms of advertising still have a place, improved technology and increasing household penetration of broadband has brought greater use of rich media advertising. These ads are typically more entertaining than banners and pop-ups, with the best being leading examples of viral marketing. In Australia, Carlton Draught's Big Ad and its successor, Flash Beer, became viral hits on the internet before their premiere on television. When they have success like this, advertisers can leverage the cost of their television commercial across media.
- Highly targeted and increasingly personalised communications.** Services such as Google AdWords and Yahoo! Search Marketing allow companies to create ads featuring specific keywords. When net users perform a search using these keywords, ads containing those keywords appear on the page, with links to other sites. Because ads are contextually delivered, users see them when they are already interested in the topic, product or service. These ad services often charge on a pay-per-click basis, which helps contain costs and measure effectiveness.

Online classifieds and auction sites, such as Domain, Seek, Carsales and eBay, allow people to tailor searches for property, jobs, cars, and other products so as to return only the ones that are relevant to them. This differs from print classifieds, where people must trawl through all listings to find what they want.

Social networking sites, such as MySpace, Bebo, Friendster and Facebook, also provide targeted marketing opportunities. As of September 2006, MySpace had 108 million members globally<sup>2</sup> (including more than 300,000 in Australia.)<sup>3</sup> Advertising is making its way into social networking sites and advertisers can pay to reach specific segments based on age, gender, location or other parameters.<sup>4</sup> Brands such as Telstra, Vodafone and Coca-Cola have already created MySpace microsites to profile their products.<sup>5</sup> In August 2006, Google guaranteed News Corporation a minimum of US\$900 million to provide advertising on MySpace and other News Corporation websites.

While it is important for those who own social networking sites to obtain a return on their investment, it is critical that they are not dictatorial or too corporate in their manner. If they restrict how people use these sites, the communities will disband as members seek out less intrusive alternatives. In doing so, the value to advertisers will evaporate.

A similar result will occur if advertisers fabricate communities. Some high-profile brands have launched websites masquerading as blogs only to have them exposed as an underhanded way to sell products. In some instances, this created vocal criticism from the very consumers these companies were seeking to attract. People felt they had been duped and some went as far as to develop their own reactionary websites to criticise the offending companies. This demonstrates how difficult it is to manufacture a viral marketing campaign; it must develop organically and this makes it a risky proposition.

<sup>1</sup> "Internet's \$620 million puts old media on notice", Lara Sinclair, *The Australian*, 22 February 2006.

<sup>2</sup> "Hanging with the in crowd – social networking", *The Economist*, 16 September 2006.

<sup>3</sup> "It's not OurSpace yet, say advertisers", Julian Lee, *The Sydney Morning Herald*, 7 September 2006.

<sup>4</sup> "The new (and improved) web", Foad Fadaghi, *BRW*, 7 September 2006.

<sup>5</sup> "It's not OurSpace yet, say advertisers", Julian Lee, *The Sydney Morning Herald*, 7 September 2006.

In addition to using the internet for paid advertising, most retail and consumer companies operate corporate websites to allow them to develop a direct relationship with their customers. These range from providing static information (effectively replicated print catalogues) and contact details to sophisticated virtual tours that allow people to experience products and services and, in some instances, check their availability in bricks-and-mortar stores or purchase them online.

Around the world, many companies use their websites to provide unique products and services, allowing them to offer a broader range than they are willing to stock in-store. Clothing brands such as Banana Republic and The Gap use their websites to showcase their clothes as outfits with a purpose – such as corporate, casual or creative – to encourage sales. Many US clothing retailers also use their websites to sell clothes for unusually small, big or tall people. Other companies give customers an opportunity to create customised products via their websites. For example, Puma created the Mongolian Shoe BBQ (<http://mongolianshoebbq.puma.com/pindex.jsp>) to allow people to design just about every element of their footwear.

Digital music download services, such as iTunes and BigPond Music, provide 30-second song sound bites so customers can listen before they buy. Sanity's online music store includes a feature that seeks to capitalise on the positive power of word-of-mouth. Customers can send digital tracks they have purchased to five friends who can then listen to them twice in full. Friends are then given the opportunity to buy the tracks themselves.

Amazon.com allows visitors to search inside many of its books so they can review tables of contents, excerpts and indexes. This helps overcome any resistance customers might have to buying a book before being able to flip through the pages as they can in a store.



### Subscription TV and interactive advertising

Advertising on subscription TV is expected to grow by 23.4 per cent compounded annually, from \$159 million in 2005 to \$455 million in 2010.<sup>6</sup> Convergent technologies will help to drive this growth by enabling interactive advertising.

Interactive advertising began in Australia in April 2005. When viewers see an interactive ad for a product that captures their interest they press a red button on their remote control, enter relevant contact details (often an e-mail address) and are subsequently contacted by the advertiser. The benefit for advertisers is that they are more likely to reach their target audience because of the niche-driven nature of subscription TV channels, greater engagement with their target customers, improved customer awareness and robust accountability. During 2005, subscription TV hosted 12 interactive campaigns from a broad range of companies, including Emirates, Canon, Toyota and the Commonwealth Bank. In other countries, interactive advertisements command a 20 per cent premium over standard ad rates and a fee per qualified lead.

During 2006, the subscription TV industry introduced dedicated advertising locations (DALs) that enable advertisers to construct their own interactive sites to provide more detailed information for customers. As with existing interactive ads, viewers are taken to these DAL sites when they press a red button on their remote controls.

<sup>6</sup> *Australian Entertainment & Media Outlook: 2006-2010*, PwC.

### Using convergent technology to enhance advertising in traditional media

While the internet and subscription TV will experience the greatest growth rates, traditional media will also embrace convergent technology to enhance their advertising offerings.

Out-of-home advertising has been particularly proactive. Recent examples include integrating Hypertag technology into posters to allow commuters to download digital content to their mobile phones and PDAs via infrared or Bluetooth. For example, in 2005, when EMI Music launched a new single from Gorillaz by allowing people to download the single as a ring tone for their mobile phones, 3,300 people did so.<sup>7</sup> These downloads allow advertisers to increase their level of involvement with their audience and further their viral marketing efforts each time the phones ring.

Some out-of-home advertising companies are rolling out video screens in shopping centres and within stores and programming them with customised advertisements. Ads in shopping environments can be highly effective because they target consumers when their purchasing intention is highest. The screens can be readily updated to target traffic in specific parts of a centre or certain customers by time and day.

Some magazine publishers have used websites to offer unique promotions. In a campaign, readers of Australian Consolidated Press's *Cosmopolitan* could register for SMS promotional offers and previews of the next month's magazine. Each day the November 2005 issue of *Cosmopolitan* was on sale, 54,000 women in the ACP database received text messages telling them to head for the stores, where they would receive a free gift or discount.<sup>8</sup> ACP has stated that such campaigns could be targeted at a national or even suburban level, depending on the advertiser's needs.

While traditional media will retain the dominant share of advertising over the next five years, these examples demonstrate the value of providing personalised and contextual communications. The decision to undertake one-to-many versus personalised communications will depend on the product and the objectives of the campaign.

However, it is important to note that this is not necessarily an either/or proposition. Traditional media advertising can be used to create awareness among the broadest possible audience and then supplemented with convergent media to provide personalised messages to the most interested and relevant audiences. Undoubtedly, this is one of the reasons traditional media organisations such as News Corporation, Publishing & Broadcasting Limited and Fairfax are investing in new media.

### Facilitate purchases and digitally distribute products and services

Convergent technologies allow consumers to order and pay for products and services and, in some instances, receive their purchases over the internet.

#### Online shopping in Australia

ACNielsen's *Online Consumer Report* found 5.9 million Australians shopped via the internet in the year to June 2006, up 13 per cent over the previous year. The increased number of shoppers was driven by greater internet penetration, and greater consumer confidence in transacting online.<sup>9</sup> The research found that only 6 per cent of survey respondents were hesitant to shop online, down from 24 per cent two years ago. Benefits such as better prices, greater convenience, a broader range of items and enhanced consumer protection technology have helped many consumers overcome their concerns.

ACNielsen reported that more than half of Australia's 5.9 million online shoppers had made repeat purchases. Their average spend was \$1,900 (up 19 per cent over 2005), resulting in total revenue of \$11.4 billion.

<sup>7</sup> "Out, loud and proud", *B&T Weekly*, 16 February 2006.

<sup>8</sup> "Come on girls, let's shop". *The Australian*, September 2005.

<sup>9</sup> "Aussies' online spending tops \$11 billion", Peter Keli, *ACNielsen*, 18 September 2006.

Chart 5 shows the percentage of internet shoppers who have purchased various products and services online.

Australians are most likely to purchase entertainment and leisure products and services via the internet. One possible reason for this is that these items are easy to browse. Shoppers can preview music, view film trailers and read book excerpts. They can see seating allocations for concerts, events and airplanes prior to purchasing and can take virtual tours of hotels. This is easier than buying clothes online, for example, where most people want to see and feel the fabric and try on the garment.

### The ongoing need for middlemen

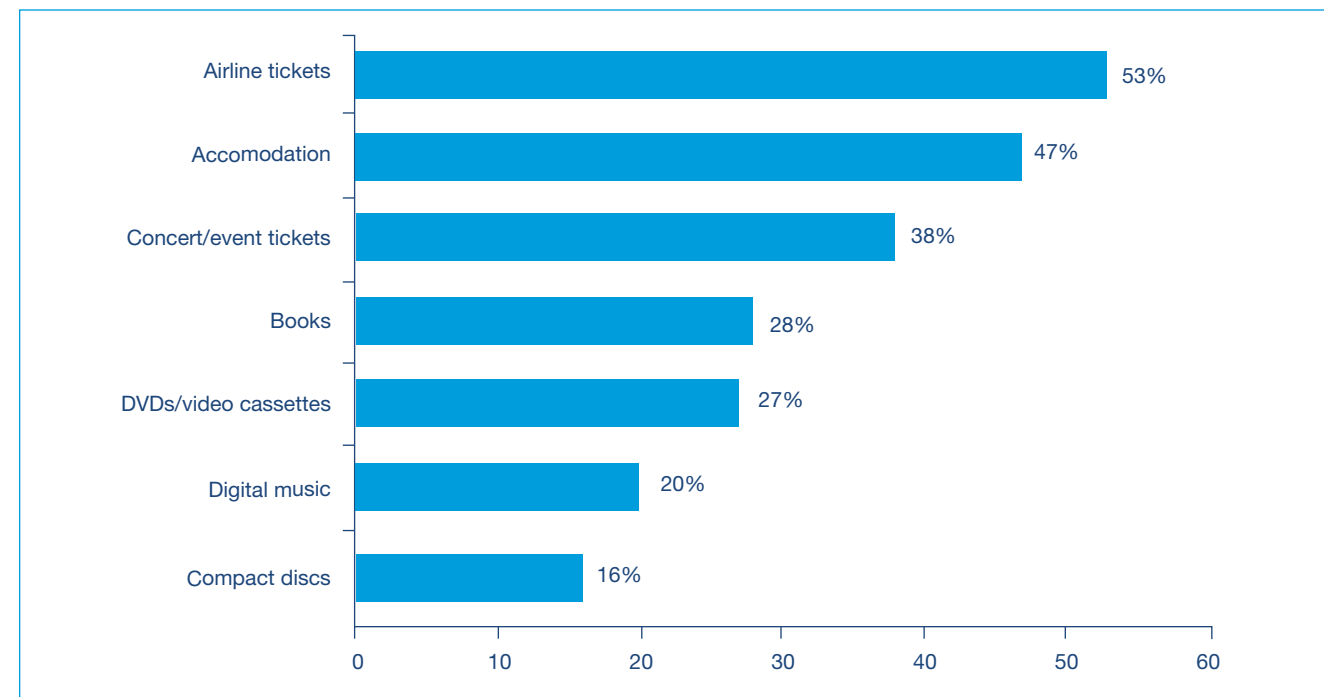
Convergence allows producers to interact directly with end users, bypassing distributors and other intermediaries. ACNielsen reports that three of the most active online retailers are Virgin Blue, Qantas and Jetstar,<sup>10</sup> which all have websites that remove the need for travel agents.

For this approach to be effective, website producers must build meaningful relationships with customers. They must understand who they are, what they want and how they wish to acquire and use the product or service. However, many producers have never dealt directly with end users. As a result, middlemen still exist. In the past, the middlemen were bricks-and-mortar retailers. Now, they are electronic – such as Apple Computer with iTunes for music and Amazon for books – but their purpose is the same.

While there is no doubt many website producers will become more adept at interacting with end customers, there will always be a place for electronic middlemen like Amazon, Google and Yahoo! to aggregate products and services. This is because consumers, in most instances, don't care who the producer is. Using entertainment and media as an example, consumers buy because they like the actor, musician or author, not because they are loyal to a film studio, record label or publishing house.

<sup>10</sup> "Aussies' online spending tops \$11 billion", Peter Keli, *ACNielsen*, 18 September 2006.

Chart 5: Most popular items purchased online



Source: ACNielsen 2006.

### Customer service: giving customers a voice

Traditional marketing wisdom states that if someone receives a bad product or service, they typically tell about 10 other people. However, in an era of constant connectivity, the implications of not looking after your customers can be instantaneous, global and brutal. This is because convergence has given customers a much stronger voice. Blogs, SMS, instant messages, user ratings and reviews all ensure that an offending company will be trapped like a fly in what has become an unforgiving worldwide web.

It is now commonplace for moviegoers to text or instant message their friends from the cinema auditorium to tell them whether a film is any good, potentially destroying the impact of expensive pre-opening advertising campaigns in the first sessions. Websites such as Amazon and CNET encourage user reviews and place them side-by-side with the opinions of professional reviewers. Many eBay vendors pursue their customers with maniacal fervour to ensure they provide feedback to enhance their reputation with potential buyers. Photos and video captured on mobile phones can be beamed directly to a friend's phone or uploaded to users' personal internet blogs, adding compelling images to verbal tirades.

Collecting customer feedback is logical. It allows companies to identify trends, respond to complaints before matters fester and continuously improve their product and service standards. However, the decision to make such feedback public is less clear-cut. This is because organisations cannot censor the feedback: they must run the bad with the good and any attempt to paint an artificially rosy picture will almost inevitably be exposed – with dire consequences.

As with much in the world of new media, traditional business principles still apply to customer service. The best way to avoid negative feedback is to provide excellent, consistent service that at least meets customers' expectations. With this single-minded focus, companies have little to fear. In fact, satisfied customers will use convergent technology to share their positive experiences with the world.



**Ajoy Roy-Chowdhury**  
Head of Creative Services  
Ninemsn

An increasingly convergent media world has resulted in the marketing mix being shaken hard over the past few years with the number of consumer touch-points multiplying rapidly and the amount of time spent at each point constantly changing. The term describing this phenomenon is “media fragmentation” which comes down to a simple point – reaching your consumer at the right time and with the right message is more complex than it used to be. But complex does not necessarily mean more difficult and those marketers that can begin to understand the role of each medium will be at a much greater advantage in producing effective results.

The key driver of this fragmentation has been the internet. This medium, that has been around for only 10 years, has seen a phenomenal increase in usage with most consumers finding it difficult to remember life without it. My company, ninemsn, has seen a huge growth in audience numbers with, according to Nielsen, over eight million Australians visiting our network every month. While with broadband penetration, again according to Nielsen, approaching three million households we have seen the flourishing of our video offering as consumers begin to have an audio visual experience on par with other media. Yet interestingly there is still a disparity between the amount of time spent online by consumers and the amount of marketing budget being spent – for example according to Roy Morgan in 2005-6 there was a disconnect where the consumer spent almost 16% of their time online but online advertising spend was only 8%. This will change not just because of the reality that the audience is spending more time online but also because of the diverse capabilities of the web – it is the only medium that allows the consumer to interact with an advertising message for one second, or one hour. But, we at ninemsn do not believe for one moment that the vast majority of

advertising spend will go into the digital space alone. We know that in 2010 free to air TV will still be the dominant player while the Australian consumption of magazines, for instance, will still be very high. The reason for this is that the audience themselves will continue to use each medium for different purposes and at different times and marketers with brands that can leverage each of the different mediums effectively via cross-media (or cross-platform) campaigns will be the brands that will win.

Cross-media campaigns are not simply about having a magazine advertisement, a few online banners and a TVC – that is simply a multi-media campaign. True cross-media campaigns are those where each medium is in dialogue with each other to achieve a single goal for the advertiser. At ninemsn we often produce both media and creative solutions that work across our partners at PBL Media (ninemsn is a joint venture between Microsoft and PBL Media). To achieve success in these campaigns we analyse the target audience first and not a particular media channel. We try to investigate what the audience does, their patterns of behaviour and how different forms of media touch them at different parts of the day and week. Creatively we simultaneously strive to devise one clear message that delivers a key “idea” that is strong enough to form the basis of all platform communications. From this we start to map out exactly how each medium interacts with each other and how each message will be communicated effectively.

For instance we may devise that the TV campaign on the Nine Network is there to create awareness, a web environment on ninemsn lets people interact while a promotion in Australian Women’s Weekly encourages them to buy the product – all with one key message to answer a client’s business objective.

Therefore the challenge for all marketers is to ensure you understand not just when the consumer is interacting with a medium but also what their mindset is, so the message can have context. To do this the client must ensure that all parties are talking to each other – media agencies, creative agencies and media companies. Equally the convergence of technologies can easily seduce a marketer into trying to use too many mediums which can prove immensely difficult to plan and deploy – so push your partners to educate you on what is the most appropriate. There will be a right time and a wrong time to use the different environments.

## Conclusion

As with any major change, this new era is one of great uncertainty. But one thing is certain: convergence is real and it is here to stay. Companies that embrace convergent technology

as a means to forge stronger relationships with their customers and provide them with better service will enjoy significant opportunities. Those that resist its inevitability will be left behind.

## Take action

- **Assess your readiness for convergence along each link in your value chain.** Benchmark yourself against peers to identify gaps in your ability to develop products and services.
- **Investigate ways to build and manage networks;** acquire and manage content; sell and manage advertising; market and sell services; serve customers; and bill and collect payments.
- **Decide which elements of your business model and business plans should stay the same and which need to change.**
- **Conduct a risk assessment** to review impending opportunities and threats and to determine how to respond.
- **Assess markets and customer segments** often when they are new and validate core value propositions to consumers.
- **Understand how to combine the data you gather on customers with revenue and cost information** to maximise the value of the customer to the company. Segment your customers to identify and target the most attractive.
- **Consider where piracy may affect your business** and put in place initiatives to mitigate the impacts.
- **Keep watch on the accuracy of invoicing:** you will be operating in a significantly more complex environment for revenue and billing assurance.

*The insight in this chapter has been provided by Paul McNab, Partner and Australian leader of the Technology, Entertainment & Media sector.*

*Paul has 20 years experience advising Australian and multinational companies on issues in relation to business structures and operations associated with intangible assets, particularly the taxation consequences of their plans. Paul is the lead partner of the Australian Entertainment & Media Outlook publication.*

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# 06

## Innovate to differentiate

Chief executives in the retail and consumer sector must find ever more creative ways to generate growth and differentiate themselves in the marketplace. The ability to be innovative is the key to achieving continued growth and profitability in this competitive industry.

Technological advances are driving fundamental changes in the global economy. These changes, combined with Australia's deregulated labour and financial markets and geographic barriers, present a serious threat to the competitiveness of local manufacturers.

If companies are to stay ahead of the game they must address what innovation means and the ways in which this method to differentiate can be embedded into their strategy. There are two fundamental types of innovation: those activities that build on the core and those that enable breakthroughs. Companies need to consider how both types can be implemented at an operational, cultural and product level.

The structural environment for innovation in Australia will have a profound effect on local retail and consumer goods companies seeking fresh avenues to growth. A growing chorus of business leaders, industry bodies and academics is calling upon the Federal Government to deliver a national innovation strategy. With an election on the horizon, the policies of both major parties for supporting the generation and commercialisation of new products and services may well determine Australia's international reputation as an investment location.

### The outlook

- Companies will survive and flourish in a growth-driven marketplace through innovation supported and directed by the CEO.
- Innovation is bigger than a new product; it will come to be seen as a tool to deliver the right business model for your company.
- The culture and structure of companies will support and encourage innovation and must be brave enough to fail.
- The KPIs of a company, and its employees, will be aligned with the objectives of its innovation strategy.

## The state of play

First, let's put Australia's innovation profile into perspective. As figure 1 below shows, Australia ranks 11th in the OECD on its business expenditure on research and development (R&D), sitting at 0.95 per cent of our GDP. This is below the average and below that of comparable countries such as Canada and Denmark.

The most pressing international issue Australia faces is how to compete with countries such as Brazil, Russia, India and China – the BRIC economies – which Goldman Sachs global economic team predicts will be larger than the current G6 economies within 40 years.<sup>1</sup>

In 2001, Goldman Sachs said some of the BRIC countries may even be among the world's four dominant economies by 2050. An updated analysis in 2004 concluded the BRIC economies' share of world growth could rise from 20 per cent in 2003 to more than 40 per cent in 2025. Also, their total weight in the world economy would rise from approximately 10 per cent in 2004 to more than 20 per cent in 2025.<sup>2</sup>

The Central Intelligence Agency's (CIA) World Factbook estimated that in 2006, three of the four BRIC companies would outgrow the world GDP growth rate, with China and India GDP growth rates in particular estimated to grow at more than three times the rate of GDP growth in Australia and the UK.<sup>3</sup>

A huge middle class is likely to emerge in these countries, with a resulting increase in demand for consumer goods. By 2025, urban households in China are predicted to make up one of the largest consumer markets in the world.<sup>4</sup>

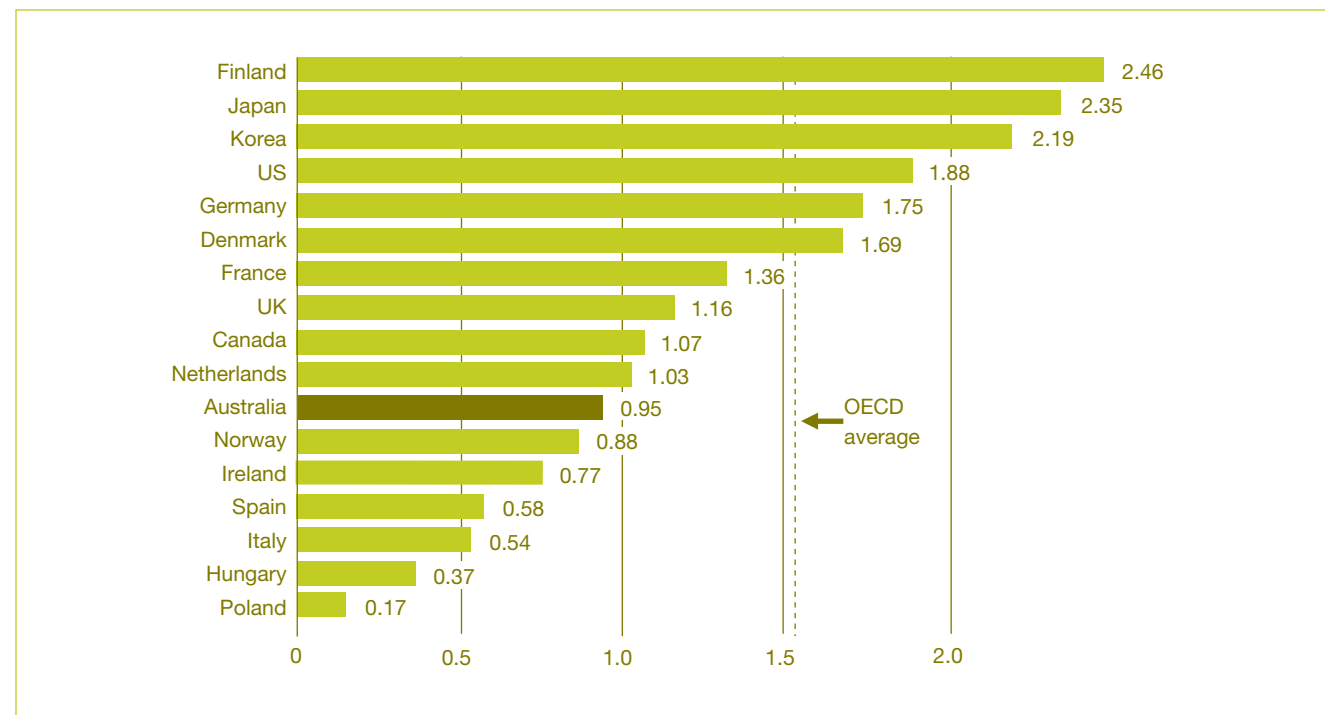
<sup>1</sup> Global Economics Paper No.99: Dreaming with BRICs: The Path to 2050, Goldman Sachs, October 2003.

<sup>2</sup> Global Economics Paper No.134: How solid are the BRICs?, Goldman Sachs, December 2005.

<sup>3</sup> *The World Factbook*, Central Intelligence Agency, 2007.

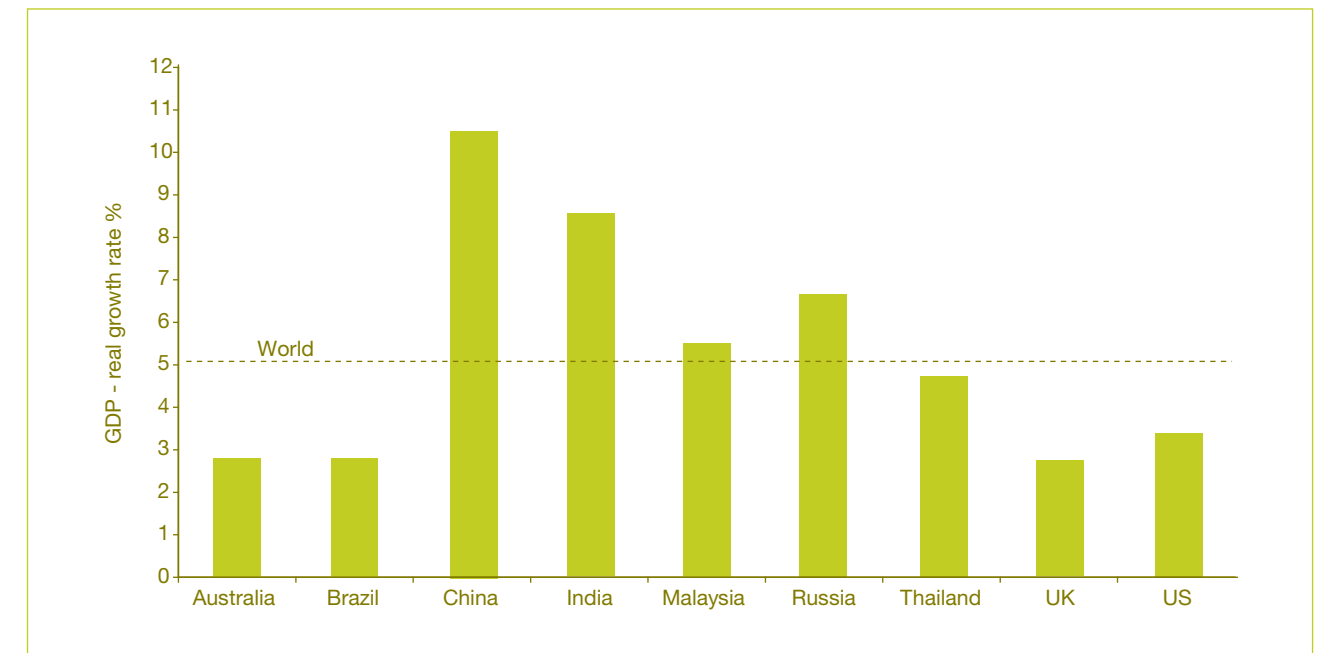
<sup>4</sup> The Value of China's emerging middle class, *The McKinsey Quarterly*, November 2006.

Graph 1: Business expenditure on R&D as a percentage of GDP in OECD countries, 2004 – 05



Source: ABS (Australian Bureau of Statistics)

Graph 2: Estimated GDP real growth rate 2006



Source: *The World Factbook*, Central Intelligence Agency, 2007.

Given Australia's proximity to two of the BRIC economies and other several rapidly growing economies in the Asia Pacific, this presents an enormous opportunity for Australian retail and consumer goods companies. However, there is also the danger these emerging economies will further marginalise Australian manufacturers of retail and consumer goods.

To effectively harness the market opportunities presented by the emerging economies, Australia will need to develop new techniques, ideas and products to meet their maturing needs. Australia will also need to be highly innovative to remain competitive against other players from these new powerhouse economies that enjoy large and growing domestic markets.

### We need to work smarter

According to the Australian Government's most recent innovation scorecard,<sup>5</sup> compared with other OECD economies Australia is performing well on productivity, scientific input and output, and workforce measures. However, Australia falters in bringing these new ideas to market and in the significant reliance we place upon foreign companies for investment in manufacturing R&D.

A measure of investment in innovation is business use of government tax concessions and grants. In the year to November 2006, of the 1.5 million registered companies in Australia<sup>6</sup> only 5,830 claimed the R&D tax concession. Only 460

applied for other federal assistance such as the Commercialising Emerging Technologies (COMET) program and the Commercial Ready program and of these companies, only 67 had R&D spends greater than \$10 million a year. This equates to only 1 per cent of the companies that claimed the tax concession, according to the Industry Research and Development Board.<sup>7</sup>

Australian companies must find new ways of turning home-grown ideas into international market winners whilst protecting the intellectual property they've developed during the process. Australian manufacturers should also harness techniques developed overseas in order to drive local innovation and/or develop innovative products and services, and explore the many government tax concession and incentive programs available to help them achieve their innovation goals.

<sup>5</sup> Backing Australia's Ability – Chapter One: Australian Innovation Scorecard, 2004.

<sup>6</sup> www.asic.gov.au

<sup>7</sup> Industry Research & Development Board annual report, 2005-06.

## What is innovation?

PricewaterhouseCoopers' research suggests Australian companies currently have too narrow a view of innovation. PwC's *Business Insights Survey 2007* revealed that whilst 73 per cent of CEOs believe government should support innovation through tax concessions, relatively few companies actually apply for the tax breaks. As a result, in the retail and consumer goods sector there has only been limited uptake of programs such as the R&D tax concession. This program allows companies to track R&D activities and expenditure to obtain additional tax savings that will deliver benefits of between 125 per cent and 175 per cent or a permanent difference of up to 22.5c in the dollar for every dollar spent on R&D.

Unfortunately, Australia's R&D tax concession program is currently limited to Australian-registered companies, which may act as a deterrent to foreign-owned retail and consumer goods companies investing in Australian innovation. The Productivity Commission's *Draft Report 2006 into Public Support for Science and Innovation* supported extending these incentives to international companies undertaking R&D and other innovative activities in Australia.

Innovation is certainly the new buzzword and is being given a lot of attention from the research lab to the boardroom. Innovation strategy is central to a company's direction and must be supported and driven from the top down – as such is something the CEO and leaders of a business must be held accountable for.

Innovation is also a common theme amongst Australian consumer goods manufacturing success stories. Companies that invest in R&D to produce a new product continue to invest to stay ahead

of the pack. A great example is MasterFoods, a company that takes its new product development seriously and whose New Product Development Manager, Peter Crane, says, "innovation is doing something different that adds value."

### Different types of innovation

We believe there are essentially two types of innovation: continuing or iterative innovation which builds on your company's core (such as skills, products, processes), and inventive or breakthrough innovation which invents what's next (such as a new product, a new remuneration framework or a new supply chain management methodology).

Within most companies the greatest benefit can be attained when both core and breakthrough innovation are applied in:

- operational innovation
- cultural innovation
- product innovation.

All three are inextricably intertwined. A CEO with the leadership skills and courage to introduce an innovation strategy based on these three factors will deliver their company short-term financial benefits and leave a valuable legacy.

It must be recognised, however, that being a successful product innovator is not the only means to differentiation in the marketplace. An over-arching methodology that embeds innovation within your company – that is, makes innovation part of its operations – is the only way to create significant competitive advantage.

Figure 1: The two types of innovation – core and breakthrough

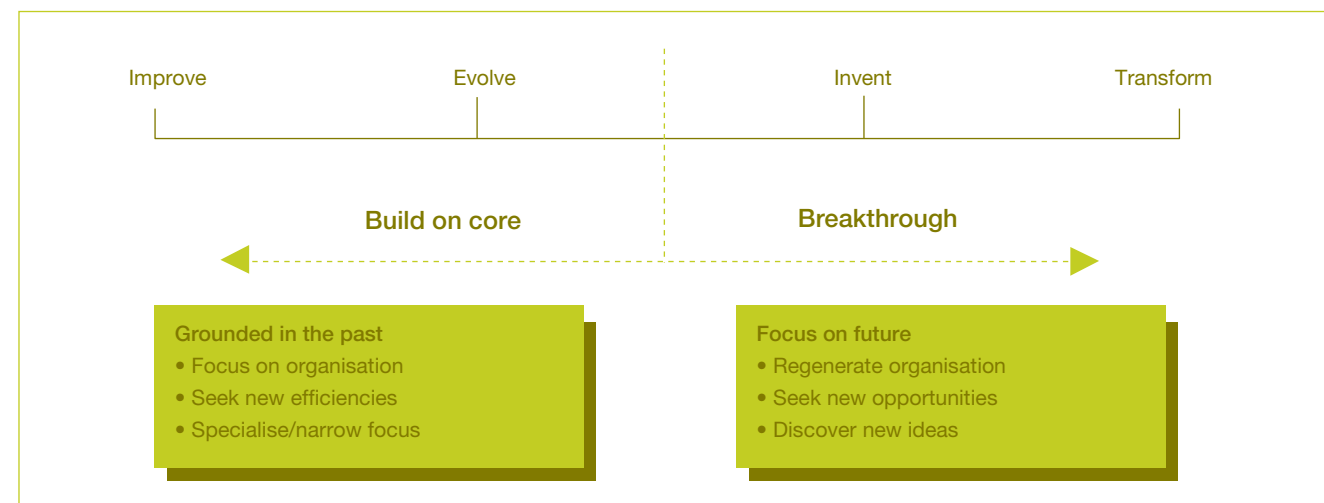
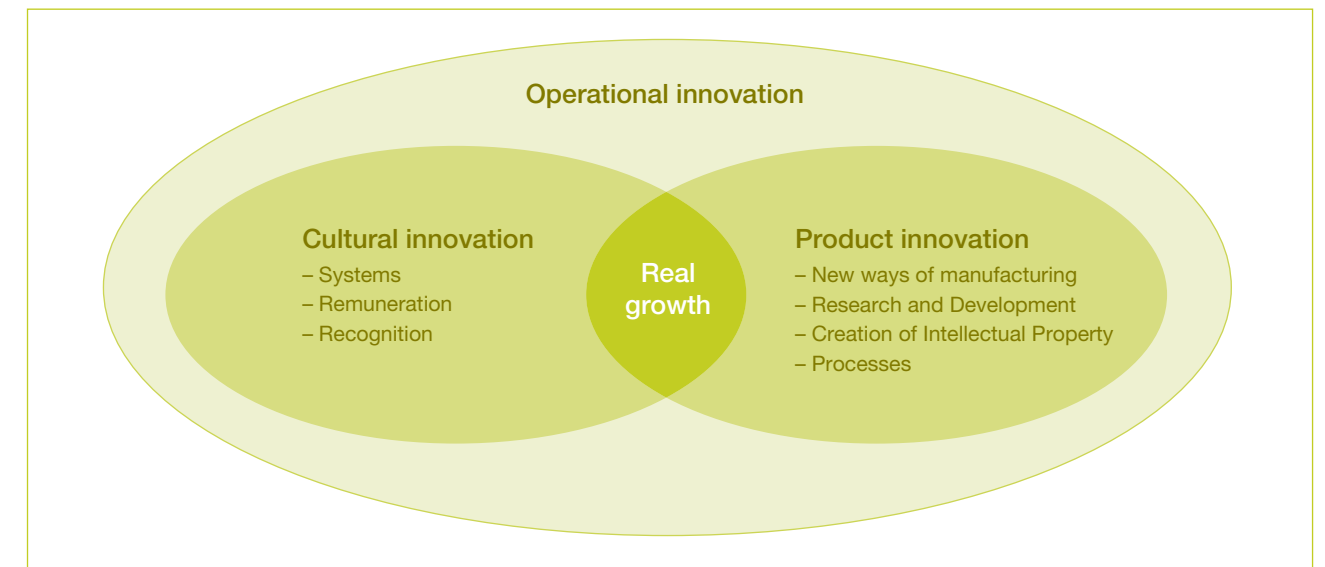


Figure 2: Operationalising innovation – a framework



## Operational innovation

The first and most important area of innovation is operational innovation – the establishment of deliberate process. The ability of a company to implement and replicate any new process successfully, to become operationally innovative, is essential to its ability to drive cultural and product innovation.

Whilst the journey to successfully implement operational innovation is long and often difficult there are many change management methodologies available to assist. The dilemma is in knowing which process a company should adopt.

The most innovative companies give much credit to having a defined, replicable process. One such change management model was outlined by Michael Hammer in the September 2004 edition of the *Harvard Business Review*. Hammer provided six steps which can mean the difference between failure and success in operational innovation:

1. **Process focus** – define the end-to-end process.
2. **Process ownership** – assign owners and make them accountable.
3. **Full-time design team** – provide adequate resources by creating a dedicated workforce that has carriage of the design process and accountability for the outcome.

4. **Managerial engagement** – require managerial staff across all areas of a company to focus on the larger goals of the end-to-end process rather than their own patch of grass. Leadership is critical in this step.
5. **Building buy-in** – ensure all staff are included in the redesign to overcome resistance to change. This prevents the feeling that something is *being done* to them; rather there is a feeling that they have contributed to the development of a new way of doing things.
6. **Bias for action** – do not overcommit when embarking on operational innovation. Companies that strive to completely reinvent the wheel usually end up failing. Focus on quick wins and start the transformation when the design process is only 70 per cent complete. This engages staff to ensure that momentum builds and the company is not locked into a specific way of doing the redesign. When a company has the correct people committed to innovation the desired outcome will follow.

## Cultural innovation

The PwC *Business Insights Survey 2007* of CEOs from the retail and consumer and other sectors revealed that more than 40 per cent of respondents believed new frameworks for developing people and strategies were critical to success. The challenge was knowing how to build an innovative culture within a company and how to capture employees' ideas on a day-to-day and long-term basis. The ultimate goal is to establish a framework that embeds this innovative culture into the fabric of the company.

Cultures are often described as being innovative but it can be difficult to define what this means. Some important factors are the tone at senior levels of the company, the level of employee engagement in the innovation process and transparency around incentives for innovation. Fostering innovative workplaces by creating a climate in which new ideas can thrive is a key outcome of inclusive leadership. Company leaders should also have a clear definition of the desired behaviours to support an innovative culture.

In any company, employees hold most of the innovative ideas. The *Innovation in Australian Business 2005* report from the Australian Bureau of Statistics found that internal sources were the most common contributor of ideas or information for innovative activity at 75 per cent of the 6,800 companies surveyed.

The difficult part is getting staff engaged sufficiently to share their ideas, then rewarding them. Companies should have a consistent approach to how new ideas are treated and taken through the decision-making process, or 'innovation funnel' as it is known. Important considerations when reviewing this funnel include:

- Does it capture learning from innovators across the company?
- Is the company's risk appetite aligned to its expectations?
- Is the process comprehensive – from idea generation to implementation?

Many companies strive to create an environment that encourages robust dialogue and champions individuals who bring new ideas to the table. PwC itself has been on such a journey over recent years. A successful element in our quest has been iChallenge, a program for our graduates that has delivered some great ideas and since been taken up by a number of clients. It gives graduates an opportunity to work in teams to explore new ways of tackling internal or external issues. They are mentored and supported by senior leaders in the firm.

Consideration should be given to a system that will not only *define* what innovation means for your company, but will also *capture* and most importantly *evaluate* ideas.

An excellent example of this system is the model implemented at MasterFoods, where a third-party market research company is employed and associates receive incentives based on product performance. Furthermore, MasterFoods supports this program by including senior leaders in innovation committees established across all three areas of its business. Such a system provides the leadership team with an invaluable and timely knowledge base from which to drive future direction.

By ensuring there is complete transparency about any incentive programs, and the metrics these are based on, trust is established at MasterFoods. These steps help to build and maintain a culture of innovation until it simply becomes the way things are done.



While such systems are a critical tool for capturing data and creating intellectual property, they do not necessarily give rise to an innovative culture. The key to success here is inclusive leadership. No plan, process or new remuneration strategy will in itself drive cultural change. Frank, clear and consistent communication from leaders about the value and importance of innovation is paramount. People need to know there is a willingness to accept the risk that comes with generating new ideas and that these ideas are essential to growth. They should also understand that the reason to embark on cultural change is ultimately to ensure the long-term financial viability and success of the company.

An example is Don Grover, CEO of Dymocks, who describes how he sees the role of a CEO as fundamental in developing and delivering on a company's innovation strategy, and how integral that is to its future prosperity, (refer to *The Way I See It* in this article).

## Product innovation

You might assume that companies are more attuned to identifying the traditional area of product innovation because it is concrete. This is true to an extent but companies rarely identify the full scope of, or place sufficient value on, product innovation due to the difficulty of valuing intangibles. Furthermore Australian consumer goods manufacturers should avoid the example of the US consumer packaged goods industry where although more and more products are being launched, fewer of them are truly innovative.

Measuring innovation within a company has always been difficult. Companies need to be able to measure the output of such initiatives. Consideration should be given when committing to an innovation strategy to ensure that appropriate methods of measurement are factored into the strategy. The MasterFoods example gives an indication of the commitment, both financial and cultural, required to embed a measurement mechanism within a product innovation strategy – and how this is inextricably linked to the culture of a company.

Companies can take measures to successfully introduce new and exciting products. These will necessarily include making investments, so it is important companies have a system for effectively capturing and valuing the intangibles associated with bringing new products to life. This will assist companies in streamlining their product development timelines and ensure that any intellectual property generated is not undervalued.

How can you continually innovate and constantly adapt to prosper? Smart companies are those that are able to change and have the ability to innovate and can link the two through their dealings with customers and employees. A constant cycle of review is required to keep the innovative flair alive.

One caution: companies that employ short-term programs aimed at identifying the next big thing without focusing on making their culture and operations innovative are unlikely to succeed in the long term.



**Don Grover,**  
Chief Executive Officer  
Dymocks

In my opinion, innovation should be on the front page of every chief executive's list of things to do. Ownership and accountability for the innovation process must be driven at the CEO level because the decisions being made are those which will determine the future direction of the company.

At Dymocks, we had to approach innovation from two angles as we faced the challenge of tighter margins coupled with an extremely competitive marketplace. We aimed to innovate by considering our business model and how this could be improved to make it more attractive to today's customers. The goal was to create an uncontested space in the market and we recognised that we needed to take a strategic approach to formulating this strategy before re-engineering our existing model.

Dymocks is among Australia's largest booksellers and an institution that has been in business since 1879. What struck us was the advancement in the music industry and the challenge digital delivery of printed media presented to the book industry, coupled with the threat of overseas online retailers.

One tactical issue we considered was the digital output of products and what this means for our market. Is this a threat or an opportunity for us? The concept of a world where a person owns a hand-held device that holds 300,000 books in a digital online library, with print-on-demand facilities, is a very real prospect. Picking up and reading a book as we know it might all be about to change – we couldn't ignore this.

An example I use is that of a South Korean town where every home is hooked up to a wireless network. There is no music store because every inhabitant downloads their music needs. We considered this in the context of bookstores and digital books but instead of seeing it as a threat, we seized it as an opportunity and started our research.

We studied the market closely and used the similarities in the music industry as a comparison, choosing a high-level strategy that focused on digital delivery in a market where this concept was not yet established. We wanted to lead in the customer space by establishing an integrated approach that combined physical book stores with online services. Strategically, we were focused on the company's long-term future rather than short- to medium-term profitability.

In April 2006 we got board approval to proceed with our 'Brave New World' strategy. The first phase involved an online retail site that we launched before Christmas, which has a web interface with the functionality to go above and beyond current expectations. We invested substantially in the infrastructure of the system because we realise that it doesn't end simply with a user-friendly web interface. Not all customers want to buy their books online.

The second phase will be launched towards the end of May and will see a totally new way of approaching the delivery of both printed and digital media via our stores. This will be an Australian first and is something of which we are very proud. We've found through this exercise, that in addition to making the commitment to enhance our own delivery channels, that we've had to pressure our suppliers to be innovative in order to provide us with content in formats we require.

The functionality of our website and its scalability will allow our customers to decide which way they'd like to have their books delivered, and to check on whether a book is in stock and read through the latest reviews.

Dymocks has a history of innovation going back 20 years, when we started franchising our stores. This new delivery method was initially confronting to franchisees, but the more we all understood about its potential to bring new customers in the door, the happier everyone was with the idea.

For us, the key to innovation is speed and agility. There is a need to constantly review and nurture our innovation strategy and we must be agile enough to change direction if something doesn't work. We meet regularly to document our processes and constantly review the marketplace to see what our competitors are doing. The commitment of all our employees is key to its ultimate success, and Dymocks is certainly excited about being pioneers in this uncontested book delivery space.

## Conclusion

All companies should regularly review strategies for innovation, but this is especially important for those in the retail and consumer sector, due to the increased pressure on margins and the need for fresh avenues to growth. Companies that fail to recognise that innovation is the tool to achieve growth will struggle to remain competitive.

CEOs and boards across the country need to put an innovation strategy firmly back on top of the agenda to ensure it is occurring and that the results are being captured and used to the most productive effect. Unfortunately, companies often fail to address this vital area until they face

declining customer satisfaction and profits, or increasing costs. Given the global pressures on the retail and consumer goods sector and the opportunities presented by emerging giants such as India and China, now is the time to act.

To keep ahead of the pack and to ensure future financial prosperity, companies must embed systems that promote the creation and commercialisation of great ideas. Innovation is a driver of change but without systems for defining, capturing and evaluating the outputs of being innovative, companies risk missing its full potential.

## Take action

- Set up a system that defines what innovation means for your company, but will also capture, and most importantly, evaluate the ideas. Use these ideas to decide your company's direction.
- Make innovation integral to your day-to-day operation. Put the right tools and processes in place to assist in establishing a robust system that will instil innovative activity.
- Investigate your eligibility for the R&D tax concession and other grants to ensure your organisation is benefiting fully from available incentives for innovation.

*The insight in this chapter has been provided by Sandra Mason, Partner, R&D and Government Incentives, Tax and Legal.*

*Sandra specialises in assisting companies that utilise government incentive programs such as the R&D tax concession and grants. She works across industry sectors and has helped companies identify, capture and maximise innovation in their organisations. Sandra has spent many years advising on innovation and assists with the delivery of permanent savings for companies.*

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# 07

## The war for talent

The war for talent is on. Nearly 70 per cent of franchisors claim that a lack of suitable franchisees is the number one inhibitor of growth in their business<sup>1</sup> – a problem that is likely to worsen.

IBIS forecasts that in the five years to 2011–12, the franchising industry will have annualised revenue growth of 5.5 per cent.<sup>2</sup> To meet this demand, IBIS forecasts that employment in the franchising industry will increase at an average annualised rate of 6.5 per cent or about 40,000 new employees each year.<sup>3</sup> Compare this figure with the forecast Australian labour force growth rate of 1 per cent or approximately 150,000 new workforce entrants a year in the three years to 2010.<sup>4</sup> This means the franchising industry would need to claim 26.6 per cent of all new employees entering the labour market.

The increased demand for franchisees and employees, coupled with insufficient growth in workforce supply, will cause the cost of talent to increase. It is not just the immediate cost of salary and wages either. There are also the hidden costs of recruitment and retention policies, such as training and culture programs, and the opportunity costs of the risk of not achieving growth targets and customer service.

Franchisors, with franchisees' support, must take appropriate steps and devise strategies to attract and retain their share of talent if they want to survive.

<sup>1</sup> *Franchising Australia Survey*, Griffith University, 2006.

<sup>2,3</sup> *Franchising in Australia*, IBISWorld, 29 November 2006.

<sup>4</sup> *Economic Implications of an Ageing Australia*, Productivity Commission Research Report, 24 March 2005.

### The outlook

- Increased longevity and decreasing fertility will result in a shift in Australia's age demographics and place great pressure on the country's labour market.
- The cost of talent will rise as the franchising industry grows at a rate faster than the Australian labour market's ability to support it.
- As older employees leave the workforce, employee turnover is also likely to rise – turnover of younger employees (20–24 years old) is currently five times higher than that of older employees (55–59 years old).<sup>5</sup>
- Younger employees will be attracted to franchising because it offers first-hand experience, independence and the promise of immediate returns.
- Retention and recruitment strategies will target market segments with low employment participation rates such as baby boomers, women, school leavers and immigrants.
- Programs that generate organisational pride will be key to retention and recruitment for example organisational values, environmental awareness, community contribution, as well as career prospects, learning experience and empowerment.

<sup>5</sup> "Aussies switch jobs at drop of a hat", *National Business Review*, 3 November 2006.

## Keep the boomers in the game

In coming decades, the greatest pressure on Australia's workforce supply will come from the ageing population. Increased longevity combined with decreasing fertility is resulting in a shift in age demographics. The percentage of the population that is of working age is expected to fall by 7 per cent to 56 per cent over the next 40 years, while the percentage aged over 65 will double.<sup>6</sup>

An immediate threat is the retirement of baby boomers. There are 4.7 million people aged 44–65 and they represent 22.6 per cent of the population.<sup>7</sup> Of this group, 3 million (40 per cent) have already retired. The main source of income for almost half (44 per cent) of these retirees is a government pension or allowance.<sup>8</sup>

This population sector presents a golden recruitment opportunity. Employers may be able to retain baby boomers longer or entice them back into the

workforce with the right strategies. Jim Penman of Jim's Mowing says: "We like baby boomers, actually. People regard Jim's as a sort of a Dad's Army of franchising in some ways. We get a lot of people in their late 40s and 50s."<sup>9</sup>

Another important factor to consider is that baby boomers have attractive traits that may have a positive effect on your business.

<sup>6</sup> *Economic Implications of an Ageing Australia*, Productivity Commission Research Report, 24 March 2005.

<sup>7</sup> *Generational Cohorts – "Baby Boomers"*, IBISWorld, 2006.

<sup>8</sup> [www.abs.gov.au/AUSSTATS/abs](http://www.abs.gov.au/AUSSTATS/abs)

<sup>9</sup> "The future of franchising", BRW, 20 July 2006.

**Table 1: Eight reasons to keep boomers in the workforce**

1. Baby boomers have experience – not just industry or business skills, but valuable life experience.
2. Baby boomers can mentor management and staff.
3. Baby boomers are loyal – 20 per cent of workers aged 46 years or older are considering leaving their position within the next 12 months compared with more than 30 per cent of those aged 28 years and younger.<sup>10</sup>
4. Depending on your customer demographic, baby boomers may be an asset because of their ability to relate to your customers, who may be of a similar generation.
5. There is little decrease in productivity with age.
6. There is no observable difference in absenteeism.
7. Mature age workers have high loyalty, a strong work ethic and are reliable.
8. Investment in training mature age workers is as valuable, if not more valuable, as that for younger workers who are more likely to leave in the short term.<sup>11</sup>

<sup>10</sup> *What Keeps Employees Engaged with their Workplace?*, Australian Institute of Management, 29 November 2006.

<sup>11</sup> *National Strategy for an Ageing Australia*, Department of Health and Ageing, reprinted February 2002.

Employers can use a number of strategies to entice baby boomers back into the workforce.

- **Offer flexible hours** – employees nearing retirement may wish to make the transition by reducing their hours or taking advantage of more flexible working arrangements. Some will be courted out of retirement if they do not need to work full-time or can have flexible arrangements such as extended periods of leave. Take the time to understand individual needs and how to best incorporate them into your business. For example, some employees may want to work half days, so you could create a job sharing arrangement that allows two employees to split a morning and evening shift. You may be able to negotiate terms so these workers are available during high demand periods, such as school holidays. Such conditions may best suit older employees who want to travel during off-peak or cheaper periods and, in turn, allow you to cover those periods when other employees are likely to want leave. Alternatively, older employees may want to take leave during school holidays to spend time with grandchildren, which would allow you to employ casual labour during their holidays.
- **Address ageism** – according to some reports, 'young people tend to associate ageing with disability, dependency or irrelevancy'.<sup>12</sup> These attitudes are outdated. Increased life expectancy and improved health and wellbeing make engagement of mature age workers an opportunity to increase employment participation rates. It will also be key for sustained economic growth as Australia's population ages. People in their 50s, just like their younger peers, are individuals. They have varying capacities and abilities to adapt to change and use their talents and skills to contribute to the economy and the community.<sup>13</sup> Companies can take advantage of their employees' best skills and maximise performance and cohesion across all age groups by planning thoroughly, developing training programs that include incentives, and encouraging employees of all ages to share skills.
- **Provide training** – some baby boomers have been out of the workforce and will need to be retrained in certain skills. As with all training, people learn and adapt at different speeds and it may seem that young people can understand concepts more quickly because they have just come from a school learning environment. Baby boomers, however, are fully capable of learning new skills and, due to an increased likelihood of a longer tenure with your organisation, the investment may be worth more than training younger, transitory staff.

- **Create a supportive team** – often, baby boomers have come from senior, well-respected positions and may struggle with taking orders from anyone, much less someone half their age. To combat this problem, create a supportive team environment where everyone respects and uses each other's best skills and lines of responsibility are clear. This will help avoid power struggles.

## Encourage and support women

Between 1983 and 2003, Australia's workforce participation rate for women aged 45–84 almost doubled to 41 per cent.<sup>14</sup> However, there is still a significant gap between this rate and men's participation rate of 58 per cent.<sup>15</sup> This opportunity was identified by West Australian pool franchise system, PoolWerx, whose search for franchisees shifted away from reliance solely on men and is now actively targeting women.<sup>16</sup>

Strategies to recruit more women might include offering:

- more flexible working arrangements such as the choice of working from home or working during school hours to accommodate family needs
- assistance with sourcing affordable, high-quality childcare close to the workplace
- paid maternity and parental leave, which has been shown to help women reconcile work and family life and strengthen workforce attachment.<sup>17</sup>

<sup>12</sup> *Bridging differences: Effective Intergroup Communication*, William Gudykunst, 2nd edition, California, 1994.

<sup>13</sup> *National Strategy for an Ageing Australia*, Department of Health and Ageing, reprinted February 2002.

<sup>14, 15</sup> *Measuring the Age of Withdrawal from the Labour Force*, Australian Bureau of Statistics, 10 November 2005.

<sup>16</sup> "PoolWerx in growth phase", *WA Business News*, 7 July 2005.

<sup>17</sup> *Workforce Participation Rates – How Does Australia Compare?*, Productivity Commission working paper, December 2006.

## Get them while they're young

Gen Y are those people born between 1982 and 2001. In Australia there are about 5.5 million people in this group, who make up 26.7 per cent of the population.<sup>18</sup> Of the Gen Y currently in the workforce Australian data suggests that 63 per cent of Gen Y members stay with an employer for less than two years.<sup>19</sup> It is predicted that recent graduates will hold 22 different jobs during their working life.

Franchising is an excellent fit with the Gen Y outlook. These people want to gain the most experience they can in the fastest time possible and expect immediate returns. Gen Y wants to work with a highly motivated team of committed people, but have a strong sense of independence. Using the relative safety of a proven franchise system, franchising allows these young people to experience first hand how to manage a business and they are able to achieve an immediate financial return for their efforts.

You can attract this demographic by offering the following opportunities:

- **Be your own boss** – assisted by the wealth of their baby-boomer parents, Gen Y is entering the franchising sector. The founder of fast-growing sandwich chain Healthy Habits, Katherine Sampson, says the under-30s want to be their own boss and franchising offers them the support and training they need.<sup>20</sup>
- **Immediate rewards** – franchising offers franchisees a share of the profit and there is a strong correlation between the effort put into a business and the economic return achieved. This satisfies Gen Y, which looks for an immediate return and is less interested in the long-term, career-building model where benefits are realised in 10–15 years.
- **Overseas experience** – the Subway sandwich franchise is trying to create incentives for staff and franchisees to stay with the system beyond the term of their first franchise agreement. The company is offering secondments overseas and is building up training mechanisms so that people join to develop their retailing, managing and marketing skills.<sup>21</sup>
- **Information technology** – a point of differentiation for young people is the status of your IT systems. Gen Y is IT-savvy. It won't take long for these employees to become frustrated with antiquated systems and associated manual tasks when a more streamlined approach that can give up-to-date real-time information is more interesting.
- **Development** – young employees, and often franchisees, do not just focus on immediate financial returns such as wages or profits. They are thirsty for opportunities such as learning



industry and retail strategy skills, and business and management skills. These could help them with future enterprises or career prospects. A formal development program might include an apprenticeship such as that established by Brumby's, which allows employees to complete a bakery apprenticeship qualification in three or four years, mentored by an experienced craftsman as they learn their trade.<sup>22</sup> Similarly, in 2004, Gloria Jean's Coffees launched an elite traineeship alliance with William Angliss Institute of TAFE, offering Gloria Jean's managers the opportunity to become traineeship trainers and instruct staff in the nationally accredited Certificates II and III in Retail (Operations).<sup>23</sup> Informal development can include exposure to retail strategies of the franchisor, managing supply contracts and sales courses.

<sup>18</sup> *Generational Cohorts – "Net Generation"*, IBISWorld, February 2006.

<sup>19</sup> "Aussies switch jobs at drop of a hat", *National Business Review*, 3 November 2006.

<sup>20, 21</sup> "Chain-store squeeze", *BRW*, 20 July 2006.

<sup>22</sup> [www.brumbys.com.au/careers/income.aspx](http://www.brumbys.com.au/careers/income.aspx)

<sup>23</sup> [www.gloriajeanscoffees.com/pages/content.asp?pid=103](http://www.gloriajeanscoffees.com/pages/content.asp?pid=103)

- **Career paths** – development of employees can play an important role in the identification of future franchisees. Assisting employees to become franchisees gives them more advanced career options and allows them to aspire to ownership of their own business. It also provides you with a ready source of known and capable franchisees who understand what it takes to make the franchise business successful. Similarly, franchisees may become part of your franchise's organisation, such as area managers.
- **Meaningful roles** – Gen Y has a highly developed sense of social responsibility and is willing to work for a good cause. Consequently they will be attracted to organisations that offer meaningful roles in meaningful work and companies that run corporate citizenship programs that make valuable contributions to the wider community.

## Immigration – overseas help

In a recent Productivity Commission report, the Australian Government states that immigration cannot realistically be increased to prevent or even substantially moderate the ageing of the population.<sup>24</sup> However, as a short-term measure to ease the labour force pressure, the Government expanded its annual quota of skilled migrants by 20,000 over 2005.<sup>25</sup> This represents a 20 per cent increase on current net migration of 100,000.<sup>26</sup>

Australian franchise businesses have begun looking overseas to staff their stores. Brumby's Bakery hired 20 bakers from Vietnam because, even after a two-year local recruitment drive, it couldn't find skilled locals to fill the positions.<sup>27</sup>

The overseas solution can be a great way to build your international network. It offers a chance for people overseas to buy an Australian franchise or work in one to gain experience in the local market before returning to their home country to start their own franchise.

There are a number of strategies that you could consider to recruit immigrants. Perhaps one of the best is to offer visa and immigration assistance, which may be a significant hurdle for some migrants. Language and cultural training are two essential ways that you can help these employees adapt to the Australian workplace.

Taking complex regulatory processes out of the system is a great way to assist potential franchisees. For example, 7-Eleven provides the convenience of a payroll service for franchisee employees and assists with cash management through the payment of all approved operating expenses and

merchandise purchases.<sup>28</sup> You could also help establish a buddy system with people from the same country to create a support network for migrant workers.

## Show me more than the money

Market forces will in part dictate what franchisees pay their employees and the fees that franchisors can charge franchisees. However, strategic advantages can be obtained by being creative and aligning strategic objectives to remuneration. For example, a franchisor could pay a recruitment officer a base salary plus a bonus depending on the number of new franchises established. A larger bonus could be paid depending on the number established that achieve a specified sales target within the first 12 months or that stay with the franchise for more than five years. This would help the franchisor achieve the strategic objective of increasing the number of successful franchisees.

Franchisors can be equally creative with the fees they charge franchisees. Without creating an administrative burden or opening the company up to misstatement, franchisors could craft a series of incentive-based franchise fees. For example, if the aim was to establish a new line of business in the franchise system, the franchisor could charge lower franchise fees for the sale of that line while it is being established. Franchisees could be rewarded for contributing to the franchise community: they could receive a fee rebate for volunteering to help train new franchisees, suggesting new system improvements or participating in the leadership of the franchise advisory council or the marketing fund.

One of the important aspects of reward is recognition. A sealed envelope containing a bonus is not the same as a public display of recognising achievements. A simple public gesture makes the recipient feel more honoured for the recognition and reinforces positive behaviour for other employees or franchisees to aspire to. Simple examples include naming an employee of the month, regularly seen at McDonald's, or annual conferences where franchisees and staff are recognised for their achievements.

<sup>24</sup> *Economic Implications of an Ageing Australia*, Productivity Commission, 24 March 2005.

<sup>25</sup> "Australia economy: seeking people to work down under", *Los Angeles Times*, 20 January 2006.

<sup>26</sup> *Economic Implications of an Ageing Australia*, Productivity Commission, 24 March 2005.

<sup>27</sup> Australian Associated Press report, 5 March 2006.

<sup>28</sup> [www.7-eleven.com.au](http://www.7-eleven.com.au)

Work/life balance is increasingly important to employees. Franchise businesses are now offering the following benefits to help employees achieve this balance:

- **Holidays and career breaks** – running a franchise business can be very tiring and some people leave a franchise business because they feel it is the only way to get away. In order to avoid this burn-out, it may be possible to introduce a locum system, similar to that doctors use, where previous franchisees temporarily run the franchise business while the franchisee takes a well-deserved break. Bob Jane T-Marts, for example, provides relief managers so that its franchisees can take a holiday.<sup>29</sup>
- **Family contract** – in an attempt to improve employment flexibility, McDonald's has introduced a Family Contract enabling employees to share jobs with family members.<sup>30</sup>
- **Illness or accident** – Jim's Mowing offers its franchisees help in cases of illness or accident.<sup>31</sup>
- **Short Fridays** – companies such as McDonald's and Taco Bell have introduced short Fridays during the summer and holidays to allow staff more personal flexibility.<sup>32, 33</sup>
- **Childcare discount** – McDonald's has agreements with three US childcare providers – Childtime Learning Center, Knowledge Learning Corporation and La Petite Academy – offering its employees a 10 per cent discount on fees.<sup>34</sup>
- **Educational assistance** – both McDonald's and Yum! offer an educational assistance program for employees to attend university.<sup>35, 36</sup>
- **On-site facilities** – Taco Bell promotes on-site facilities such as a basement food court, gym, dry cleaner, travel agent and car wash.<sup>37</sup>
- **Concierge services** – McDonald's has introduced a wide range of concierge services for employees including financial services (for example help with setting a budget or getting out of debt), legal services and more.<sup>38</sup>
- **Adoption assistance** – 7-Eleven and McDonald's offer adoption assistance programs to help employees with the costs associated with adopting a child.<sup>39, 40</sup>

## Culture

Many franchise systems are investing in the development of an inspirational culture. This means creating an environment where franchisees and employees feel a sense of pride to be associated with the franchise. A strong corporate culture will differentiate the business from others and potentially help to retain for longer franchisees and employees

who want more from the company beyond an immediate financial return. An inspiring organisational culture can be fostered through consideration of a number of important issues including:

- **Organisational values** – organisation values are about what the company wants to be known for. What will franchisees and employees say the franchise stands for? It could be good service but does that provide the inspirational motivation or pride that will wholly engage franchisees and employees? Boost Juice's signature value is 'love life' and this theme is carried throughout the company, even to selecting employees who have bright personalities and are passionate about their work. On the Boost Juice Bars website, a checklist for staff includes those who can "smile at least every 10 minutes" and who are "active, energetic [with] caring personalities".<sup>41</sup>
- **Community participation** – nearly every major franchise system has some element of community or charitable contribution that is also often aligned to the core business. For example, bookseller Dymocks has a literary foundation that raises funds to help children learn to read and write, and fall in love with reading.<sup>42</sup> Brumby's is another example. Each year the company offers in excess of \$25 million worth of its products to charity, community groups and the less fortunate.<sup>43</sup>

<sup>29</sup> www.bobjane.com.au/Corporate/FranchiseInformation5.asp  
<sup>30</sup> "Facing up to the benefits of working", The Northern Echo, 1 February 2006.  
<sup>31</sup> www.jimsmowing.net/franchisee.htm  
<sup>32, 34</sup> www.mcdonalds.com/corp/career/employee\_benefits/balance\_worklife.html  
<sup>33</sup> www.tacobell.com  
<sup>35</sup> www.yumcareers.com/yumgrow\_framesetup.html  
<sup>36, 38</sup> www.mcdonalds.com/corp/career/employee\_benefits/balance\_worklife.html  
<sup>37</sup> www.tacobell.com  
<sup>39</sup> www.7-eleven.com/careers/benefits.asp  
<sup>40</sup> www.mcdonalds.com/corp/career/employee\_benefits/balance\_worklife.html  
<sup>41</sup> "Catering for Generation Y", Illawarra Mercury, 14 January 2006.  
<sup>42</sup> www.dymocksliteracy.com.au  
<sup>43</sup> www.brumbys.com.au/about/community.aspx

Figure 1: Strategies to attract and retain talent in the franchising sector



- **Environmental awareness** – a study by the Australian Institute of Management showed there was a strong correlation between an employee's sense that the company was socially responsible and the length of their likely tenure.<sup>44</sup> All companies, including franchises, must face the *Inconvenient Truth*<sup>45</sup> that their company must look at its sustainability and its impact on the environment. In a recent example, Boost Juice audited the various cup options available to it including polystyrene, plastic and cardboard. Its report showed that foam releases far less airborne emissions and toxins into the environment, so it continued to use foam cups in support of the environment.<sup>46</sup>
- **Good relationships** – the second most important reason employees stay in a company is "good relationships with my co-workers".<sup>47</sup> For some franchisees there is a risk that they are isolated running their own business and do not feel a sense of community within the franchise system. Strategies such as franchise councils, seminars, training with peers, newsletters and regular communication from the franchise to share strategies help build a sense of community and ensure good relationships in the franchise system.

## Consider changes to the business model

Some franchise businesses are reviewing their business models to see how they can make themselves more attractive to franchisees and employees. Options to consider include:

- **Time-saving measures** – any opportunity to reduce the time required to manage a business should be explored. One area that can take a lot of time is managing supply. Brumby's has introduced new infrastructure, including retarder provers that make baking less laborious, to cut down on early morning starts.<sup>48</sup> Another example is Michel's Patisserie, which differentiates itself in recruiting franchisees by separating food preparation (baking) from retailing. It claims no 2 am starts, as daily orders are placed to a central bakery each afternoon and delivered fresh the next day.<sup>49</sup> Gloria Jean's has developed an advanced internet system that helps franchisees with banking, stock management and marketing.<sup>50</sup>
- **Flexible franchises** – offering more flexible franchisee arrangements such as time sharing is a great way to attract new talent. Time sharing could take the form of a part-time franchise, which might be attractive to women or semi-retirees. For example, multiple franchisees could share the business with one franchisee running the business in the morning and another in the afternoon.
- **Lower capital requirements** – consider reducing the capital requirements of the business. Young people may not have access to capital, while people approaching retirement may want to protect their nest egg. If a franchisor can develop ways to assist with finance, stagger capital payments or even reduce the capital requirements, it may attract more potential franchisees.

<sup>44</sup> *What Keeps Employees Engaged with their Workplace?*, Australian Institute of Management, December 2006.

<sup>45</sup> *An Inconvenient Truth*, Al Gore, Paramount Classics, 2006.

<sup>46</sup> www.boostjuicebars.com

<sup>47</sup> *What Keeps Employees Engaged with their Workplace?*, Australian Institute of Management, December 2006.

<sup>48</sup> *The Cairns Post*, 24 February 2006.

<sup>49</sup> www.michels.com.au

<sup>50</sup> "Franchise goes for national ADSL," *Computerworld Australia*, 9 May 2006.



**Karen Matthews**  
**Chief Executive Officer**  
**Ella Baché Australia**

In 1936, Madame Ella Baché founded her skin-care range based on the philosophy that no two skins are alike. She believed every person in the extensive network of salons across Australia should be recognised as one of our most valuable assets.

Central to Ella Baché's success and the continued growth of its 200 salons in Australia is the support it provides to its franchise owners and employees. The cornerstone of this support is the Ella Baché College of Beauty Therapy. Students are recruited by Ella Baché to undertake a Diploma of Beauty Therapy, and most of those who receive this training go on to become employees or franchise owners.

The differentiating factor for Ella Baché is our holistic approach to training. Along with traditional beauty therapy instruction in skin care, massage and make-up, students are trained in business administration, performance management and staff motivation, as well as customer communication, marketing and business plans.

The immediate pay-off is that the college acts as a fertile ground for recruitment, with 95 per cent of students being employed into the Ella Baché franchise network. Further, these employees are likely to stay within the business for longer, either as employees within the salons, as new franchise owners or as trainers.

This success is not just attributable to access to students, but also to the deep brand awareness the students develop during training, and the loyalty it encourages. They are taught the Ella Baché customer care philosophy: to respect the individual, to allow people to be their best and that skin care is about health, not glamour. Our students train with Ella Baché products. It is these products they are most familiar and comfortable with when they begin their practice as beauty therapists.

Another key to Ella Baché's success is our understanding of what motivates beauty therapists. Most are nurturers who care about people and who want people to feel better. One of the most critical motivational techniques franchise owners must employ is to allow therapists to take the time to pamper and nurture their customers rather than cut corners to meet tight time frames. This allows therapists to attain an altruistic satisfaction in caring for the customer and, in turn, helps them stay motivated.

Ella Baché continues to provide training to its beauty therapy teams, offering extensive field training that focuses on marketing; retailing and speciality beauty workshops; postgraduate courses for advanced skin care and business skills; and an annual franchisor conference that reinforces the Ella Baché principles.

Franchise owners are also trained in how to retain, motivate and engage employees by paying above-award rates, providing ongoing training support, allowing time off to attend training, ensuring clean conditions in salons and ensuring therapists have adequate breaks.

Early recruitment of students who are trained and inducted into the Ella Baché brand philosophy, and the ongoing support that we extend to staff and franchise owners, will help ensure the success of the Ella Baché business for generations to come.

## Conclusion

Australia's franchising sector has entered a period where only the fittest – and the smartest – will survive. With more and more franchising opportunities and jobs available to fewer and fewer people, franchisors can expect to pay more for their talent. Their task will be to recognise where the available talent resides. It will often be with those people who have left or are about to leave the workforce – women and mature workers – or those young people about to join it for the first time.

Franchisors will need to recruit and retain the right people by making an attractive case for employment and career progression within their chain. While salary will always have its place, franchisors will be able to hire the people they need only by using inducements other than money, such as training, career plans, an inspiring culture and flexible working conditions.

The talent is out there. The challenge is to create the organisational pride to find and keep it.

## Take action

- **Develop recruitment and retention strategies beyond salaries and wages.** Recognise that career plans, training and corporate culture are all important.
- **Build workforce attraction and retention plans** by segment and consider the individual needs of employees.
- **Use compelling employment strategies for baby boomers and women** in order to retain them longer or entice them back into the workforce.
- **Create a supportive and inspiring team environment** where everyone can learn from each other's skills and experience.
- **Tap into the franchise's alumni network.** Former colleagues can be valuable assets because they know the business.
- **Offer a range of careers** to attract a broader spectrum of employees and franchisees.
- **Ask franchisees and employees what they think can be improved, what the franchise is doing well and emerging issues in the business.**
- **Conduct exit interviews** to help discover what the market is offering employees, such as higher salary or opportunities for further training, or to reveal problems within the team that may need to be addressed to avoid more losses.

*The insight in this chapter has been provided by Cassandra Michie, Partner and leader of PwC's franchising team.*

*Cassandra assists franchises to grow their businesses. Drawing upon the firm's diverse technical capabilities, Cassandra's team advises clients on a range of issues, from traditional areas of accounting to tax and corporate finance and performance improvement challenges such as customer and employee engagement.*

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# 08

## New era for pharma

Sweeping government reforms to be introduced over five years from 2007 will substantially reshape the Australian pharmaceutical industry landscape.

Who emerges as the biggest winners and losers will depend on how participants manage and respond to the new conditions. However, one thing is for sure: there will be less money to go around as the Australian Government seeks to rein in the long-term cost of health care, and particularly the \$6 billion-a-year Pharmaceutical Benefits Scheme (PBS). About 80 per cent of prescriptions dispensed in Australia are subsidised under the PBS and total some 170 million in number each year.

The changes are aimed at saving \$3 billion over the next decade. This will require retail pharmacies to reinvent their business models and lead to significant price cuts for manufacturers of generic drugs. They will also drive a new level of transparency across the industry that will impact heavily at the distribution and retail layers.

### The outlook

- The Australian Government has announced the most ambitious reform of the PBS in 50 years to save \$3 billion over 10 years.
- Prices paid for non-patented, publicly subsidised medicines will fall by 6–25 per cent, depending on the degree of market competition.
- Consumers will not immediately enjoy lower prices as the Government seeks to reimburse pharmacists and return savings to Treasury.
- Community pharmacists will need to overhaul their business models if they are to remain profitably in business at the end of a four-year, \$1.1 billion reimbursement package.
- Generic medicines will increase from 20-28 per cent of prescriptions dispensed in Australia to closer to 45 per cent as reforms take effect and drugs come off patent.

## Need for a solution

Health spending accounts for about \$38 billion, or 18.2 per cent, of government expenditure in Australia each year. A key part of this is the PBS for subsidising the cost of medicines for individuals, which cost taxpayers \$6.1 billion in 2005–06.

The rising cost of the PBS has traditionally outstripped inflation (2–3 per cent), clocking up an average annual growth rate of 12 per cent between 1995 and 2005.<sup>1</sup> After 2001, in the lead up to the announcement of the latest reforms in November 2006, there was extensive debate when measures were first put into place to help curtail this double-digit growth rate.

In 2002, the Treasury Department released a long-range forecast document called the *Intergenerational Report*. This wide-ranging review of all government expenditure projected large and unsustainable public sector deficits that rose steadily to represent 5 per cent of national output by 2042, or more than \$40 billion a year in today's dollars.<sup>2</sup>

The PBS was forecast to be a major contributor to this deficit, and was expected to grow fivefold, from 0.6 per cent of GDP in 2002 to 3.4 per cent of GDP in 2042.<sup>3</sup> This would be driven largely by the ageing of the population and the introduction of newer and ever more sophisticated and expensive drugs. Concerned by these forecasts, the Government introduced initial reforms which began to take effect in 2005 and 2006, slowing the growth. This led the industry to ask whether further reform was needed.

## First-round reforms

The growth of PBS spending slowed significantly to 6.1<sup>4</sup> per cent in 2004–05 and 2.7 per cent<sup>5</sup> in the 2005–06 financial year.

One short-term factor was health scares such as that caused by Vioxx (commonly used for patients with rheumatoid or osteoarthritis). More broadly, the slowdown can be attributed to a range of cost containment measures introduced over the past two years. These include:

- **Increases in co-payments** – from 1 January 2005, the amount that Australians were required to contribute to the cost of PBS-listed drugs increased by 20.6 per cent to \$28.60 for general patients and by 21 per cent to \$4.60 for concession card holders (seniors and people on low incomes). Patients pay the full cost of a medicine if it costs less than the relevant co-payment amount. These co-payments rose again on 1 January 2007 to \$30.70 for general patients and \$4.90 for concession holders. Patients pay the full cost of a medicine if it costs less than the relevant co-payment amount.

<sup>1</sup> Minister for Health and Ageing Tony Abbott, speech to the National Press Club, 2 August 2006.

<sup>2</sup> *Intergenerational Report Review*, s3.3., Access Economics, prepared for Medicines Australia, 6 September 2006.

<sup>3</sup> Medicines Australia Chairman John Young, speech to National Press Club, 6 September 2006.

<sup>4,5</sup> 'Summary of Pharmaceutical Benefits processing, year ending 30 June 2005', Treasury Department.

Figure 1: Timetable for PBS reform

Activity	Commencement date
Streamlined prescribing of authority prescriptions	1 July 2007
Separate lists of PBS medicines created	1 August 2007
Pharmacy incentive of 40c for prescriptions processed using PBS online	1 August 2007
Price reductions for F2 medicines	1 August 2008
Requirement to agree to price disclosure when listing new brands	1 August 2007 – low price competition 1 January 2011 – high price competition
Pharmacy incentive of \$1.50 per premium-free prescription dispensed	1 August 2008
Changes to pharmacy mark-ups and dispensing fee	1 August 2008
Increase to CSO Funding Pool for pharmaceutical wholesalers	1 August 2008
Prices adjustment based on disclosure	1 August 2009 – low price competition 1 August 2012 – high price competition

- **Increases in safety net thresholds** – to protect patients who may spend a large amount each year on medicines, the Government provides safety nets. From 1 January 2007, general patients' co-payments fall after they have paid \$1,059 in a year. Concession card holders pay no further co-payments after they reach \$274.40 in a year, as long as the drugs prescribed are outside the safety net 20-day rule. To achieve further savings, the Government also reduced the number a prescription repeats allowed in a year with the 20-day rule.
- **New generics price reduction of 12.5 per cent** – from 1 August 2005, the first generic version of a medicine already included on the PBS have had to be priced at least 12.5 per cent below the existing drug. Due to price referencing, this effectively led to a fall in the price of all drugs in the same category.

- **Fourth Community Pharmacy Agreement** – this agreement between the Australian Government and the Pharmacy Guild of Australia was signed in November 2005. In return for continued protection from a range of competitive threats, particularly supermarkets, Australia's more than 5,000 pharmacies agreed to a new funding package for pharmacy and wholesalers of \$11.1 billion over the five years to 30 June 2010. In real terms this represented an increase of 6.2 per cent per prescription on the previous agreement<sup>6</sup> but it is expected to generate savings to the PBS of approximately \$350 million. These savings are to come primarily from a 3 per cent cut in wholesaler margins from 10 per cent to 7 per cent.

<sup>6</sup> Department of Health and Ageing website: [www.health.gov.au/internet/wcms/publishing.nsf/Content/pharmacy-4cpa](http://www.health.gov.au/internet/wcms/publishing.nsf/Content/pharmacy-4cpa)



## Patent expiries

Changes to government policy have not been the only reason for the decline in PBS cost growth. The expiry of patents on major drug groups is also key.

The market capitalisation of the world's large research-based pharmaceutical companies has declined over the past few years as major drugs have come off patent and not been replaced by a pipeline of new patent-protected products. Worldwide sales in 2003 of 'blockbuster' drugs with patents that will expire in 2006 stood at about US\$14 billion.<sup>7</sup>

The expiry of patents has been a windfall for government in containing the PBS. According to Access Economics, between 2004 and 2010 patents will expire on 16 major types of drugs that collectively cost the PBS \$1.5 billion in 2004–05. This amount was more than a quarter of PBS subsidies in that

year, highlighting the importance of the small group of major drugs that account for a large portion of PBS spending. Consequently any change to pricing in this group has a disproportionate impact on the overall cost of the scheme.

Notably, Australia is behind many major markets in its consumption of generics drugs. According to IBISWorld, generic medicines are believed to account for about 20 per cent of prescriptions in Australia. Reports put this at 20–28 per cent, compared to 47 per cent in the United Kingdom, 45 per cent in the United States and 40 per cent for Canada.<sup>8</sup>

<sup>7</sup> Datamonitor, DOLPHIN patent database, Thomson Scientific, November 2004.

<sup>8</sup> 'Pharmaceuticals wholesaling in Australia F4797', IBISWorld, 22 November 2006.

Figure 2: Major patent expiries 2004–10

Brand name (s)	Generic name	Medicine type	Expiry date	PBS cost 2004-05(\$m)
Aropax	Paroxetine Hydrochloride	Depression	February 2004	55.3
Zocor, Lipex	Simvastatin	Cholesterol	July 2005	390.3
Zoloft	Sertraline	Depression	October 2005	94.8
Seretide	Fluticasone	Asthma	February 2006	25.1
Pravachol	Pravastatin	Cholesterol	June 2006	125.9
Monopril	Fosinopril	Blood pressure	November 2006	17.1
Ramace, Tritace	Ramipril	Blood pressure	April 2007	69.6
Norvasc	Amlodipine	Blood pressure	February 2008	63.4
Serevent	Salmeterol	Asthma	April 2008	185.5
Betaferon	Interferon beta-1b	Mutiple sclerosis	October 2008	38.9
Efexor	Venlafaxine	Depression	December 2008	100.1
Nexium	Esomeprazole	Peptic ulcers	March 2009	157.3
Lexapro	Escitalopram	Depression	June 2009	24.4
Zoton	Lansoprazole	Peptic ulcers	September 2009	42.0
Somac	Pantoprazole	Peptic ulcers	January 2010	114.0
Zanidip	Lercanidipine	Blood pressure	February 2010	25.0
<b>TOTAL</b>				<b>\$1,528.7m</b>

Source: *Intergenerational Report Review*, Access Economics, prepared for Medicines Australia, 6 September 2006.

## Latest reforms

Despite a looming 2007 federal election, the Coalition Government and Health Minister Tony Abbott continued their campaign to further curb the cost of the health system. One of their most important targets was the PBS, and in particular the high profit margins on generic drugs. Manufacturers were keeping these margins or passing them on to distributors and pharmacists rather than patients and taxpayers. Another motivation for reform was that patents on more than 100 medicines are due to expire over the coming decade, making generic substitutes more important.

Negotiating what have been described as the most ambitious PBS reforms in 50 years<sup>9</sup> required a delicate balancing of the interests of stakeholders. These include the politically powerful Pharmacy Guild of Australia, which represents the nation's 4,910 retail pharmacies, the medical profession, drug manufacturers managers (both originators and generics) and wholesalers.

The outcome is a package that will force manufacturers of certain high competition drugs to make relatively swift price cuts and in turn reduce the discounts they can afford to pay to pass on down the supply chain. To soften the blow, pharmacies will receive reimbursement from the Government, estimated to be worth \$1.1 billion over four years,<sup>10</sup> to ensure they remain solvent and have time to evolve their business models.

The reforms are expected to be voted into law during 2007 and feature the following key changes:

### Price cuts

From 1 August 2007, medicines on the PBS will be reclassified into two formularies:

- **Medicines where there is only a single brand listed will be referred to as F1.** This group will not be subject to mandatory price reductions. These will be both patent and off-patent medicines that cannot be substituted for other brands or medicines.
- **Medicines where there are many brands listed or that are interchangeable will be known as F2.** These are already subject to a 12.5 per cent price reduction when the first new non-blockbuster brand of a drug (same form/strength/manner of administration) is listed on the PBS.

From 1 August 2008, further price reductions will be enforced – a drop of 6 per cent over three years where price competition between brands is low and an immediate drop of 25 per cent if competition is high.

- F2 is further broken down to F2A and F2T. F2A are drugs that did not attract significant trading terms at pharmacy at 1 October 2006 (low competition), and F2T are drugs that did attract significant trading terms as at 1 October 2006 (high competition).

The Government has said that about 100 medicines that cost the PBS \$2 billion a year will fall into the F2 high-competition group. According to the Pharmacy Guild of Australia, from 2008 patients will pay an average of \$2.73 less for approximately 424 general items on the PBS – including many of the most common drugs such as antibiotics, blood pressure pills, painkillers and asthma inhalers. Whether consumers will in fact see these savings will depend on whether they are currently below the co-payment level.

### Disclosure

The Government hopes to further control costs by enforcing transparency in pricing, so consumers can find out how much drugs really cost the pharmacist and so that the price government pays is ultimately the same as the market price. It will require price disclosure where there is competition according to the following timeline:

- Any new brand of a drug (same form/strength/manner of administration) that comes on to the F2A list from 1 August 2007 will have to disclose its ex-manufacturer price. Actual price changes based on disclosure will commence for these medicines from 1 August 2009.
- If competition is high, suppliers of new brands of a drug (same form/strength/manner of administration) on F2T will have to disclose these prices from 1 January 2011. Price changes based on these disclosures will be implemented within a two-year period.

<sup>9</sup> 'Capital Hill' editorial, *The Australian Journal of Pharmacy*, Vol. 87, December 2006.

<sup>10</sup> '2006-07 Mid-Year Economic and Fiscal Outlook', Treasury Department.

## Compensation for pharmacists

To maintain the commitments it made under the Fourth Community Pharmacy Agreement, the Government has introduced a new group of payments and incentives for pharmacists that will replace the income lost from lower manufacturers' incentives during the transition period.

From 1 August 2008, the fees pharmacists receive for supplying PBS medicines will increase, although the exact amount has not yet been disclosed. There will also be an incentive payment of \$1.50 each time a medicine is dispensed that costs no more than the standard co-payment and from 1 July 2007, pharmacists will receive 40 cents for each prescription processed using the new PBS Online electronic commerce system.

These measures are aimed at encouraging greater use of generic medicines and driving efficiencies through the system as a whole.

## Other changes

The Government will provide an extra \$23 million in funding over three years for the Community Services Obligation Funding Pool to further underpin the national distribution of medicines. To streamline the way doctors prescribe medicines, from 1 July 2007, doctors will be able to authorise the prescriptions they write for about 200 of 450 medicines that previously required a pre-approval call to the central funding body Medicare Australia.

## Market responses

In what is seen as a victory for the Department of Health and Ageing and its Secretary, Jane Halton, the new reforms have been welcomed, or at least appear to have been accepted by key stakeholders. The Pharmacy Guild was particularly pleased with the reforms, with its National President, Kos Sclavos, dubbing Prime Minister John Howard the group's 'guardian angel'.

However, the changes are not without critics and stakeholders that feel the Government has missed some opportunities. The consumer advocate group Choice said the money saved through the reforms should be passed immediately to patients in the form of lower co-payments, rather than increased compensation for pharmacists.

Then Opposition health spokeswoman, Julia Gillard, did not criticise the reforms but questioned whether the savings would be retained within the health system or simply returned to the Treasury for general government spending.

There are also concerns that introducing a wide price disparity between F1 and F2 medicines will lead the pharmaceutical industry to redirect resources from research and development of new drugs to seeking ways to 'evergreen' (extend the life of) existing patented drugs or prove why existing medicines are not substitutable with others on the market. Clearly there will be winners and losers in the reclassification process.

The most vocal critics and the groups that stand to lose most, however, are the generic and innovative drug manufacturers. These parties must accommodate substantial price cuts without any benefit beyond playing their part in making the PBS sustainable long-term.



## Impact on drug manufacturers

The most significant impact of the new regime will be the change in pricing of off-patent drugs and an increase in transparency across the market. With immediate price drops of 25 per cent in 2008 or a phased 6 per cent between 2008 and 2010, the reforms will directly affect the approximately 155<sup>11</sup> local and international drug manufacturers operating in Australia.

As a group, medicinal and pharmaceutical product manufacturers in Australia turned over \$6.8 billion in 2005–06.<sup>12</sup> To respond to the government reforms, they will need to both reduce rebates offered to distributors and pharmacies – estimated to range from 2–5 per cent on patent-protected drugs from major pharmaceutical firms and up to 20–30 per cent for generic drugs – and find operational efficiencies if they are to retain margins.

Generic manufacturers should gain some benefit from the \$1.50 incentive pharmacists will receive for dispensing substitutable premium-free brands of PBS medicines. However, because the cuts in manufacturers' prices are not going to be passed on immediately to consumers, they cannot expect to see any price-driven rise in volume that might have otherwise offset their loss of margins.

The group that will be hit hardest is the major innovative (R&D) pharmaceutical manufacturers with drugs coming off patent. This group is mainly represented by Medicines Australia, which interestingly welcomed the reforms as a way of securing Australians' access to research-based medicines but expressed caution. "The package's implementation will require close consultation however, as there is potential for a significant negative impact on the business of many of our member companies," said then Chairman John Young, who was at that time also managing director and chairman of Pfizer Australia.

## The consumer benefit

All Australians should be concerned that these drug originators retain an incentive to stay in the market, and continue to invest in local R&D. With new drugs generally taking up to 12 years and upwards of US\$1 billion to develop, this is not a trivial concern. In an address to the National Press Club last September, John Young said it was important to take a patient-centric view of healthcare delivery. This would focus more on prevention, early diagnosis and early treatment – not just treating sickness.

He said spending on effective medicines reduced total health costs. He drew attention to New Zealand, where the Government is strictly rationing medicines through the PHARMAC system, first introduced in 1993. Medicines Australia claims this approach has produced significantly higher hospitalisation rates and poorer health outcomes.

As an example, it cited the restricted access to many medicines for depression and schizophrenia and New Zealand's relatively high total expenditure on mental health services. It also found that since the turn of the century, Australians had gained access to 23 innovative new medicines on the PBS, while New Zealanders have gained access to only two.<sup>13</sup>

## Concerns exist

At least one industry chief executive, quoted anonymously in *The Australian Journal of Pharmacy*, believes the Government's proposed reforms are too extreme and will hurt R&D. "To consider a further price cut of 25 per cent simply consigns Australia to the R&D scrap heap, resulting in withdrawal of pharma companies, and restricted access to drugs as happened in New Zealand," the person said.

The CEO's comments also suggest that the early silence on the reforms may soon give way to a vigorous rear-guard action from major pharmaceutical companies. For example, the person said the industry might take legal action to test whether the reforms meet Australia's obligations under its Free-Trade Agreement with the US. This sounds a risky strategy in a market where the only effective purchaser of drugs is the Government.

<sup>11</sup> 'Pharmaceuticals wholesaling in Australia F4797', IBISWorld, 22 November 2006.

<sup>12</sup> 'Medicinal and pharmaceutical product manufacturing in Australia C2543', IBISWorld, 9 November 2006.

<sup>13</sup> Medicines Australia media release, 6 September 2006.

### Impact on retail pharmacies

Despite their four-year reprieve, pharmacists will need to be on their toes in the new environment and be working to change their business models. According to industry analyst Bruce Annabel, from Johnston and Rorke, all pharmacists will need to shift to offering value-added healthcare services and driving efficiencies – especially those that serve hospitals and the aged.

“Pharmacy owners, especially providers to hospitals and aged care institutions, need to adopt a lean service delivery model by looking for greater operating efficiencies, more efficient dispensing, better use of technology, a radical new retail and healthcare strategy, improve business management skills and negotiate improved supplier trading terms,” he argues.<sup>14</sup>

These incentives will remain in place until the end of the current Community Pharmacy Agreement. The challenge for retail pharmacies is to maintain profitability beyond this point.

Although the pressure to deregulate the pharmacy industry appears to have abated for the time being, pharmacists will continue to be under pressure to address margins, change their business practices and adopt or adapt to new business models.

It will be important to continue to focus on product segments where pharmacy is perceived to add value and where high margins can be achieved through differentiation while continuing to drive savings through innovation and investment.

The PBS reforms continue to provide pharmacy with a window of opportunity to get their house in order.

<sup>14</sup> Medicines Australia media release, 6 September 2006.

### Impact on wholesalers

Wholesalers will be less affected by the reforms, except that any slowdown in PBS spending growth will flow through to distribution revenues.

The major players in this area are Australian Pharmaceuticals Industries, Symbion Health, Sigma Pharmaceuticals, and an emerging DHL. The Government did not announce any mandatory changes to wholesale margins, which were already cut from 10 per cent to 7 per cent from mid-2006.

If wholesalers can overcome the increasing challenge of manufacturers choosing to bypass them and consumers buying online, they should remain on track to grow at about 2 per cent a year to reach turnover of \$14 billion and gross product as a sector of \$1.75 billion by 2012, as forecast by IBISWorld.<sup>15</sup>

A new measure introduced with the Fourth Community Pharmacy Agreement is the Community Service Obligation (CSO). In a bid to ensure drugs remain available nationally, among other social benefits, the Government set aside \$150 million a year in CSO funding to give full-line (those that carry the full range of PBS drugs) wholesalers an incentive to guarantee to supply all PBS medicines to pharmacies across Australia within 24 hours. This has opened up the wholesale distribution market as new players, particularly DHL Pharmacy Supply, have now entered the market to take advantage of the new funding package.

<sup>15</sup> ‘Pharmaceuticals wholesaling in Australia F4797’, IBISWorld, 22 November 2006.

### Figure 3: Initiatives to protect retail pharmacies

The Government introduced the following measures to ensure pharmacists are not worse off as a result of the changes to the PBS. These changes will be made through an amendment to the 4th Community Pharmacy Agreement and include:

- Adjustments to pharmacy mark-ups from the 1 August 2008, including:
  - a 15% mark-up for medications dispensed up to and including \$30
  - \$4.50 for medications dispensed between \$30.01 and \$45.00
  - a 10% mark-up for medications dispensed from \$45.01 and \$180.00
  - a flat \$18.00 for medications dispensed at a price of \$180 to \$450
  - a flat 4% for medications dispensed between \$450.01 and \$1,750.00
  - a \$70 mark-up for medicines priced above \$1,750.
- An increased dispensing fee of 0.15c from the 1 August 2008 (indexed).
- A 40c payment for each prescription processed using PBS Online from 1 July 2007.
- A \$1.50 (indexed) incentive for dispensing substitutable, premium-free brands of PBS medicines from 1 August 2008.
- Additional funding of \$69m over three years from 1 August 2008 for the Community Service Obligation funding pool, which will continue to ensure that all Australians have access to PBS medicines in a timely manner no matter where they live in Australia.



**Tony Abbott**  
Federal Health Minister

In November 2006, the Commonwealth Government announced historic reforms to the Pharmaceutical Benefits Scheme (PBS) that should ensure its sustainability over the long term.

These changes seek to address two basic problems. The first is that historically we have been spending too much on the generic drugs on the PBS. To give one example, the common cholesterol-lowering drug simvastatin costs the PBS about \$300 million a year, because we here in Australia pay more than \$50 for this drug. In the UK, they pay less than \$10 for the same drug.

The difference in price under our system mostly goes to pharmacists by way of discounts, so what we are trying to do with these changes is to harvest most of those discounts for the benefit of taxpayers. Under the reforms, the real price to pharmacists will become the real price to government for these off-patent drugs.

The other issue, which has become apparent only recently, is the interaction of reference pricing with the now mandatory 12.5 per cent price cut for the first new generic drug on the system. The mandatory price cut has meant that some patients may pay premiums for the PBS drugs that they need. We have taken measures to ensure that patients aren't penalised but it's cumbersome and that kind of system was not going to be sustainable.

In brief, what that reform involved was the establishment of two formularies inside the PBS. We call them, for better or for worse, F1 and F2.

F1 essentially comprises patented drugs and some off-patent drugs. F2 comprises off-patent drugs for which there are identical competitors. The F1 group is essentially not exposed to reference-pricing arrangements. F2 drugs will be exposed to much stronger reference-pricing arrangements in the years ahead. In fact, drugs that are in the F2 formulary will be subject, starting from the middle of next year, to 25 per cent mandatory price cuts.

This is a good thing because we have been paying too much for generic drugs, and arguably we have not been sufficiently recognising the importance of innovative drugs. This fundamental reform is in accordance with best principles.

These changes should produce gross savings over the forward estimates period in the order of \$1.7 billion and net savings of about \$600 million. We think they will produce net savings over 10 years of \$3 billion. Savings to government become much more significant in five years' time and beyond because there are about 100 major drugs that are coming off patent in that time.

The reason for the difference between the gross and net savings is that there will be a significant adjustment to the funding the Government provides to pharmacists. There will be a modest increase in the dispensing fee; there will be a modest increase in the mark-up, particularly for very costly drugs; there will be a \$1.50 incentive payment per dispensed script that does not involve a patient premium; and there will be a 40 cent per script incentive to use PBS online.

All of these measures will cost \$1.1 billion over the forward estimates period. They will essentially ensure that over the life of the current Community Pharmacy Agreement the position of pharmacists remains as it would otherwise have been.

The savings that these changes will produce should give future governments the resources to put new and innovative drugs on the PBS. Since August 2006 alone, the Government has added drugs to the PBS costing more than \$1 billion to the forward estimates. These include Herceptin for early stage breast cancer and Lantus and Levemir for people with diabetes. We have also made statins (cholesterol-lowering drugs) more widely available.

Medicines ought to go onto the PBS if they are cost-effective. To keep the system sustainable, it is important to pay no more than is absolutely necessary for drugs which are off patent and that is what we are trying to do with these changes.

There is something in these reforms for everyone. There are substantial savings for taxpayers. There is some opportunity for lower-priced drugs for patients. Certainly there should be continued availability of a wide range of drugs to Australian patients. There is a recognition of the importance of innovative patented drugs for Medicines Australia. There is compensation for community pharmacy and there is a certain amount of systemic protection, I believe, provided to the domestic generic manufacturing sector.

## Conclusion

The Pharmaceutical Benefits Scheme is an effective system that has served Australians well for almost 60 years.

The aggressive but balanced PBS reforms announced in November 2006 should enable the Government to make substantial savings while avoiding potentially disastrous pitfalls. Chief among these concerns was causing the failure of community pharmacies and undermining local R&D.

Even so, like all cost-cutting measures, almost every major stakeholder must pay a price. It will take time for price reductions to flow through to consumers.

Pharmacies will need to radically transform their operations over the next four years to maintain margins. Drug companies must find efficiencies and revisit R&D operations. And the transition from patent protection of drugs to generic production will become an area of intense focus and potential dispute.

The next decade's industry leaders will be those organisations that manage these transitions and thrive in the new environment.

## Take action

- **Learn more.** The Government's reforms will redefine the health industry. Take time to understand the changes and how they will affect all stakeholders.
- **Seek efficiencies.** The reforms require most stakeholders to improve production or supply chain efficiencies.
- **Revisit your business model.** Pharmacists need to find new ways to make money if they are to continue to prosper – or simply survive.
- **Consider your options.** Few major changes are introduced without a degree of impact. Review the changes that will affect you and ask whether they are reasonable.

*The insight in this chapter has been provided by John Cannings, Partner, PwC Legal.*

*John specialises in corporate and commercial transactions and regulatory advice. He has extensive experience in the pharmaceuticals industry has advised clients in each stage of the supply chain, including government, local and overseas manufacturers, wholesale distributors and community pharmacy groups. He leads PwC's Australian Pharma sector.*

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# 09

## Smart tax strategies

Retailers and suppliers of consumer goods need to stay on top of tax to remain competitive with their industry peers. That means achieving high levels of tax efficiency both in terms of total tax paid and the effectiveness of the finance function.

At the same time, the Australian Taxation Office (ATO) is continuing its campaign to interest boards in the taxation issues facing their companies. Chief financial officers are being targeted by the ATO as key risk advisers who should seek to interest their directors in good governance of tax issues.<sup>1</sup>

Clearly it is part of every CFO's role to take final responsibility for ensuring their company meets its tax obligations, accurately and on time, to reduce the potential for penalties. What the ATO does not say is that it is also incumbent on boards and CFOs to ensure their companies do not pay more tax than is legally necessary. In this chapter, we list 11 areas where your company could reduce its tax imposts.

<sup>1</sup> 'Why we need to govern well', speech by Commissioner of Taxation Michael D'Ascenzo to the International CFO Forum, Sydney, 19 October 2006.

### The outlook

- Income tax savings through permanent differences are becoming increasingly rare, but timing differences can still be beneficial.
- Goods and Services Tax (GST) continues to be a hot topic, with arguable positions on grey areas still leading to savings.
- Employment taxes are increasingly complex however Fringe Benefit Tax (FBT) savings can still be identified or planned.
- The increasing number of Free-Trade Agreements (FTA's) provides useful opportunities to continually revisit the duty savings available on imports.

## Eleven top tax tips

The quest to legitimately reduce a company's total tax contribution to government coffers requires skill and time. Minimising the cost of complying with the law can be a competing objective with that of decreasing the tax burden. Finding the right balance is a challenge for every CFO.

Even so, quick wins – that is, tax savings for minimal effort – can still be achieved by ensuring that the finance department:

- has incentives to seek tax savings
- is close enough to the business to know what alternative proposals are being considered for a multitude of operational issues
- has a say in structuring business solutions to take advantage of tax-saving opportunities.

Savvy CFOs, empowered by their boards and chief executives, are ensuring that all tax-related deferral and saving opportunities are identified and are in turn adding value to their companies.

The article is a summary of 11 common ways for retailers and suppliers of consumer goods to save or defer tax. Commonwealth taxes are the focus, although opportunities for savings on state taxes

should not be forgotten. By obtaining appropriate advice on these opportunities and implementing savings strategies accordingly, companies can significantly reduce their cash outflows.

### 1. Inventories

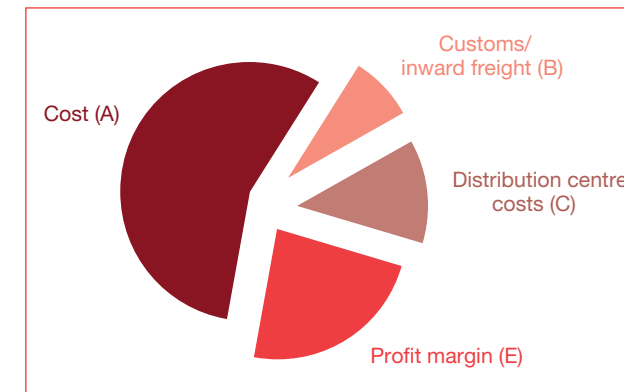
Inventories, known as 'trading stock' in tax speak, are increasingly a focus of the ATO. This trend is likely to continue, because many consumer goods companies are being forced to increase inventory buffer levels to meet the just-in-time distribution requirements of retailers.

The ATO has finalised and confirmed its controversial view on how the cost of inventories of retailers and wholesalers should be determined for income tax purposes.<sup>2</sup> At issue is the treatment of storage and distribution costs. Accountants generally interpret the Accounting Standard<sup>3</sup> as requiring the cost of inventories on hand to only include costs of bringing inventories to the place from which they are sold (A + B in Chart 1).

<sup>2</sup> Taxation Ruling TR 2006/8.

<sup>3</sup> Accounting Standard AASB 102: Inventories.

Chart 1: Components of inventory value



Storage costs and overheads relating to the company's warehouse and/or distribution centre (C) are usually excluded from the cost of inventories recognised in the balance sheet.

The ATO's view, however, is that all costs (A + B + C) should be included, up to arrival of the inventories at the final place of sale. Hence, an apportionment of warehouse and distribution centre costs is to be made to inventories that remain on hand at year end.

Retailers and wholesalers that use the cost method for tax purposes, but do not adopt the ATO's view, face a potentially significant compliance effort (or litigation) in the event of an ATO audit of their inventory valuations for income tax purposes. Such audits can cover periods of up to six years (or more, in the case of loss-making companies).

What options are available to retailers and wholesalers for the income tax treatment of their inventories? In Chart 2, we judge the alternative methods of valuing inventories on hand for income tax purposes. Of course, a company's particular circumstances need to be considered in forming a view as to which method is most appropriate.

Country Road Limited adopted the ATO's method in its accounts, thereby reducing the ongoing compliance effort of maintaining two sets of inventory costings (tax and accounting). The result was a net benefit to the company's profit for the year of adoption.<sup>4</sup> This approach might be acceptable to the auditor only if the impact of departing from the Accounting Standard is not material to the accounts.

<sup>4</sup> Country Road Limited Annual Report 2005.

### What is your total tax contribution?

PricewaterhouseCoopers believes every company should know the total amount of tax it pays, including not just income tax but taxes such as stamp duty, goods and services tax, excise etc.

A proper focus on total tax contribution shows a company's internal stakeholders the impact of all taxes on the business and enables management to make more informed investment decisions. It also facilitates better tax risk management and controls, and the efficient allocation of tax resources.

A Total Tax Contribution Framework provides a way for companies to communicate their tax contribution to external stakeholders. Total tax contribution is an economic measure of what companies pay into (and spend on paying into) the public finances, and reporting of this may meet the needs of some stakeholders better than the tax disclosures in their financial statements.

### The PwC Total Tax Contribution Framework

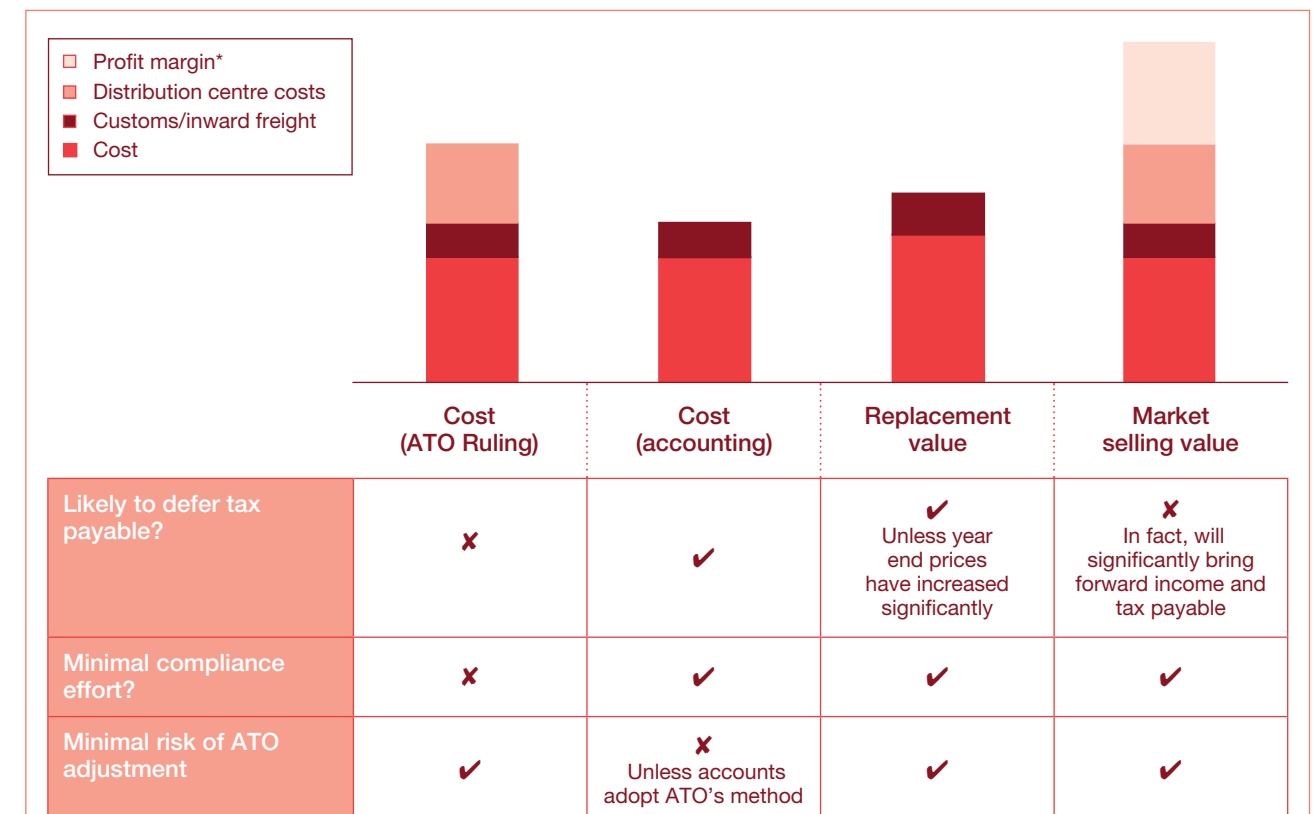
The framework defines the components of a company's overall economic contribution in taxes, examining three specific areas:

- **business taxes borne** by the business that affect the profit and loss account
- **business taxes collected** from customers and employees that are remitted to government
- **tax compliance costs** incurred in assessing and remitting taxes borne and collected.

The Total Tax Contribution Framework is designed to enable the tax contribution of companies to be measured on a consistent basis. This consistency allows companies to benchmark themselves against other businesses in their industry.

In 2006, PwC worked with the Business Council of Australia (BCA) and the Corporate Tax Association (CTA) using our framework to survey their membership (170 companies) to discover the total tax contribution of each company. The report is due for release in April 2007.

Chart 2: Comparison of inventory valuation methods



\*Assumes item sold at a profit. However, for items such as slow moving stock, market selling value may be lower than cost or replacement value, so could be a beneficial tax valuation choice.

To date, the ATO's interpretation of replacement value is untested. However, this method of valuing inventories on hand at year end for income tax purposes may be an ideal tax deferral opportunity (with minimal compliance cost) for many retailers and wholesalers. That is, it could be beneficial if a one off accounting profit increase is not achieved through adopting the ATO's view of costing.

## 2. Occasional financial supplies

Branded credit cards and store cards are becoming commonplace in retailing. The prevalence of these and other customer financing arrangements, such as lay-buys, extended payment terms and interest-free deals, means that claiming GST input tax credits on all acquisitions may no longer be appropriate.

Retailers should not ignore the financial acquisitions threshold (FAT). GST input tax credits on certain financial supplies are denied if the FAT is exceeded in a particular month. Generally speaking, the FAT is \$50,000 of input tax credits, and must be calculated monthly on a rolling 12-month basis. Just one GST-inclusive acquisition of \$550,011 (being \$500,010 plus GST of \$50,001) relating solely to a financial supply is enough to trigger the denial of credits for that month and the next 11 months.

The credits denied are those relating to direct and indirect costs of providing financial supplies. Hence, the costs relating to provision of customer finance need to be analysed and the FAT test applied.

Where are the savings? Two opportunities should be considered in order to minimise denied input tax credits:

- Ensure that only financial supplies as defined are captured in undertaking the FAT test. (For example, the costs of investigating the feasibility of alternative customer financing options are not costs relating to financial supplies; nor are costs associated with borrowing funds).
- Claim reduced input tax credits – broadly 75 per cent of GST paid on certain costs of providing financial supplies. (For example, the costs of maintaining a share registry, making dividend payments and issuing shares all potentially give rise to reduced input tax credits if the FAT is exceeded).

## 3. Gift vouchers

Gift vouchers play an important role in the operations of Australian retailers. Sales of gift vouchers represent \$1 billion of annual Australian retail sales,<sup>5</sup> however up to 15 per cent of gift vouchers are never redeemed.<sup>6</sup>

Although they come in a variety of forms, all gift vouchers have a common purpose: the customer purchases the voucher, the retailer receives the proceeds, and the recipient of the voucher exchanges it for goods or services. Depending on the form of voucher and the conditions to which it is subject, the sale of a voucher may be subject to income tax and/or GST up-front, or tax may be paid on redemption.

It is important to appreciate the sometimes subtle differences between voucher entitlements that can impact the tax treatment. Chart 3 shows some examples of the different conditions attaching to vouchers and the GST and income tax consequences that are likely to arise.

If a company's board is proposing a new voucher scheme, the CFO can suggest how to tweak the proposed features to take advantage of legitimate tax timing advantages or to save tax. Even if the voucher scheme is already in place, it might be possible to make some changes that result in a positive tax difference.

In addition, correct classification of the company's particular form of gift voucher insulates the company against potential future penalties by ensuring the GST and income tax treatment are appropriate.

The structure of a voucher system can provide a retailer with cash-flow advantages over its competitors. On a \$1 million year end balance of unredeemed gift vouchers, appropriate deferral of income tax alone could lead to interest savings of \$20,000 per annum.

<sup>5</sup> 'Blame your house, not your car for struggling Christmas sales', *IBISWorld media release*, 24 November 2005.

<sup>6</sup> 'Success not always on the cards', *The Australian Financial Review*, 13 January 2006.

Chart 3: GST and income tax treatment of gift vouchers

Voucher A	Voucher B	Voucher C
<p><b>This voucher entitles the holder to:</b></p> <ul style="list-style-type: none"> <li>• obtain any goods or services in any applicable store to \$50 value, or</li> <li>• redeem the voucher for the monetary equivalent.</li> </ul> <p><b>Conditions:</b></p> <ul style="list-style-type: none"> <li>• Only redeemable online.</li> </ul>	<p><b>This voucher entitles J. Bloggs to:</b></p> <ul style="list-style-type: none"> <li>• obtain one pair of denim jeans from B Company on Broadway.</li> </ul> <p><b>Conditions:</b></p> <ul style="list-style-type: none"> <li>• Not redeemable for cash.</li> </ul>	<p><b>This voucher entitles the holder to:</b></p> <ul style="list-style-type: none"> <li>• a discount of 5% off anything in store, or</li> <li>• \$20 off any purchases over \$200, or</li> <li>• buy one, get one free.</li> </ul> <p><b>Conditions:</b></p> <ul style="list-style-type: none"> <li>• Not redeemable for cash.</li> </ul>
<ul style="list-style-type: none"> <li>■ No GST payable when voucher issued (GST payable on face value of voucher when redeemed).</li> <li>■ If unredeemed, GST is payable on face value of unredeemed part at time it is written back to income.</li> <li>■ Proceeds assessable for income tax when voucher redeemed.</li> </ul>	<ul style="list-style-type: none"> <li>■ GST payable on selling price of voucher when it is issued (no GST payable when voucher is redeemed).</li> <li>■ Proceeds assessable for income tax up-front, in full (whether or not customer ever redeems voucher).</li> </ul>	<ul style="list-style-type: none"> <li>■ GST payable on selling price of voucher when it is issued (no GST payable when voucher is redeemed).</li> <li>■ Proceeds assessable for income tax up-front, in full (whether or not customer ever redeems voucher).</li> </ul>

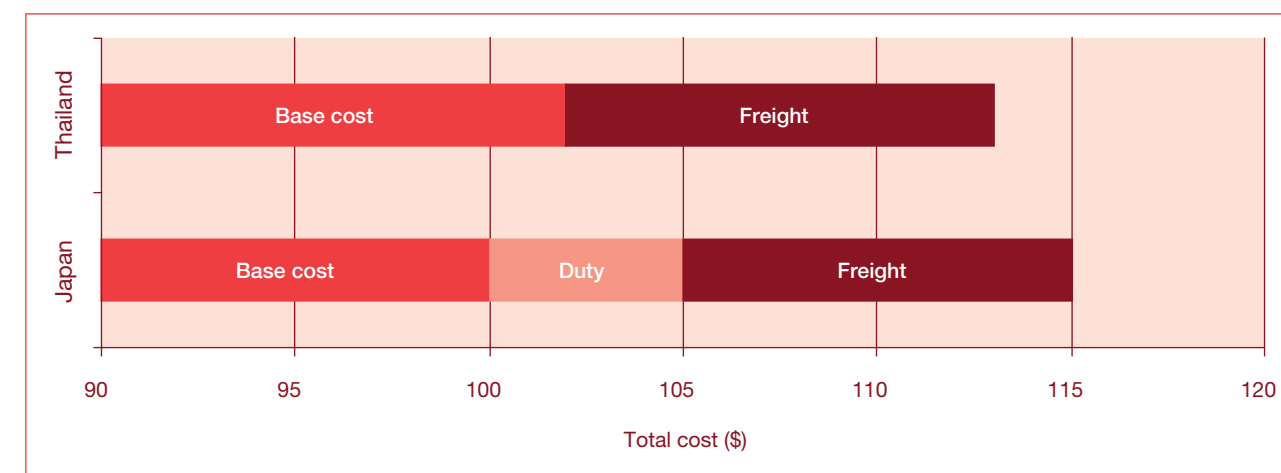
## 4. Importing goods

Customs duty is a hidden tax as it is imposed directly on the cost of goods rather than on profits. For companies that are more focused on earnings before interest and tax (EBIT) than profit after tax, duty savings can be an attractive option for above-the-line tax optimisation.

Customs duty savings might be uncovered by asking:

- How much duty do we pay on our imports? If significant, either in dollar terms or as a percentage of net profit, it is worthwhile asking further questions as every dollar of duty saved is an additional dollar of pre-tax profit.
- From what countries do we import our products? Many imports from Singapore and New Zealand are duty-free under FTAs with Australia. Thailand and the United States are phasing in FTAs with Australia, and duty-free status is obtainable on a broad range of goods. Switching to imports from a FTA country may lead to overall savings, even if the base cost is slightly higher than with the current source country, as illustrated in the example in Chart 4.
- Have we sought tariff concessions? Where there is no local manufacturer of equivalent (substitutable) products, companies can apply to the Australian Customs Service for a Tariff Concession Order to reduce duty payable.

Chart 4: Importing from Thailand (FTA) v Japan



- Have we checked the tariff classifications of our products? Incorrect tariff classification may result in a higher duty liability. For example, the duty rate could differ for appliances, depending on whether they are to be used domestically or industrially.
- Have we optimised our supply chain to minimise duty? For example, if goods are purchased from the factory gate in the foreign country rather than from the wholesaler or distributor, duty might be payable at the lower factory gate price, not on the marked-up price charged by the middleman.

Total reliance on the customs broker or freight forwarder to identify potential duty savings is inadvisable. The broker is paid to process transactions, and is unlikely to have an incentive to identify potential duty savings for its customers. Therefore, the CFO must ensure that the company identifies and obtains available savings.

From a compliance perspective, liability for any additional customs duty and penalties rests with the customer, not the broker. Hence, it is important that the CFO (or appropriate nominee) take responsibility for customs compliance.

### 5. Marketing costs

Consumer goods companies have in recent times trended towards increasing their promotional activities. The prevalence of private label brands and growing competition for limited shelf space has fuelled short-term solutions to the challenge of selling more product.

The emergence of innovative marketing delivery mechanisms has increased the challenge for the CFO seeking to stay on top of the tax and accounting issues associated with the spend of the marketing department. The basic premise from which to start is that all marketing costs of a retail or consumer goods

business are deductible for income tax purposes. Companies can cut their tax bills by identifying the nature of each expense and taking advantage of legitimate timing benefits, as indicated in Chart 5.

### 6. Terms of trade

Despite the trend towards increased promotional activity among many consumer goods companies, there is a continued drive to maximise customer loyalty. As both retailers and suppliers seek to generate more business from their existing customers, boards and their CFOs are becoming more creative in varying and expanding loyalty arrangements.

Favourable trade terms to encourage customer loyalty come in many different shapes and sizes. In Chart 6, we list some common rebate and reward arrangements and outline the income tax treatment of each.

Beneficial income tax timing differences can be obtained through:

- careful structuring of loyalty arrangements from the perspective of the company as either provider or recipient
- ensuring that an accurate analysis is undertaken at year end of the specific arrangements with each recipient or provider, as applicable.

Note that the impact of rebates and discounts on the determination of cost of inventories for income tax purposes is an unresolved area. The ATO agreed in mid 2006 to consider various issues relating to such arrangements. It is hoped that the ATO will issue guidance in the form of a ruling or practice statement sometime in 2007, after further consultation with industry and professional bodies.

Chart 5: Income tax deductibility of marketing costs

	Costs deductible when incurred	Costs deductible over period of service	Costs depreciable
<b>Form of marketing</b>			
Traditional media (eg TV, radio, newspapers)	Production cost of advertisement	Media placement cost (over the period for which the advertisement is run)	
Internet based media (eg online catalogues, online ordering)	Cost of creating simple website <sup>1</sup>	Ongoing website operation and maintenance costs	Hardware Software (eg cost of development of complex website)
Mobile phones (eg competitions entered via SMS)	SMS costs		
Sponsorships	Costs of one-off event	Costs of events to be run over a sponsorship period	
Premiums (giveaway items)	Purchase of giveaway items (not inventories)		
Coupons (discount or otherwise)	Cost of services for which coupon redeemed	Cost of goods for which coupon redeemed (goods treated as inventories until redemption)	
Cash register docket		Cost of placement (over the contract period)	
Product placement: a) pay for product to be shown in TV show or movie b) pay for the production of the TV show or movie	Running costs, if only relating to one off show Production costs	Running costs, if related to multiple showings	

<sup>1</sup> Taxation Ruling TR 2001/6.

Chart 6: Income tax treatment of rebates and rewards

	Income tax treatment for provider	Income tax treatment for recipient
<b>Type of rebate/reward</b>		
<i>Volume rebate (based on purchases or scan sales):</i>		
a) Before relevant threshold reached	✗ No deduction for rebate payable	✓ Only assessable once threshold reached and rebate legally due
b) Once threshold reached	✓ Deduction allowable for rebate legally due	
<i>Settlement discount:<sup>1</sup></i>		
a) If virtual certainty that discount will be taken	✓ Net invoice price taxable upon sale	✓ Full invoice price deductible up-front
b) If no certainty	✗ Full invoice price taxable upon sale ✓ Discount deductible when taken	✗ Discount assessable upon payment
<i>Rewards under points-based loyalty program:</i>		
a) Points credited	✗ No tax deduction <sup>2</sup>	✓ Not assessable as income
b) Reward provided for points redeemed	✓ The cost of providing the reward is deductible when incurred (if inventories, deductibility is deferred until the year in which the points are redeemed)	✗ May give rise to a taxable business benefit (at market value)

<sup>1</sup> Taxation Ruling TR 96/20.

<sup>2</sup> Taxation Determination TD 2003/20.

## 7. Opening new premises

The CFO must stay informed about proposals to enter into new property leases. Being on the front foot with such arrangements will enable him or her to have a say in structuring the lease and any associated incentive to ensure that valuable income tax savings are not missed and that any adverse tax impacts are minimised. The CFO, armed with the relevant information, can apprise the board of the tax consequences of lease proposals and any available options.

Lease incentives come in a wide variety of forms, and the income tax consequences can be significant, as summarised in Chart 7.

Store fit-outs generally involve a combination of tax-depreciable items (deductible over effective life), capital works (4 per cent or 2.5 per cent per annum write-off of construction costs), business-related capital expenditures (deductible over five years) and non-deductible costs.

The timing differences relating to these different categories of costs can lead to significant income tax deferral benefits for the owner, provided the details can be identified. Invoices from architects, interior designers and landscapers need to be itemised to facilitate the analysis. It is strongly advised that consultants are given early warning of the need for detailed invoices.

**Chart 7: Income tax consequences of lease incentives**

Income tax treatment <sup>1</sup>	
Type of incentive	
Cash incentive	✗ Assessable
Surrender costs of former lease paid by new landlord	✗ Assessable
Removal costs	✗ Assessable (except to extent related to inventories)
Fit-out or equipment:	
a) to be owned by landlord	✓ Tax-free
b) to be owned by tenant	✗ Assessable up-front (market value); tax depreciation may be allowable
Rent-free period	✓ Tax-free

<sup>1</sup> Taxation Ruling IT 2631.

## 8. Closing leasehold premises

To ensure valuable income tax savings are not lost, it is vital the CFO is involved up-front in structuring lease termination agreements.

To increase or bring forward tax deductions:

- **Prepay rent rather than make a surrender payment.** Lease surrender payments are now generally deductible to the exiting lessee over five years. If the remaining lease term is less than this, structuring the termination agreement to incorporate a prepayment of remaining obligations instead of a lease surrender payment should enable an income tax deduction to be taken in the year in which the lease is terminated.
- **Destroy leasehold improvements.** If structural improvements made by the lessee are of no value to the lessor, it is strongly advisable that the exiting lessee destroy those improvements to enable a tax deduction to be claimed for the undeducted

balance of the construction cost. No deduction is available if the improvements are left in situ for the lessor or new lessee to deal with, even if the lessor subsequently informs the former lessee that the improvements were demolished.

- **Destroy/scrap unwanted depreciable items.** Similarly, the undeducted cost for tax depreciable fittings and equipment can be written off for tax purposes if such items are destroyed or scrapped. If they are left behind, market value proceeds are deemed to be received, potentially leading to a taxable balancing charge.
- **Identify demolition costs as either:**
  - a) deductible outright, as an ordinary incident of business, or as a reduction of any proceeds on disposal (destruction) of the improvements or depreciable items
  - b) capital, which may be deductible over five years or not deductible at all.

- **Identify and claim the repairs component of make-good costs.** Leasehold make-good costs which are capital in nature are, at best, deductible over five years. Repairs should be deductible outright. To the extent that make-good costs can be categorised as repairs, deductions should be available. It is important to ensure that consultants engaged to undertake make good works provide itemised invoices to help identify deductible items.
- **Structure make-good payouts.** If the lessor agrees, describe the payment (or part thereof) as payment for failing to comply with a lease obligation to make repairs. The lessor is unlikely to have a problem with this, as either type of payment is probably taxable. To the lessee, however, the difference could be significant between make-good (capital, five-year deduction) and repairs obligation (deductible outright).
- **To the extent that a payout must be categorised as make-good, specify in the termination agreement the component which is for repairs (deductible) versus replacements/improvements/demolition (capital).**

## 9. Franchise fees

The franchising phenomenon continues apace, with the entry of 110 new franchise systems into Australia between 2004 and 2006.

The retail trade (food and non-food) currently accounts for 44 per cent of franchisors and 52 per cent of franchise units operating in Australia.<sup>7</sup>

It is possible to plan for the income tax consequences associated with the sometimes very large fees franchisees pay franchisors, and to avoid any surprises, through appropriate of structuring agreements up-front. In particular, separating regular payments for services provided from up-front payments for access to licences, business names or rights to distribute products can provide significant legitimate tax benefits to the franchisee.

Chart 8 summarises the income tax treatment of some common components of franchise fees.

It is important that the board, via the CFO, of a franchisor seeking new franchisees, understand candidates' questions about the tax consequences of franchise fees and is able to respond to them. Significant resources are invested in identifying potential franchisees, so it is important that tax issues do not become a deal breaker, culminating in the franchisee walking away.

It is important to note that if fees are flowing into or out of Australia, non resident withholding tax obligations may need to be complied with.

<sup>7</sup> *Franchising Australia Survey*, Griffith University, 2006.

**Chart 8: Components of franchise fees**

Component of franchise fees	Income tax treatment	
	for franchisee	for franchisor
	Deductible	Assessable
Initial franchise fee	✗	✓ May be capital gain
Purchase of equipment from franchisor	Tax depreciable over effective life	✓
Franchise service fee/royalty	✓	✓
Marketing/advertising levy	✓	✓
IT service fee	✓ But software licence tax depreciable over 2.5 years	✓
Training fee	✓	✓
Other fees (for administration, conferences, communications levies)	✓ Except conference fees may have a non-deductible entertainment element	✓
Interest on loan from franchisor	✓ Subject to thin capitalisation	✓

## 10. Salary packaging

With unemployment at record low levels, demand for quality staff will continue to exceed supply for almost all growing businesses. Every employer whose business would suffer from the loss of key staff should consider showing those staff how much they are valued by providing them with effective salary packaging options.

The CFO should discuss with the human resources department the personal tax saving options that can be achieved for employees at no additional outlay for the company. While each employer should undertake a cost-benefit analysis before adopting such

arrangements, tax-effective alternatives to cash salary that maximise take-home benefits to employees may not cost the employer other than to add some administrative effort.

It is true that the lowering of personal tax rates, particularly for employees on gross salaries of less than \$150,000, has reduced the marginal benefits of standard salary packaging options. However, there are still numerous types of non-cash benefits that can be provided to employees tax effectively, even if the FBT cost is passed on to the employee, as is commonly the case. Some examples are listed in Chart 9.

Chart 9: Non-cash benefits

	Type of non-cash benefit	Conditions for tax saving
✓✓✓ Entirely FBT free	<b>Products of employer</b> (up to \$1,000 a year per employee from 1 April 2007)	Employer must provide identical or similar products to outsiders as part of its business
	<b>Any products</b> consumed at the employer's premises, eg lunches, even if in the nature of entertainment	Must be on a working day; must not make 50/50 meal entertainment election
	<b>Minor benefits</b> (up to \$300 each from 1 April 2007)	Only if no related benefits; must be provided irregularly and infrequently
	<b>Laptop computer</b>	Only one allowed per employee each FBT year
	<b>Utes or vans</b> for work-related travel and/or travel from home to work	Only minor incidental private use allowed
✓✓ Partly FBT free	<b>Cars for private use</b>	
	<b>Car parking</b>	
	<b>Mobile and home phone calls</b>	Only to extent work related
	<b>Meal entertainment costs</b> for employee and/or family	If 50/50 split method adopted by employer
✓ Not reportable <sup>1</sup>	<b>Car parking</b>	
	<b>Meal entertainment, corporate box entertainment</b>	
	<b>Pooled or shared cars</b> for private use <sup>2</sup>	From 1 April 2007

<sup>1</sup> Reportable benefits are included in the same way as cash salary and wages in the determination of an employee's liability for various tax and non-tax obligations, such as HECS repayments and Medicare levy surcharge. If an employee's total annual benefits are up to \$2,000 (from 1 April 2007), these are not reportable.

<sup>2</sup> Government proposal outlined in Treasury discussion paper 'Fringe Benefits Tax Reporting Exclusion for Pooled or Shared Cars', released on 11 October 2006.



## 11. Transfer pricing

In the face of intense competition, multinational corporations are seeking to realise global efficiencies and create synergies by centralising duplicated functions. They are achieving such gains by transferring procurement and manufacturing activities to low-cost economies.

This form of value chain transformation has the potential to generate major cost savings for multinationals, particularly in industries where the labour costs are a significant proportion of the overall cost of business.

The decision of where to locate procurement or manufacturing activities should depend on a critical analysis of the potential cost savings. Low-cost procurement and manufacturing reorganisations typically involve a holistic review of all strategic functions performed across international borders along the value chain, including design, sourcing, manufacturing, marketing and distribution.

The reorganisation of functions, assets and risks can lead to a commensurate reallocation of income and ultimately profit in all affected locations. This will give rise to income tax issues, particularly transfer pricing considerations.

To comply with transfer pricing rules under tax law, related entities must trade across borders in accordance with arm's length principles. When entities are party to a cross-border transaction, it is expected that the largest portion of the transactional profit should flow to the entity that proportionately employs the greater share of functions and assets, and carries the higher commercial risk under the deal.

If the principal entity is located in a lower-tax jurisdiction, the reallocation of profits to that territory may provide an improved global effective tax rate for the corporation. While this may be the best tax result for the corporation globally, experience indicates that companies undertaking such transfers face greater scrutiny from tax authorities in the jurisdiction where taxable income declines.

To meet such scrutiny with confidence, ensure the company has clear evidence that substantial commercial reasons support any migration of valuable functions, assets and risks. This is especially important given the increasing complexity of transfer pricing principles globally and the increasing enforcement activity of tax authorities.



**Jonathan Peters**  
 Director of Finance  
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 Kellogg's Australia

At Kellogg's, we spend a lot of time ensuring that we are tax compliant. There are four areas that we pay close attention to: marketing, food classification, salary packaging, and inventories.

#### Marketing

We don't find it difficult to stay on top of the tax consequences of our marketing expenditure, other than the amount of time we spend with our marketing people. However, it is time well spent. Aligning our finance and marketing teams means we are at the front-end of the ideas generating process so we do not get surprised by any tax issues.

Take cereal, which is a GST-free product. When we do an on-pack promotion we have litmus tests to ensure the product does not become GST-rated just because we've put a 'premium' in the box, for example. The promotion sign-off process goes through our financial controller, who has the tax experience to identify any potential GST concerns. We try to cover things up front, rather than after people have committed to large expenditure that may need to be stopped or modified to avoid a tax issue.

We always use high perceived-value premiums in our packs, whether it is a game, a CD or movie tickets. The value of that item needs to be considered for tax purposes and if it is greater than a certain amount, it triggers GST implications for us. At 10 per cent, and in the volumes in which we deal, that can be a substantial amount of money.

#### Food classification

Identifying the tax implications of our food is always a major consideration for Kellogg's because of GST. For example, adding chocolate to the base of one of our cereal bars immediately attracts GST. If it was a plain cereal bar we wouldn't need to charge GST. This requires constant review of the legislation for us to be aware of the tax treatment of our snacks portfolio, as we need to be conscious of the precise ingredients to know whether we have a taxable or non-taxable product.

#### Salary packaging

Salary packaging is an area where we can deliver benefits to our employees without any cost to the business. This takes time, but at Kellogg's we have a compensation manager and financial controller who work together to develop ideas about what we can do for our employees and to identify the tax implications. Cost effective proposals are presented to me and the board for review and approval.

#### Inventories

Being a large manufacturer of a wide variety of packaged goods, our storage costs are high. So watching inventory levels is an important way to manage costs. With the tax treatment of inventories changing, this is an area we monitor daily. Unfortunately, there is an increased administrative cost associated with valuing inventories one way for accounts purposes and another way for tax purposes. We have accepted that this is just an extra cost that we have to bear to ensure Kellogg's is compliant with the rules.

Tax aside, we don't want to hold too much inventory because that's holding cash. However, we also need to maintain high service levels to retailers to ensure they don't need to hold inventory for any longer than necessary, which means having a very efficient supply chain.

## Conclusion

The CFO is the key provider of tax-related information to the board, and the linchpin in ensuring that the company maintains its competitiveness with its peers through management of its taxes obligations. But boards must also get on board with tax. It makes good business sense for directors to understand the tax implications of their company's transactions (as recommended by the ATO) and it is important that they are on top of its total tax contribution.

Supported by the board, the CFO can ensure that the finance function maximises its effectiveness by facilitating the company's compliance with legitimate imposts, and by positively contributing to the bottom line through identification and realisation of tax saving opportunities.

The competing objectives of minimising tax paid and minimising the cost of compliance can be balanced if the CFO and the finance team have appropriate incentives to seek legitimate savings. Companies should also ensure the CFO has sufficient access to the business to proactively manage tax issues.

The achievement of tax savings or deferrals requires a detailed understanding of the law. CFOs and boards alike should seek specialist advice on the tax treatment of specific transactions and arrangements, in light of the company's particular circumstances.

## Take action

- Use replacement value for inventories on hand at year end for income tax purposes to defer tax payable if storage and distribution costs are an issue.
- Maximise GST input tax credits by understanding the rules for claiming them, even where occasional financial supplies are involved.
- Change gift voucher conditions if this will make a positive tax difference.
- Seek customs duty savings opportunities to optimise above-the-line profits.
- Identify and understand marketing costs to take advantage of legitimate timing benefits for tax deductions.
- Structure trade terms and reward arrangements, and ensure accurate year-end analysis, to maximise tax timing benefits.
- Be involved early in the structuring of lease agreements and termination agreements to ensure that valuable tax savings are not missed.
- Prepare to respond to franchisees' questions about tax issues relating to fees to ensure they do not become a deal breaker.
- Offer tax-effective alternatives to cash salary, at minimal cost to the company, to retain employees.
- Plan, implement and document centralisation activities to maximise value through operational and cost efficiencies while optimising tax outcomes and minimising tax risk.

*The insight in this chapter has been provided by Steve Williams, Partner, Corporate Tax.*

*Steve leads a team of specialists in serving retail and consumer clients. He has considerable experience in advising Australian and multinational clients on the tax consequences of their transactions, particularly the planning and implementation of cross-border restructuring, financing options, acquisitions and divestments.*

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# 10

## A year on...

Australia's major grocery retailers began rolling out their private label strategies in earnest over the past year and the next wave of products are hitting the supermarket shelves. Coles and Woolworths have a long way to go to reach the level of private label sales they originally proposed in 2003, let alone the levels of their British counterparts.

Increases in private label sales are not yet showing up in the statistics. ACNielsen's *Market Information Digest* at December 2006 shows only limited and variable results, which PwC's own analysis confirms. However, we still expect the supermarkets will meet their objectives.

Private labels make good business sense in terms of profit (gross margins are generally 2 per cent higher than on leading national brands) market positioning, competitive differentiation and consumer loyalty. The major supermarkets will push hard to capitalise on these advantages with the result that private labels will make up a significantly greater share of the packaged grocery market over the next 18 months.

Private labels also present opportunities for consumer goods companies, which are starting to feel the shelf-space squeeze. Manufacturers are reliant on the supermarkets to reach an increasingly discerning consumer and must ensure the value proposition of every single product they make is spot on. Manufacturers will also need to invest in research and development of products for their target markets to stay ahead of private label brands.

### The outlook

- Coles has rolled out about one-third of planned private label products and Woolworths will continue its rollout until the market reaches a balance.
- Over the next 18 months, the sales and market share of private labels will progressively increase as the major grocery retailers extend their ranges.
- Research by the major retailers shows early indications of a positive consumer response to the new private label brands.
- Australian consumer goods manufacturers will continue to feel the impact of private label sales on their brands.
- Consumer goods manufacturers will need to continue to innovate through research and development to ensure their brands remain relevant to their customers, the major grocery retailers, and their target consumer markets.
- Manufacturers will also need to focus on driving down costs.

## How far have Coles and Woolies come?

Last year the combined sales of two of Coles' three new private label brands, Coles \$mart buy and You'll Love Coles, were more than \$2.2 billion.<sup>1</sup> Coles announced the release of over 300 private label products at its annual general meeting in November 2005, and at its November 2006 meeting reported having over 2,000 new private label products on the shelves. This figure is set to rise substantially: Coles plans that private labels will take up 30 per cent of shelf space by the end of 2007.

### Coles

**Coles \$mart buy** – superseding brands including Coles Savings, Reliance, Farmland and Persona brands, Coles \$mart buy generated \$209 million in sales last year.<sup>2</sup> With \$mart buy prices approximately 30 per cent below those of the leading brands, Coles claims it offers “quality at the lowest price” and at December 2006 had more than 200 products on shelves. Coles plans to expand the range, which is pitched to meet the “everyday needs of an Australian family”, to between 500–700 products and expects it to contribute 10 per cent of private label sales.<sup>3</sup>

**You'll Love Coles** – Coles launched its “Love the quality, love the price” national marketing campaign for this brand in October 2006, declaring it offered “quality at least equal to the market leader, at a lower price.”<sup>4</sup> You'll Love Coles is set to become Coles' signature brand, with expectations it will comprise 80 per cent of its private label sales. Priced about 10 per cent below the national brand, at November 2006 the range had more than 1,600 products on the shelves and Coles plans to expand it to up to 6,000 products. You'll Love Coles generated \$2 billion in sales last year.<sup>5</sup>

**Coles Finest** – appearing on shelves in November 2006 and comprising mainly luxury Christmas items, the top-tier brand in Coles' three-tier private label strategy replaces the formerly announced, but never launched, George J. Coles range. This range will eventually consist of about 200 premium products<sup>6</sup> likely to be modelled on Tesco's Finest in the UK and will be marketed as “premium and distinctive ... leading edge and best in class.”<sup>7</sup>

### Woolworths

Woolworths continues to offer its Home Brand label and has begun rolling out its new private label brand, Woolworths Select, maintaining that ultimate targets have not been set and private label “will settle where it settles.”<sup>8</sup> Woolworths' 2006 annual report states its product range “features the major industry brands and a strong private label business,” and that “Woolworths will continue to support, develop and grow national brands.”<sup>9</sup>

**Home Brand** – pitched as “everyday household products at great value for money”, Home Brand has been in stores for about 20 years and consists of close to 1,000 products<sup>10</sup> priced about 40 per cent below leading national brands.<sup>11</sup> Woolworths consistently claims Home Brand is Australia's highest-selling grocery brand.<sup>12</sup>

**Woolworths Select** – the top tier of Woolworths' two-tier private-label strategy “is a premium range of Woolworths branded product and will be at least equal to or better quality than the existing category leader but at a lower price.”<sup>13</sup> Promising “highest quality products that are second to none”<sup>14</sup> and positioned about 10 per cent cheaper than leading national brands, Select is now offering about 600 products, up from an estimated 400 in the first quarter. While some reports indicate plans to stop at 1,000 products, in February 2007, Chief Executive Michael Luscombe said new products will keep hitting shelves until customers signal the strategy has reached saturation point.

<sup>1, 2, 3</sup> Coles Myer shareholder presentation, September 2006.

<sup>4</sup> Coles Myer *Annual Report*, 2006.

<sup>5, 6</sup> Coles Myer shareholder presentation, September 2006.

<sup>7</sup> “Shelf life & death”, *The Courier Mail*, 9 December 2006.

<sup>8</sup> “Woolworths sees fresh merit in own products”, *The Australian Financial Review*, 16 October 2006.

<sup>9</sup> Woolworths *Annual Report*, 2006.

<sup>10</sup> “Coles, Woolies flogging flawed home-brand future: Aldi chief”, *The Australian*, 25 September 2006.

<sup>11</sup> “Shelf life and death”, *The Courier Mail*, 9 December 2006.

<sup>12, 13</sup> Woolworths *Annual Report*, 2006.

<sup>14</sup> Woolworths website, [www.woolworths.com.au](http://www.woolworths.com.au), February 2007.

## Positive consumer response

Early indications from the major grocery retailers are that consumers have a positive opinion of the new brands. According to Coles' research, 48 per cent of its customers have tried its You'll Love Coles brand and 76 per cent intend to repurchase.<sup>15</sup> The General Manager of Woolworths' private label division, Steve Greentree, says 75 per cent of shoppers who have tried Select have repurchased and the combination of Select and Home Brand ranks first or second in each category Select has entered.<sup>16</sup>

Strategies the majors use to entice consumers into buying the new brands include discounting the middle-tier private label products, even at the expense of their own entry-level private label brands, to get consumers to switch; product demonstrations and taste-testing; heavy advertising and product giveaways. Research in the UK shows that once a level of trust in a private label product's quality and taste is built, consumers start to buy the rest of the private label brand portfolio.<sup>17</sup> Major Australian grocery retailers are developing their promotional campaigns around building these themes of trust.

While Coles and Woolworths have different approaches in the number and the market positioning of their tiered ranges, they both follow strategies similar to those of successful private label retailers in the UK, for example Tesco, Sainsbury's and Asda. It is important to the major grocery retailers that consumers are positive about the new ranges and products. This is especially so for Coles as its name is at the forefront of its private label branding.

## Hitting suppliers hard

According to ACNielsen's *Retail Barometer* survey conducted in November 2006, private label growth was top of the list when it came to areas of concern among grocery suppliers. Such concern is well grounded since both the major retailers have warned they are not afraid to enter categories traditionally owned by national brands. Woolworths' Steve Greentree warned that suppliers and rivals should not assume Woolworths will not enter Select into categories dominated by national brands.<sup>18</sup>

An example is Woolworths' bold entry of its Select brand into the disposable nappies category dominated by Kimberley Clark. Greentree said: “We found an innovative product that gave us a point of difference. Select nappies are selling ahead of expectations.”<sup>19</sup>

Likewise, Coles' 2006 annual report stated its intentions for “more space devoted to growing

categories and less to commodity products.” Coles recognises that key to its private label strategy will be customer engagement with the new brands and that this will be dependent on both product and price. Coles said: “We must also lead with innovative differentiated product at competitive prices.”<sup>20</sup>

Woolworths has also said it is working to ensure its private label products have a point of difference and are of high quality.<sup>21</sup>

Most consumer goods companies now agree that if their brand isn't number one or two in its category then action is required to stay on the shelves. Unilever recognises this and has publicly stated its strategy is to be the first or second brand in each category and if it is third or worse, it will get out.<sup>22</sup>

Strategies being adopted by consumer goods companies to compete with the new private labels all tend to vary around the themes of increased marketing, new product development or finding alternative channels to market. While each of these has merit, we believe that in isolation they will not work and that a wider approach is needed.

New products have been vital to the success of major overseas consumer goods manufacturers such as Gillette, Procter & Gamble and Unilever. Examples of Australian consumer goods manufacturers that have been successful in developing innovative new products and capturing new markets over the past few years include Sanitarium with its Up & Go liquid breakfast, Patties with its Traveller Pie and Nudie with its fresh juices.

Consumer goods companies' ability to innovate in every aspect of their product development and go-to-market strategy will be critical to their success. This will encompass product research and development as well as the ability to manage product costs and achieve operational efficiencies to best serve the major grocery retailers and the consumer. Innovation is a whole-of-business issue, a theme discussed in Chapter 6.

<sup>15</sup> “Coles Myer 2007 first-quarter sales up 3.2 per cent”, Coles Myer news release, 15 November 2006.

<sup>16</sup> “Woolworths sees fresh merit in own products”, *The Australian Financial Review*, 16 October 2006.

<sup>17</sup> *Own-label Food and Drink*, *Market Intelligence*, Mintel, October 2006.

<sup>18, 19</sup> “Woolworths sees fresh merit in own products”, *The Australian Financial Review*, 16 October 2006.

<sup>20</sup> AGM address by John Fletcher, CEO of Coles Myer, 20 November 2006.

<sup>21</sup> “Woolworths sees fresh merit in own products”, *The Australian Financial Review*, 16 October 2006.

<sup>22</sup> “Off the shelf”, *BRW*, 5 October 2006.

## The statistics so far

Sales of private label packaged grocery goods grew by 7.1 per cent (to \$5.8 billion) over the year to December 2006, based on ACNielsen *Market Information Digest* data, while overall packaged grocery sales grew by 5.8 per cent (to \$41.2 billion). Despite growing at a faster rate than the market overall, the private label share of total grocery sales remained essentially unchanged.

At the end of 2006, according to the ACNielsen digest, private label sales (excluding tobacco) made up 15.7 per cent of total packaged grocery sales. Although penetration levels have hovered around this mark for the past four years,<sup>23</sup> the scene is now set for private label market share to increase as the new products introduced towards the end of 2006 start to take a greater proportion of sales.

As expected, some categories have shown significant increases 2005 to 2006 while others have decreased. Numerous reasons such as pricing, promotions and new product launches can account for variations in share category by category.

As Figure 1 shows, the private label share of dry packaged groceries increased by between 0.5 per cent and 2.9 per cent in 11 of the 23 categories observed. Minor share decreases occurred in 11 categories. Overall there was a 0.2 per cent gain in dry packaged private label market share.

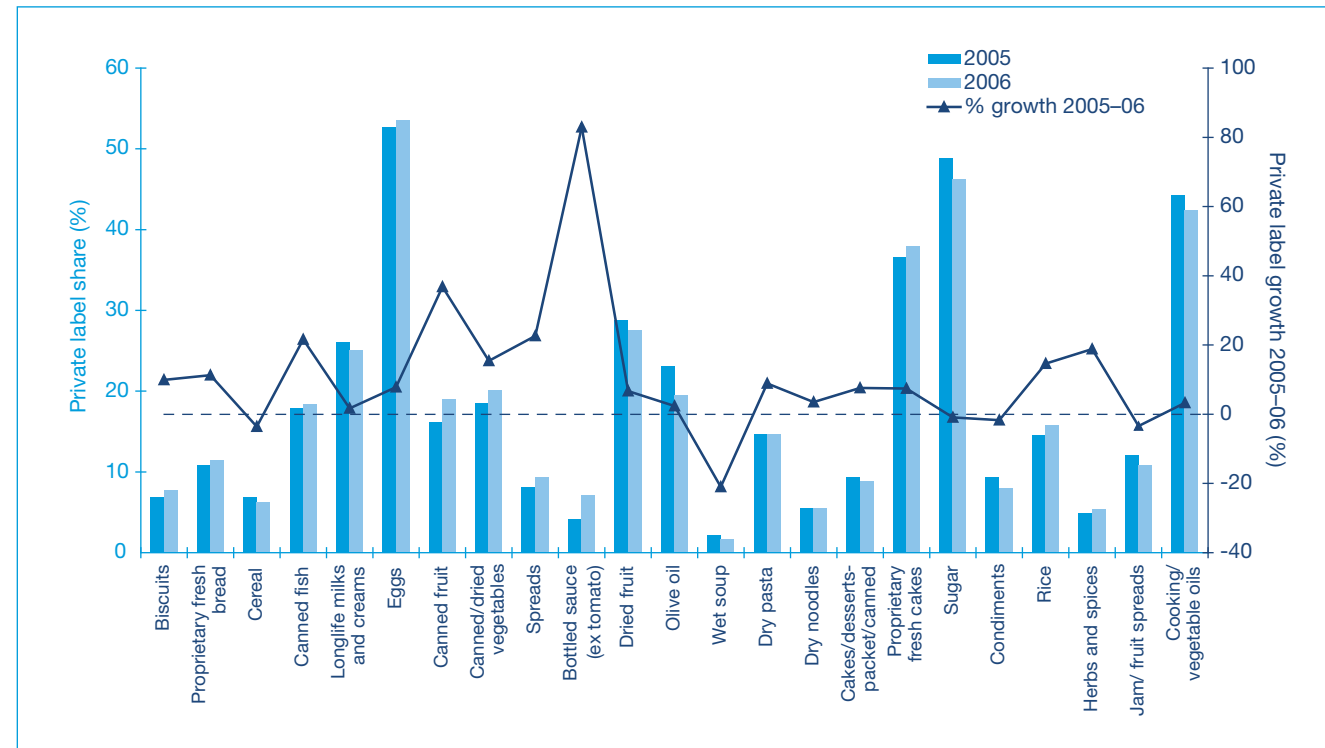
<sup>23</sup> "Aldi driving private label growth", ACNielsen news release, 10 April 2006.

Table 1: Dry packaged groceries

Overall	Private label
2006 value: \$12.4 billion	2006 value: \$2.4 billion
2005–06 sales growth: 6.5%	2005–06 sales growth: 8.4%
2006 share of packaged grocery market: 30.1%	2006 share of packaged grocery market: 5.8%
2005 share of packaged grocery market: 30.1%	2005 share of packaged grocery market: 5.6%

Source: *Market Information Digest*, ACNielsen, December 2006.

Figure 1: Dry Packaged Goods Private Label Sales



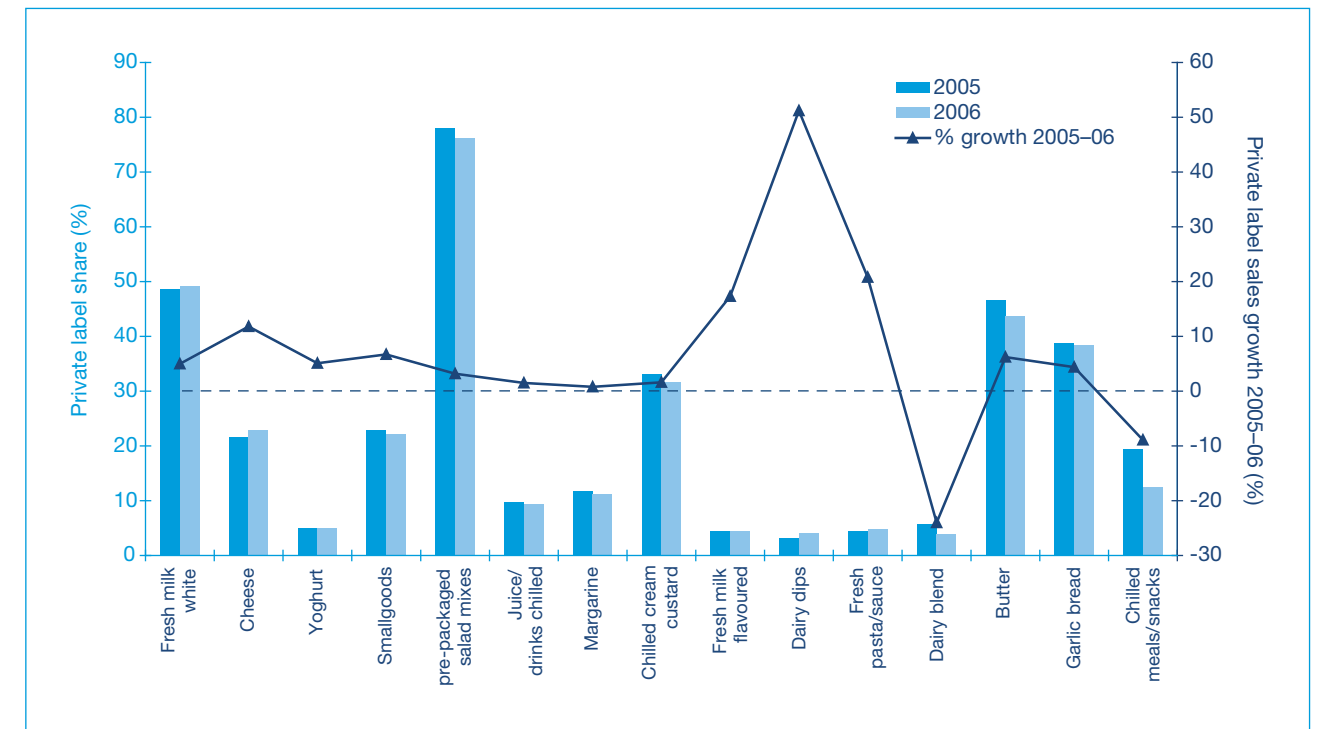
Source: *Market Information Digest*, ACNielsen, December 2006.

Table 2: Chilled foods

Overall	Private label
2006 value: \$6.5 billion	2006 value: \$1.9 billion
2005–06 sales growth: 6.5%	2005–06 sales growth: 5.5%
2006 share of packaged grocery market: 15.8%	2006 share of packaged grocery market: 4.6%
2005 share of packaged grocery market: 15.5%	2005 share of packaged grocery market: 4.6%

Source: *Market Information Digest*, ACNielsen, December 2006.

Figure 2: Chilled foods private label sales



Source: *Market Information Digest*, ACNielsen, December 2006.

Figure 2 shows private label sales increased in six of the 15 chilled foods categories analysed. In most cases the increase was less than 1 per cent.

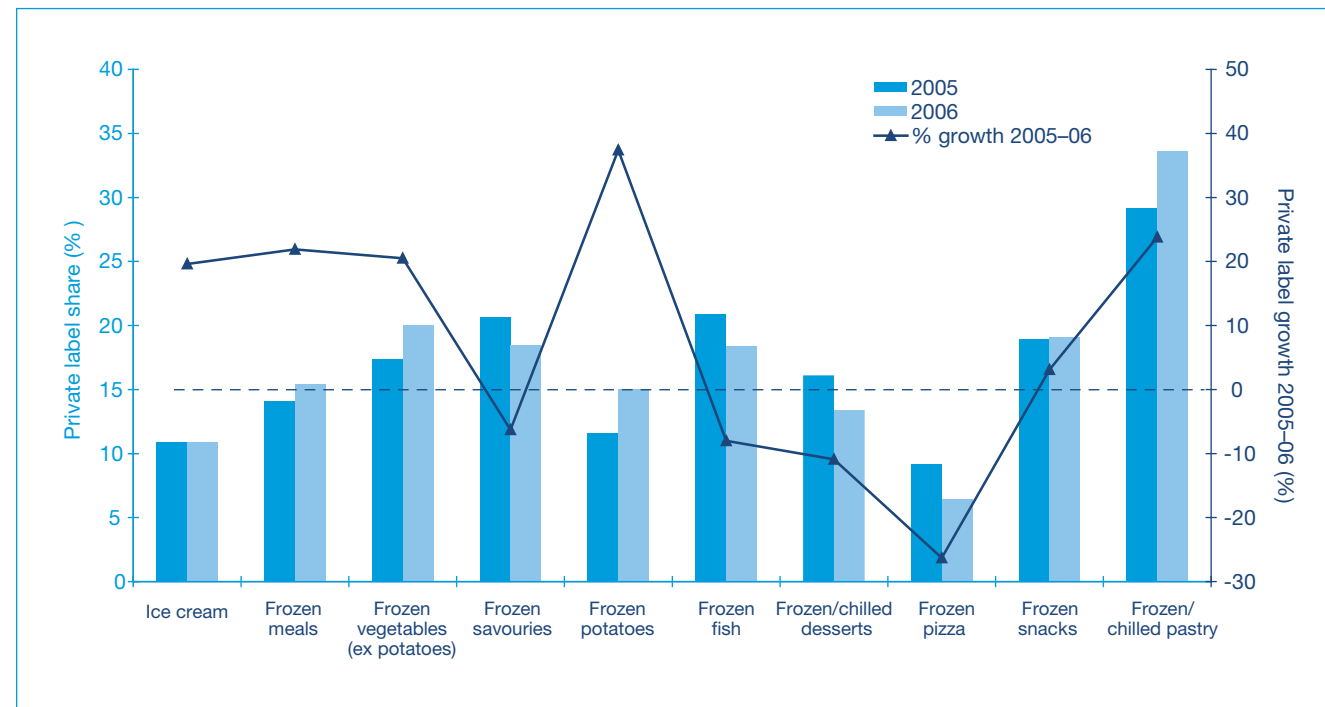
Market share for private label chilled foods remained static. This was more or less in line with growth in the chilled market as a whole, which gained 0.3 per cent over the period.

Table 3: Frozen foods

Overall	Private label
2006 value: \$2.5 billion	2006 value: \$0.4 billion
2005–06 sales growth: 8.5%	2005–06 sales growth: 10.1%
2006 share of packaged grocery market: 8.0%	2006 share of packaged grocery market: 1.0%
2005 share of packaged grocery market: 5.8%	2005 share of packaged grocery market: 0.8%

Source: Market Information Digest, ACNielsen, December 2006.

Figure 3: Frozen foods private label sales



Source: Market Information Digest, ACNielsen, December 2006.

Figure 3 shows private label sales increased in five of the 10 frozen foods categories analysed, with proportional increases of between 0.2 and 4.4 per cent.

Overall private label sales grew as a share of total frozen food sales by 0.2 per cent even though there was overall category growth of 2.2 per cent.

# Through the eyes of a consumer

In PwC's research at two supermarkets in suburban Melbourne (Coles and Safeway) we observed the following:

## Coles

In the tinned food section, there was a heavy presence of private label canned fish and canned vegetables, all at eye level. The pasta and pasta sauce aisle was arranged by brand, so You'll Love Coles and Coles \$mart buy were equally visible with the national brands. Coles \$mart buy was available in bulk vegetable oil and You'll Love Coles was available in Peanut Oil, but not vegetable oil.

In tinned fruit, Coles \$mart buy was on the bottom shelf, You'll Love Coles at eye level and national brands somewhere in-between. Sugar was dominated by the national brand and Coles Farmland, but Coles \$mart buy was beginning to creep up the shelves. You'll Love Coles was prominent in eggs, offering several different sizes, and Coles \$mart buy eggs had a heavy presence across the middle of the shelves.

In breakfast cereals, Coles \$mart buy was available in basic cereals whereas You'll Love Coles competed with national brands with varieties such as You'll Love Coles Cocoa Puffs, You'll Love Coles whole wheat biscuits and You'll Love Coles corn flakes.

In the soft drink and biscuit aisle, You'll Love Coles was available in five varieties of mineral water, plus regular and diet varieties for several soft drinks. Coke occupied three quarters of the shelf space allocated to cola, but You'll Love Coles cola had made its debut. You'll Love Coles digestives, Anzac biscuits, chocolate nobles and chocolate butternut snaps sat next to equivalent national brands. You'll Love Coles Water Crackers and five flavours of You'll Love Coles rice crackers were nestled between national branded dry biscuits.

In frozen foods, private label was widespread, with the new brands visible in fish, vegetables, chips and 2, 4 and 8-litre tubs of ice cream (in all the usual flavours).

In personal care, You'll Love Coles body wash was available in three varieties, as was You'll Love Coles hand wash. The new brands were also present in basic white bars of bath soap. Colourfully packaged bottles of You'll Love Coles shampoo and conditioners were present in three varieties and Coles \$mart buy 1-litre pump packs of everyday shampoo and conditioner were on the bottom shelf.

## Safeway

Woolworths Select was available in several varieties of tinned fruit, plastic tubs of fruit and snack-size jellied fruits, alongside national brands. In breakfast cereals, Home Brand wheat biscuits, cornflakes, rice pops and tropical muesli sat alongside similar products from national brands.

An array of tinned vegetables were arranged with Select at eye-level, national brands below and Home Brand on the bottom shelf. Select has made a big entrance into the tinned fish category, with tinned salmon and at least ten flavours of tuna.

About half the shelf space allocated to sugar and a quarter of the space for eggs was occupied by Home Brand products. Eggs were also available in Woolworths Fresh brand and Select brand in a number of different sizes and varieties.

In snack foods, Home Brand corn chips, cheese rings, cheese twists, potato chips and large Home Brand variety packs sat alongside national brands. There was a wide offering of Home Brand nuts and rice crackers and Select brand nuts, with new varieties such as Chilli Peanuts and Sea Salt Cashew taking up about two-thirds of the category shelf space.

In biscuits, Select luxury biscuits sat at eye level, packaged in premium-looking cartons and available in compelling flavours such as Rich Mocha Shots and Honey and Apple Squares. Additional Select biscuit varieties occupied an entire aisle end, with new flavours such as Select Orange Delights and Select Rocky Road mallows. Several varieties of Home Brand water crackers were available as well as Home Brand Chicken or Barbeque Snax.

In the dairy case, Woolworths brand milk occupied about a quarter of the space dedicated to fresh milk, and Select cheese slices and blocks sat among national brands. Also present were Woolworths Fresh cream and sour cream, bulk tubs of Home Brand margarine and packs of Home Brand garlic bread.

Select was absent in both the frozen and chilled ready meals departments. However, Home Brand had a strong presence in frozen snack foods, fish, vegetables and ice-cream.

In the detergent category, Select was present with liquid and powder washing detergents, several fabric softeners and stain removal products all at eye level and up against national brands. Select dishwasher tablets sat between national brands with Home Brand below.



## Conclusion

Whilst the full impact of the new round of private label introductions is yet to be seen, it is not far away. The major grocery retailers are gaining momentum and significant shifts in packaged grocery sales in favour of private label products are likely to occur over the next 18 months. This will result in increased private label market share.

The major supermarkets hold carefully planned private label strategies and are not afraid to take on even the most well-established national brands. As the major grocery retailers continue to roll out their extended private label ranges, their success

will depend on their ability to understand their target markets and ensure the value proposition for the consumer.

The private label market in the UK continues to expand and if Australian grocery retailers are to enjoy the same success there will be implications for consumer goods manufacturers and consumers. To survive in such an intensely competitive environment, consumer goods companies will need to take action. Critical to survival will be their ability to innovate and reduce costs.

## Take action

Our analysis of Private Label – ‘A year on’ – has highlighted significant expansion in the availability of products on the shelves but little movement in their share of the consumer wallet, in the packaged goods categories. It is clear that both the major grocery retailers and their suppliers are still coming to grips with the impact that private label is having on patterns of customer spending, product innovation and brand awareness. Our take action recommendations for consumer goods manufacturers, remain current.

### Spot the trends

- Monitor overseas private label trends and incorporate the learnings into your strategy.
- Know and love your customer. Identify market segments, assess what your products offer them and deliver what consumers want.

### Reassess your product and brand strategy

- Protect your brands through focusing on the development of ‘premium’ and innovative products to differentiate from the competition – current and future – and to engage retailers’ and consumers’ interest.
- Review your product portfolio to justify every product line in your range: do you believe they can all justify shelf space allocation and do the retailers agree?
- Strengthen brand positioning with retailers by increased customer demand pull.

### Rethink promotions

- Continue to build brand equity and drive baseline sales, rather than inducing promotion-only buying.
- Invest in brand positioning and promotion. Aim to position all brands at number one or two in the category and avoid the relegation zone.

### Become lean and mean

- Understand your own cost structure and aim to be the lowest cost producer you can be.
- Be ready to compete on price if it is the main point of differentiation against private label products. Know your limits.
- Build flexibility and agility into your whole business, from product development to manufacturing to marketing.

### Work with retailers to grow categories

- Strengthen relationships with supermarket retailers. Work with them to grow categories, understand their business drivers and adapt your dealings with them accordingly.
- Become integral to the retailers’ vertical supply chains by investing in innovation with the aim of longer term contracts and better deals.

*The insight in this chapter has been provided Mike James, Partner and leader of the National Retail & Consumer Products practice.*

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# 11

## The offshore option

Many retail and consumer companies face a challenging outlook as their markets mature and become increasingly competitive. The desire for growth has driven many to seek new customers or products, to create new businesses, to acquire other companies or expand offshore.

In today's global business environment, such opportunities are developing in emerging markets such as Brazil, Russia, India and China as well as more mature markets. The attractions of large populations and increasing wealth and the opportunity to help define the market are only growing stronger.

Many Australian companies in the retail and consumer sectors have attempted to enter offshore markets in pursuit of growth. All have discovered that the journey is difficult. Indeed, for every company that succeeds in an offshore market, about four fail.<sup>1</sup> In Asia and Latin America, the failure rate reaches 60 per cent.<sup>2</sup> While 49 Australian retailers have entered more than 90 markets since 2001, Australian retailers left 17 markets in 2005 and another 19 markets in 2006.<sup>3</sup>

<sup>1</sup> "Beating the odds in market entry: How to avoid the cognitive biases that undermine market entry decisions", J.T. Horn, D.P. Lovallo & S.P. Viguierie, *McKinsey Quarterly*, no. 4, 2005.

<sup>2</sup> "Retail growth principles for international development", L. Miller, Bain.com, 30 June 2006.

<sup>3</sup> Emerging Market Priorities for Global Retailers, *The 2006 Global Retail Development Index*, A.T. Kearney, 2006.

### The outlook

- Competitors may adjust prices, broaden product offerings, refine the customer value proposition or change strategy in response to an Australian company entering a market.
- Cultural and consumer preferences in overseas markets will continue to be pitfalls for companies that do not respect local needs and desires.
- Alternative distribution channels will become important to companies entering new markets, especially those where road and rail infrastructure is poor.
- Expatriating staff overseas will become more common as Australian companies look to expand offshore.
- Australian companies expanding overseas will realise that the best way to grow a local business is to hire and develop good local management.
- Support infrastructure including IT, supply chain and people, will be critical to success for companies that expand offshore.

## Where to start the journey

Offshore expansion is a popular growth strategy but Australian retail and consumer companies should not underestimate the challenges involved in making an overseas foray. We believe there are four main areas of focus for all retail and consumer goods companies as they contemplate expanding offshore:

- researching the market and its size
- localising products and services
- identifying infrastructure and supply chain constraints
- building scale, and people issues.

**Table 1: Common challenges and risks in offshore expansion<sup>4</sup>**

1. **Market research and sizing** – Failing to adequately confirm the size of the target market, the potential market share and competition issues before securing board approvals.
2. **Localisation** – Assuming that offshore customers have the same needs as Australian customers, can result in poor sales.
3. **Local operations, infrastructure and supply chain constraints** – Failing to identify unsophisticated IT and logistics systems and highly localised sales channels can cause significant delays and increase costs.
4. **Building scale and people issues** – Lack of staff, relevant business metrics, structural incentives, international business experience, language skills and passports.
5. **Developing a well-grounded business case** – Lack of detailed understanding of true costs and revenues due to optimistic planning and failure to adjust key assumptions.
6. **Government relationship management** – Underestimating the power of local governments to control local operations and source expatriation permits.
7. **Customer ownership** – Relying on local business partners to manage key business and customer relationships, resulting in a loss of control and ownership.
8. **Regulatory environments** – Failing to anticipate regulatory obstacles that may result in controlled product pricing and/or irrational competition.
9. **Partnering and local operations management** – Rushing to sign up local partners with the result that the wrong partner is chosen and/or contracts are poorly constructed or ambiguous, leading to disputes, poor performance or higher costs.
10. **Tax, customs and excise** – Failing to manage the variety of tariff and non tariff barriers faced when importing goods into another country, for example restrictions on quality and labelling and financial barriers (customs duty, border tax and excise duty).

<sup>4</sup> PwC client experience and research including “Born global”, *BRW*, December 2005; “Along the silk road”, *BRW*, September 2005; AXA Asia Pacific Growth Strategy, Asialink presentation, May 2006.

## How big is the pie?

Assumptions can be dangerous when trying to size a market accurately. The two most common pitfalls are optimism and the failure to adjust assumptions as new information becomes available. Many decision makers also fall into the confirmation trap – they seek information to confirm, rather than question, their hypotheses.

For example, estimating the potential size of the Malaysian market for New Zealand Natural’s ice-cream involved making key assumptions about the propensity of local customers to spend on ice-cream, market growth rates and potential market share. These assumptions underpinned

New Zealand Natural’s market-sizing analysis and were the foundation for many decisions, such as how much to spend on marketing and distribution channels and locations for stores.

It is critical to anticipate responses from potential competitors that may affect your market-sizing model. In the 1970s and 1980s, after establishing operations in the main urban zones of China, Coca-Cola wanted to expand into rural areas. However, local imitation brands had strong relationships with the local distributors in these areas. The local brands were able to maintain a monopoly on distribution, giving Coca-Cola little chance to compete.

Determining the life-cycle stage of the market is the first step to ensuring your company is chasing a growing market with the appropriate entry strategy. Markets generally progress through four stages as they evolve over five to 10 years, from emerging to mature. In 2007, Kazakhstan would be an example of a country entering the opening stage, while peaking markets would include India and Vietnam.

When determining how big the market for a product may be, it is vital to identify which variables are key to your estimation of size, particularly those where due diligence is limited due to lack of information. It is also important to develop reasonable ranges based on fact and run scenarios based on a combination of assumptions.

For example, when IKEA was looking to determine the potential size of the do-it-yourself home furnishing market in China, the company needed to incorporate into its market-sizing model forecast ranges of gross domestic product growth, industry growth rates, income elasticity, propensity to spend on DIY home furnishings and potential market share estimates.

Comparing markets forces companies to consider a greater range of possibilities. Examining both successful and failed market entries accelerates a company’s learning curve, providing a better basis for assumptions. It also puts in perspective analysis of just one or two cases whose selection is subject to bias. For example, New Zealand Natural assesses potential markets against its experiences in similar markets and the experiences of others in complementary industries and markets.

## Underestimating competitors

Misjudging the competition is a common mistake when estimating potential market share. Too often we see companies assuming exclusivity or that they will have a monopoly in emerging markets where a product is not offered. While this may appear reasonable, things can change rapidly. To assume competitors won’t adjust their prices, broaden their product offerings or otherwise change strategy in response to an entry is a foolish omission from any business case.

When brewer Anheuser-Busch attempted to diversify into the snack food business it underestimated the competitive response from Frito-Lay. Anheuser-Busch overestimated its potential market share and underestimated the pricing war its expansionist actions created. In another example, British Satellite Broadcasting (BSB) outbid Sky Television in 1988 for the rights to broadcast on a new British satellite. While it seemed BSB would have first-mover advantage, Sky Television obtained the rights to broadcast from a Spanish satellite that could reach Britain. The result? Sky beat BSB to the market by 13 months.

The impact of governments, local innovators, other foreign players and existing competitors on the business case should always be played out in competitive gaming scenarios. In this age of convergence, where companies find themselves in new or morphed industries with new competitors, brainstorming the realm of possibilities becomes an important strategic defence technique.



The advantages of gaming techniques were revealed by Softsoap, the world's first liquid soap manufacturer. Softsoap was not able to protect its revolutionary liquid soap with patents, so to stop its competition copying its innovation, Softsoap signed up the existing capacity of all the pump-pack manufacturers before releasing its new product. This created an 18-month time lag before copycat competitors could enter the market with their version of a liquid soap.

### Same model, but different place

A business model that proves successful in Australia will not necessarily succeed overseas. Major issues to consider include pricing and customisation to fit local tastes and preferences. Resisting the temptation to transplant the business model to a new country can be tough. However, a recent A.T. Kearney study shows that companies that cut a strategy from new cloth tend to be more successful.<sup>5</sup>

Companies must understand the expectations and price sensitivities of consumers in different geographic markets. Casella Wines, a successful Australian wine exporter to the US, put it succinctly: "We researched the market intensively to determine the right price points, the right packaging, the right wine style and we certainly had the right marketing approach to enter the lucrative US market."<sup>6</sup>

Similarly, recognising that 80 per cent of Indian demand for any product comes from the middle or lower socio-economic segments, LG Electronics re-engineered its televisions to offer three price points, including a no-frills model to expand the market, and a premium 21-inch flat screen for the middle market. By keeping the price of the latter to within 10 per cent of conventional televisions, LG convinced many consumers to purchase the premium model. This strategy drove LG to a top-three market position in India within three years.

In addition to price and innovation, successful entrants adjust their formats to local needs. For example, B&Q, a British do-it-yourself retailer, discovered that Chinese people prefer not to assemble themselves. So B&Q became a 'buy it yourself and get somebody else to do it for you' retailer. Similarly, Hyundai recognised the importance placed on lifetime ownership costs by Indian consumers, so it introduced the Santro vehicle, which was highly fuel-efficient, had reasonably priced spare parts and was tailored to local climate and infrastructure conditions.

<sup>5</sup> Emerging Market Priorities for Global Retailers, *The 2006 Global Retail Development Index*, A.T. Kearney, 2006.

<sup>6</sup> www.austrade.gov.au

### Supplying the market

In emerging markets, the absence of a sophisticated IT and logistics infrastructure and the dominance of highly localised sales channels can cause significant delays and increase costs for a market entrant. Superior IT infrastructure is critical to success in order to obtain information and make informed decisions. Supply chain logistics can be problematic for many reasons. Large geographic territories can mean high costs to move product from one site to another. Poor road or rail links can increase costs and affect the security of transportation.

Unreliable transport can in turn affect the quality and continuity of service, which is critical when trying to create positive perceptions of a new brand. In India, cumulative wastage across the supply chain in food varies from 24 per cent to 40 per cent, largely caused by multiple handling of produce, poor packaging, and lack of temperature-controlled storage facilities and transportation.<sup>7</sup> Similarly, although large-scale retail formats such as supermarkets are becoming increasingly important, 77 per cent of 2002 retail sales in India were through small local shops.

For example, in India, organised retail distribution systems reach less than 2 per cent of the market, so there is tremendous pressure to develop innovative ways of getting product to customers. About 45 per cent of the retail market is in urban areas. The top 62 cities cater to only 50 per cent of the urban market and logistics costs are high due to a lack of good roads.

It is important to develop a patchwork of partners with inbuilt flexibility and formalised service level agreements and ensure that supply chain economics balance cost, quality and reliability. Companies can consider a patchwork of the best available domestic partners in order to manage the supply chain challenges. At the same time, they need to be agile to respond to changing rules and improving infrastructure.

Successful multinationals such as LG Electronics and Unilever have built deep third-party distribution networks, whose objective is to serve second-tier cities. Early infrastructure development in China focused on the industrialised eastern seaboard. It will take decades to improve underdeveloped distribution and logistics outside the major cities.

Economic modelling must balance the cost, quality and reliability of local supply compared to the cost of an imported product, including tariffs and customs duty and total time to market.

It is also important to develop and utilise alternative distribution channels. Companies entering into a new marketplace have sought alternative distribution methods and in some instances established their own local distribution network.

For example, in China, Bayer MaterialScience chose to invest in its own distribution network to supply Chinese customers with products manufactured at the company's new production facilities. Proctor & Gamble intends to build more distribution facilities to keep up with rising demand. The company has also moved from trucks to rail and inter-coastal waterways as they are more developed than China's road and trucking network.

### Leveraging home talent offshore

The major appeal of offshore expansion is the opportunity to leverage existing company capabilities in a new geographic market; assets such as brands, industry and technical knowledge, and proprietary processes and systems. Vital to this exercise is the ability to relocate key staff members who possess such knowledge and experience. This is a simple concept, but the practical realities of relocating offshore can be overwhelming. Obstacles include requirements such as local language skills and cultural understanding, difficulty in obtaining expatriate working visas, and expatriation costs.

Expatriate salary packages tend to be expensive: on average 2.5 times as much as the pay packets of local nationals.<sup>8</sup> Current average international assignment costs are about US\$311,000 a year per expatriate, according to a recent PricewaterhouseCoopers study with Cranfield University.<sup>9</sup>

Another issue is that companies tend to lose 40 per cent of returned assignees within 12 months.<sup>10</sup> Sending talent offshore also requires a balance to ensure home operations are not compromised while key resources are overseas.

<sup>7</sup> "The rising elephant: Benefits of modern trade to Indian economy", PwC, 2005.

<sup>8</sup> www.filetax.com/expatnews

<sup>9, 10</sup> "Measuring the value of international assignments", PwC and Cranfield University School of Management, 2006.



David Read, the deputy chairman of leading UK supermarket retailer Tesco – which has successfully expanded into Eastern Europe and Asia in recent years – agrees that one of the main hurdles of Tesco’s offshore expansion has been human resources. “It’s been quite difficult orientating our people to work internationally; people didn’t join Tesco to get sent off to Thailand, say. We need our best people abroad, people who are good with people and who can translate into the local market. The trouble is, we need our best people in the UK too.”<sup>11</sup>

Based on the experience of PwC’s clients, successful expatriation of staff to new markets is defined by four characteristics:

- defining criteria to select employees for expatriate assignments
- maximising knowledge transfer between expatriates and local staff
- maintaining contact between expatriate staff and their home locations
- repatriating individuals at the conclusion of their offshore assignment.

For example, expatriate selection criteria should first and foremost be determined by the objective of the international assignment. Is the aim to leverage home capabilities in the form of general know-how, systems and processes? This would infer a need to send operational-level staff. Does this knowledge need to be transferred to local employees? If so, the expatriated staff members would need to have proven success in coaching and developing protégés. Are local market language and experience important? If so, the first criteria would be staff members who either originate from, or have had prior work experience in, that country. The individual’s performance should also be a consideration: 32 per cent of expatriates surveyed in a recent PwC study were identified as top performers in the company.<sup>12</sup>

The solution to these challenges, according to Tesco, is to balance offshore and home operations by building local companies that are operated by local people. David Read from Tesco again: “We rely on relatively few expatriate employees. What we try to do is have an operating platform that provides the systems and key processes to run the business... We then find local managers who can execute the customer side to win business. [Local retail managers in Asia] ... understand the local habits and customers much better than an expat who’s flown in from the UK. We don’t need armies of expatriates.”<sup>13</sup>

## Finding and keeping offshore talent

Choosing the right talent for offshore market entry is crucial, yet a general shortage of people of the required calibre with education, business experience and language skills in new markets often results in recruitment delays and inflated salary costs. A recent McKinsey report said surveys had shown that fewer than 10 per cent of Chinese graduates across a range of technical and professional disciplines would be suitable for employment in foreign companies.<sup>14</sup>

The implications for offshoring companies range from facing long delays in setting up their offshore operations as they wait to identify and recruit people with the required skills, through to paying a premium for these new recruits in a high-demand market and/or paying significant premiums to transfer expatriate staff from their home office.

Once the required local individuals are recruited, retention then becomes an immediate problem due to fierce competition from other employers in the market. According to recent research, one in 10 executives changed jobs in the southern city of Shenzhen in 2004 and one in 12 in Beijing.<sup>15</sup> Local employee retention, therefore, becomes a critical success factor in expansion into high-growth offshore markets such as China.

The ideal situation for any company seeking to expand offshore would be to send current employees who are nationals of the target country and who wish to return home. New Zealand Natural’s expansion into Indonesia, for example, was led by a franchisee who wanted to return home to Jakarta. This franchisee had knowledge of the business, including store operations and the company culture, and combined this with his local knowledge of the Indonesian market to fuel success. Today, Indonesia represents one of New Zealand Natural’s largest international markets, with 25 stores.

<sup>11</sup> “Taking Tesco global”, *McKinsey Quarterly*, David Reid, 2 September 2002.

<sup>12</sup> “Measuring the value of international assignments”, PwC and Cranfield University School of Management, 2006.

<sup>13</sup> “Taking Tesco global”, *McKinsey Quarterly*, David Reid, 2 September 2002.

<sup>14</sup> “China’s looming talent shortage”, *McKinsey Quarterly*, Diana Farrell and Andrew J. Grant. Number 4, 2005.

<sup>15</sup> “China’s impending talent shortage”, Swati Lodh Kundu, *Asia Times Online*, 6 July 2006.

However, the key to attracting and retaining talent in offshore markets lies in the brand exposure, professional development and international opportunities that a new retail market entrant can offer a local recruit.

The oil and gas industry is renowned as being one of the first sectors to globalise.<sup>16</sup> Consequently, companies such as BP are now known as best practice global employers. In major developing markets such as the Caribbean, BP’s key to attracting and retaining local staff in a competitive local market is to offer staff unparalleled development and international opportunities, including technical training programs in the US and UK and overseas assignment opportunities.

In addition, BP has established a mentoring and coaching program that includes key performance indicators for expatriate staff. It requires them to impart their knowledge and experience to local employees in an informal coaching setting.<sup>17</sup>

<sup>16</sup> “Outsourcing can make the laborious process of relocating executives easier”, David Kneeshaw, *Energy Markets*, July 2001.

<sup>17</sup> *Lost Knowledge*, David DeLong & Associates, Oxford University Press, 2004.



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Headquartered in Milan, Italy, Luxottica Group is the world's largest designer, manufacturer and distributor of prescription eyewear and sunglasses. In 2006 Luxottica generated sales of €4.68 billion from its global wholesale and retail distribution network, including 5,500 wholly owned sunglass and optical retail stores. The group's portfolio of premium fashion eyewear brands – proprietary and licensed – includes Chanel, Prada, Bvlgari, Dolce & Gabbana, Donna Karan, Versace and Ray-Ban.

Within the Asia-Pacific region, Luxottica operates 1,093 retail stores in Australia, New Zealand, Hong Kong and China. In 2003, Luxottica added to its Australian retail operations of Sunglass Hut by acquiring the listed Australian optical company OPSM Group, whose assets included the OPSM, Laubman & Pank and Budget Eyewear networks in Australia, as well as leading optical chains in Hong Kong. Hong Kong operations have since been the launch pad for Luxottica's expansion into mainland China, led by the Australia-based Luxottica Retail team.

For a premium retail business like Luxottica, China represents a unique and compelling market opportunity. Not only are China's consumers increasingly affluent and fashion-conscious, but there is also enormous and largely untapped demand for optical correction and prescription eyewear. Luxottica already had a strong presence in Hong Kong, so the only question was the timing of our entry into the mainland. Recent changes to the legal framework for foreign companies operating in China made the conditions ripe for us to invest in the market.

Specifically, new legislation made it easier for foreign companies to own retail operations outright rather than having to work through a local equity partner, which was important to us. Luxottica was one of the first retail companies to enter China under the new legislation as a wholly owned foreign entity.

Hong Kong was the ideal platform from which to plan our approach. Our Hong Kong stores

had been repositioned to appeal to the middle-to-upper demographic, and this gave us a template for the model we wanted to deploy on the mainland. Luxottica's intention has always been to focus on the brand-conscious, emerging consumer class in China's relatively affluent major cities.

Over the past two years Luxottica has acquired leading optical chains in Beijing, Shanghai and Guangzhou, which are being re-merchandised and repositioned with our desired market in mind. These acquisitions give us 280 stores in China and Hong Kong and a very solid footing for further expansion. Ultimately, we believe there is potential for Luxottica to own 1,000 stores in China.

Many outsiders complain that tax and regulatory processes in China are too complex and opaque, either too slow or shifting too rapidly. This is true, but it helps to understand China is going through a compliance revolution. China's leaders know that for the country to be competitive, and sustain its present growth, the regulatory regime must be modernised along the lines of those in developed nations – hence the pace of legal change.

This presents challenges for foreign entrants. Not least in our case was that the law was changing almost daily as we were making acquisitions, requiring our ongoing review of the legal and financial structures being put in place.

For us, the key has been to be patient, understand and respect the process, and work within it. We learned the art of being flexible and patient. It pays to keep in mind that in most cases the reason regulations are changing so rapidly is so China can accommodate expansion.

As a fashion brand retailer, intellectual property is a critical issue for Luxottica. In China's increasingly fashion-conscious retail environment, one of our competitive advantages is being able to stand behind the brands we sell, and guarantee their authenticity. Consequently, we have been diligent in taking steps to protect our intellectual property at every step of the way as we consolidate our presence.

Other considerations have also emerged. Access to good local skills with Western exposure is fundamental; foreign entrants need people with strong local knowledge, but who can move easily between local and international business styles. Such people exist, but they can be expensive. Luckily, mobility is very high in China so the search can go beyond any one city. Generally employees are keen to learn, excited to be working for Western companies and very willing to embrace change. Cross-cultural communications issues exist and it is important to invest in bridging these upfront; both groups need to understand each other.

## Conclusion

When contemplating entry into a new market it is wise to measure degrees of difference. As the degrees of difference increase, so do the layers of complexity and risk. Selling the same product through the same distribution channel to the same customer groups, but in a new geography, represents one degree of difference. Selling to different customers adds a second degree. Selling via a different distribution channel adds a third.

Successful companies research the local market, tailor their offerings, modify their business models, ensure they have adequate capital for expansion and select the right business partners.

PwC's *Business Insights Survey 2007* shows that 68 per cent of Australian companies are pursuing strategies to support growth and expansion during 2007. Of those, 63 per cent are looking for market share gain and 57 per cent are looking for new markets.

This means that companies and their competitors are chasing the same goals. What can be done differently to succeed in this environment? Offshore expansion is an option for companies that can handle the difficult and risky nature of the venture. For those that succeed it is a rewarding exercise.

## Take action

- Determine the life-cycle stage of the country in which you are considering an investment to ensure you are pursuing a growing market with the appropriate entry strategy.
- Identify which variables are important to your market size estimation, develop reasonable ranges based on facts and run scenarios based on various assumptions.
- Examine both successful and failed market entries of other companies to gain intelligence on how you might best approach an offshore investment.
- Use competitive gaming scenarios and brainstorming sessions to discover how governments, local innovators, other foreign players and your existing competitors might have an impact on your business case.
- Research your markets to determine the right price points, packaging and marketing for your products. Appreciate the expectations and sensitivities of local consumers and adjust your approach to suit their needs.
- Develop a network of partners with inbuilt flexibility and formalised service level agreements and ensure your supply chain economics balance cost, quality and reliability.
- Seek and utilise alternative distribution channels and investigate the feasibility of establishing your own local distribution network.
- Build local companies that are operated by local people rather than rely too heavily on expatriate employees. Local retail managers understand local habits and customers better than expatriates.
- Institute superior employee practices in areas such as professional development, training and international opportunities to attract and retain offshore talent.
- Assess whether your skills, infrastructure and capabilities are adequate to support an offshore program.

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# 12

## Culture of control

Fraud doesn't discriminate. Regardless of market share, size, industry and structure, all companies and industries can suffer fraud's devastating impacts. Further, each fraud that is exposed undermines trust and damages the integrity of the entire market. This places the internal control regimes of retail and consumer goods companies under increasing outside scrutiny.

So-called 'shrinkage', in the form of crime, waste and errors, costs the retail industry between \$2.5 billion and \$3 billion a year<sup>1</sup> and is on the rise. The consumer pays the price at the checkout for these losses, which are mainly attributed to shoplifters and staff pilfering. Retailers have systems to counter these losses but even as approaches to security become more sophisticated, they cannot afford to relax.

While the push to implement more controls, regulations and standards has had an impact, the key to combating fraud in coming years will be embedding these new processes in an internal culture that deters fraud at its roots. Since an area of great vulnerability lies in the intangible realm of each employee's intentions, values and state of mind, management must explore ways to fortify and monitor these aspects of the business.

PwC research and experience indicates that retail and consumer goods companies should take a more proactive approach and openly address the causes of fraud, striving to understand its complexity and establishing formal procedures for handling misconduct. While economic crime may never be completely eliminated, a culture that shapes employees' attitudes and gives them a sense of responsibility can be an effective deterrent.

<sup>1</sup> *Retail World*, 21 February 2005.

### The outlook

- Fewer frauds will be kept confidential as pressure mounts for increased disclosure and more independent involvement.
- Detected fraud rates will remain high, primarily due to improved mechanisms for fraud detection.
- Over the next five years, companies will increasingly link culture, performance and risk, whilst measuring risk with broad indicators such as employee engagement and absenteeism.
- Technology will continue to play a major role in helping retailers prevent fraud.

## Are lies on the rise?

Preventing, identifying and responding to fraud remains a daunting task for companies large and small. Whether it's as simple as a \$3 piece of fruit being shoplifted or as complex as millions of dollars disappearing through financial misrepresentation, fraud is on the increase worldwide.

Out of a global cross-section of 3,634 companies surveyed by PricewaterhouseCoopers in the Global Economic Crime Survey,<sup>2</sup> 45 per cent reported falling victim to economic crime between 2003 and 2005 – an 8 per cent increase on the previous survey. These businesses report significant collateral damage including loss of reputation, decreased staff motivation and declining business relations.

While statistics indicate fraud is growing, a significant factor in the recent increase is improved monitoring. In Australia alone, 65 per cent of large companies have spent more than \$1 million on internal controls in the past three years and 38 per cent have spent more than \$5 million.<sup>3</sup> There is also increased pressure, especially on boards of public companies, to implement controls such as whistleblower hotlines, electronic data security monitoring and awareness training for staff.

It is difficult to gauge the effect of these new controls on the figures, but incident rates are likely to remain close to current levels or to rise as both fraud and its discovery continue to increase.

Retail and consumer companies face a greater risk than most. With intricate supply chains that require large quantities of assets to be stockpiled, transported and displayed, there are simply more opportunities for economic crime.

Companies will continue to invest in electronic technology as a means of controlling fraud with systems such as radio frequency identification (RFID) tracking set to play a major role in limiting once rampant warehouse and distribution fraud. But in the same way that technology has helped reduce the potential for fraud, it can motivate and aid perpetrators. Money and goods can be shifted faster, automated systems are more vulnerable to major catastrophes and electronic infrastructure can lead employees to feel increasingly isolated and detached. The move towards more electronic communication and data management contributes to the impression that fraud is a faceless crime.

While technological advances can help and hinder fraud, the issue ultimately comes down to people. Investing in increasing employees' job satisfaction and giving them a sense of responsibility has the greatest impact on mitigating losses. Disenfranchised



employees often play a role in enabling or turning a blind eye to the internal and external infringements of others. These perpetrators, whether individuals or groups, tend to follow a pattern: they have an incentive to commit fraud, identify an opportunity to do it, and possess the ability to rationalise why their actions were not wrong.

Part of the challenge of economic crime is the diverse forms it can take. The potential for fraud schemes differs between companies and employees. Over the past year managements have demonstrated they are better at catching the most common types of fraud and closing down avenues of vulnerability. But there is still a long way to go. While lower-level fraud is often less creative and easier to predict, fraud in the upper tiers of a company poses a constant threat with more variables and often greater consequences. In 2005, a quarter of internal fraud cases reported across the globe were executed by senior management.<sup>4</sup>

<sup>2</sup> *Global Economic Crime Survey*, PwC, 2005.

<sup>3</sup> *Internal Controls in Australia*, Economist Intelligence Unit, 2006.

<sup>4</sup> *Global Economic Crime Survey*, PwC, 2005.

## Finding a solution

As a minimum, retail and consumer goods companies should:

- consider all those points within a supply chain that provide an opportunity for pilfering
- institute better record keeping to accurately account for any losses
- deploy technology that provides a tighter tracking system, such as RFID, new point-of-sale systems and digital cameras.

By analysing potential breach points and plotting their essential components, companies can isolate specific high-risk areas and concentrate what are often limited security resources. Companies reduce the potential for fraud by eliminating the incentives and pressures individuals might have to commit

such crimes. These motivational factors can be both business-related or personal, and qualitative versus quantitative. Therefore, an inclusive corporate culture of open communication, accountability and respect is critical in establishing a fraud-free environment.

Once you have selected employees based on adequate qualifications and ethical merit, the next step is to foster the right culture. Companies need to create a climate where the entire organisation feels involved in protecting the company's reputation, liability and profitability. A comprehensive and effective risk management plan will account for every stage of fraud – from controlling the factors that can breed discontent to outlining the final stages of effective remediation.



**Duncan Shaw**  
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Shrinkage, or the loss of inventory between manufacture and point of sale, continues to be an area of great concern for the retail industry, costing somewhere in the vicinity of \$2-3 billion each year on a national basis. Shrinkage can be broken down into four broad areas – shop stealing, employee theft, administrative errors and vendor fraud.

The prevalence of organised crime in Australia is ongoing, and manifests itself in this context through violence in the workplace (for example offenders threatening and endangering staff members) and the targeting of specific types of stores, for example liquor stores and petrol outlets. Thieves tend to be highly opportunistic – they specifically target retailers with less sophisticated surveillance and security systems or where there are fewer obstacles for them to confront.

Education and training is paramount – we want to educate retailers on the importance of security measures like staff training, customer acknowledgement and surveillance and the securing of high value goods. Also, areas like store layout and access to the register are highly pertinent. We aim to reduce the incidence of shop stealing in retail and ensure the safety of those who work in the industry.

Another area of shrinkage is employee theft, which represents about one-third of total shrinkage and takes various forms – goods purposely marked or damaged in the storeroom and thus kept or consumed by the employee, or the outright stealing of goods or cash. Retailers need to ensure that they have systems in place to counteract this type of theft, be it surveillance, increased supervision, regular stocktakes or strict policies and procedures for cash handling.

In addition to this, credit card fraud is also becoming a major issue for retailers. The Australian Payments Clearance Association released figures in 2006 showing that the

highest incidence of fraud involved credit cards – between July 2005 and June 2006 there were 236,271 incidents, totaling more than \$87 million. Credit card fraud can be internal (employees using cards to make purchases) or external (consumers paying with false or stolen cards), and these figures represent around three cents for every dollar spent in Australia, which is about one-third of what is occurring in the UK.

Administrative errors include the failure to receive stock properly across the dock – there are great amounts of merchandise coming through the back of the dock that cannot be accounted for. Some items are left in the delivery van, misplaced at a warehouse or simply lost ‘off the back of a truck’. Furthermore, there are errors in paperwork – inaccuracies recorded in quantities and incorrect pricing – that is not checked on the invoice or as the item goes onto the shop floor. If these mistakes are not picked up the loss is never revealed as the administrative error it is. Another common error is the accidental inputting of wrong figures into EFTPOS machines – these types of mistakes may go unnoticed as they are difficult to detect unless the accounts are gone through to check that all stock and payments match up.

Finally, vendor fraud is a common form of shrinkage; this is particularly alarming as it generally tends to rely on collusion between an operative at the vendor and a contact at the retailer. The potential for gain here is enormous and there are numerous cases where hundreds and thousands of dollars have been siphoned off by people manipulating the supply chain. This type of fraud is difficult to detect and sometimes only discovered by accident.

To combat shop stealing and reduce the amount of administrative errors inherent in the supply chain, RFID will become a significantly important tool. It is superior to barcodes in terms of detection when passing through a reader. Vendors are starting to insert RFID tags into products in the manufacturing phase to keep track of items and assist with the incidence of theft and shrinkage.

The use of sophisticated security and surveillance systems will continue to help retailers improve shrinkage in store – systems and processes like enhanced CCTV, better staff training and improved store layout will assist in deterring offenders. These systems, however, do come at a cost, whether it be the purchase, installation and maintenance of high-tech security equipment or the investment in training and staff development.

## Conclusion

The coming years will be challenging for retail and consumer goods companies. Fraud will continue to reduce profitability and an increasing amount of criminal activity will be uncovered. Companies will have to find ways to confront and report incidents in a manner that preserves integrity and accountability.

Organisational culture and the attitudes of employees will move to the forefront in preventing and monitoring economic crime. Though investment in control technology will remain strong, the focus will shift to making existing systems more effective as part of a comprehensive risk management strategy.

## Take action

### Identify your risk profile

- Conduct an assessment of each business unit to pinpoint potential fraud schemes and scenarios and identify their essential components and participants.
- Ensure fraud cannot be committed without the participation of at least two individuals in the company, preferably in different departments and of no relation.

### Negate the risk

- Enforce routine system, data and procedure checks by both management and auditors.
- Involve the board in overseeing whistleblower procedures and reviewing the effectiveness of internal controls.

### Formalise the approach

- Establish a formal process for approaching, investigating and prosecuting those suspected of fraudulent action.
- Designate someone professionally experienced in fraud to investigate all suspicions.

### Set the climate for change

- Treat even small incidences of fraud seriously to reinforce the company’s stance.
- Set the tone of accountability from the top and make codes of ethics, investigative diligence and incentive programs a day-to-day aspect of your culture.

*The insight in this chapter has been provided David Clements, Director, Forensic Services.*

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