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Impact of Food Retail Investments on the Food Chain

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CENTRAL AND EASTERN EUROPE

IMPACT OF FOOD RETAIL INVESTMENTS ON THE FOOD CHAIN

TABLE OF CONTENTS

ANNEX 1

TRANSFORMATION OF THE RETAIL SYSTEMS IN THE CZECH REPUBLIC AND THE RUSSIAN FEDERATION

TABLE OF CONTENTS

ANNEX 2

IMPACT OF RETAIL TRANSFORMATION AND PROCUREMENT SYSTEM CHANGE ON THE CZECH FFV SUPPLY CHAIN

TABLE OF CONTENTS

ANNEX 3

IMPACT OF RETAIL TRANSFORMATION AND PROCUREMENT SYSTEM CHANGE ON THE RUSSIAN DAIRY SUPPLY CHAIN

TABLE OF CONTENTS

Abbreviations

ACE	Ahold Central Europe
AFE	(Analytical Centre of) Agri-Food Economics (Moscow)
ANTAD	Asociación Nacional de Tiendas de Autoservicio y Departamentales
CEE	Central and Eastern Europe
COGS	Cost of Goods Sold
COMECON	Council for Mutual Economic Assistance
DC	Distribution Centre
EBRD	European Bank for Reconstruction and Development
EU	European Union
FDI	Foreign Direct Investment
FFV	Fresh Fruit and Vegetables
GDP	Gross Domestic Product
GfK	Gesellschaft für Konsumforschung
HACCP	Hazard Analysis and Critical Control Point
HRI	Hotel/Restaurant/Institution
IERIGZ	Instytut Ekonomiki Rolnictwa I Gospodarki Żywnościowej (Institute of Agricultural and Food Economics, Poland)
IFRS	International Financial Reporting Standards
INCOMA	Intelligence for your Competent Marketing (Czech Republic)
IT	Information Technology
MIS	Management Information System
NGO	Non-Governmental Organisation
PMO	Producers Marketing Organisation
SAGARPA	Secretaría de Agricultura, Ganadería, Desarrollo Rural, Pesca y Alimentacíon (Mexican Secretary of Agriculture, Animal Husbandry, Urban Development, Fisheries and Food)
SISPO	Svaz pro Integrované Systémy Pěstování Ovoce (Integrated Systems for Fruit Growing Union, Czech Republic)
SKU	Shop Keeping Unit
SO	International Organisation for Standardisation
UHT	Ultra High Temperature
UK	United Kingdom
US	United States
USAID	United States Agency for International Development
USDA	United States Department of Agriculture
VUZE	Výzkumný ústav zemědělské ekonomiky (Research Institute of Agricultural Economics, Czech Republic)
WBD	Wimm Bill Dann

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CENTRAL AND EASTERN EUROPE

IMPACT OF FOOD RETAIL INVESTMENTS ON THE FOOD CHAIN

THE ECONOMIC AND TRANSITIONAL IMPACT OF FOOD RETAIL INVESTMENTS

1. INTRODUCTION

1.1 Recent studies have shown a dramatic rise of supermarkets in several developing regions around the world in only the past decade (Reardon and Berdegué, 2002; Reardon et al., 2003). The studies show that the rise of supermarkets have had a profound effect on agrifood systems via several important changes in the organisation and institutions of the food system, including centralisation of procurement from farmers, decline of traditional wholesale systems, and the rise of demanding private standards for product quality and safety. The supply-side implications of these changes are emerging: the changes have taken a great toll on smaller and under-capitalised producers unable to meet the new requirements, with a resulting exclusion of many small producers, in addition to the creation of new local dynamic markets for local farmers (Reardon and Berdegué, 2002).

1.2 There is growing evidence that a similar supermarket revolution has recently been occurring in Central and Eastern Europe, having started in countries such as Poland, Hungary, and the Czech Republic and spread rapidly East and South[1]. This report analyses the "transition impact" on food systems in CEE countries by starting with the effect of the transition on the retail sector, which then created a cascade of effects up the agrifood system, on processors, wholesalers, and farmers.

We begin by describing the retail transformation in CEE countries caused by transition (liberalisation and privatisation of food retail) and developed during the post-transition phase (Annex 1). The retail transformation mainly concerns the rise of "supermarkets" (our shorthand for large-format retail such as hypermarkets, supermarkets, discount stores). The report then analyses the evolution of supermarket chain procurement systems for food products during the above transformation. Changes in retail procurement systems in turn impact the "upstream actors" in the food system - processors (who are also undertaking some independent changes in their practices), wholesalers, and farmers. The above transition impacts downstream on retail and thence upstream on the other actors in the food system, presenting opportunities – and challenges – for the upstream actors. Our discussion of implications for policy and programmes focuses on how to help upstream actors avail themselves of these opportunities as well as address the challenges. We draw on general evidence for the CEE region, and specific evidence for the Czech Republic and the Russia Federation. The first case-study (Annex 2) focuses on the supply chain for fresh fruit and vegetables (FFV) in the Czech Republic. This sector was chosen for the following reason: supermarkets tend to penetrate FFV retail markets and make changes in their FFV procurement systems more slowly than other products such as processed/packaged products

[1] For more detailed information on the rapid transformation of the food retail sector in Central and Eastern Europe, including the Czech Republic and the Russian Federation, we would like to refer to Dries et al. (2004).

that lend themselves more easily to these kinds of changes. As a result, what we find for the FFV sector has been observed also for the procurement systems of other products, but at an earlier stage. Note further that the Czech Republic is one of the frontrunners in Central and Eastern Europe in terms of the transformation of the retail sector. Hence, we can expect to see similar changes in retail procurement in countries that are lagging behind the frontrunners, as the retail transformation occurs.

1.3 The second case-study (Annex 3) looks at the impact of the retail sector transformation on the supply chain for dairy products in the Russian Federation. The Russian Federation is a so-called third-wave country (using Dries et al. (2004) terminology), meaning that the retail sector transformation is significantly lagging in time compared to the frontrunner countries like the Czech Republic. Therefore, we focus on dairy products because, as noted above, changes in the procurement system for processed food products are more likely to occur sooner than those for FFV. Furthermore, the dairy sector is much more important than the FFV sector in the Russian Federation, both in terms of output and in terms of employment. As a result, procurement system changes in the dairy sector have a potentially more important impact on the rural population than changes in the FFV sector.

2. TRANSITION IMPACTS " DOWNSTREAM" IN THE FOOD SYSTEM: THE RETAIL TRANSFORMATION

2.1 The Rapid Rise of Supermarkets

2.1 Over the past 10 years, the supermarket sector has developed very quickly in the CEE, taking the form of an exponential curve – starting slowly after liberalisation/privatisation of the former state-controlled retail sector, and then accelerating, with the main growth taking place in the past 5-7 years. This recent growth has been spurred by Foreign Direct Investment (FDI) which has created investment competition with domestic chains (in most places). There have, in general, been three waves of development determined by socio-economic factors (income, urbanisation, infrastructure) and degree of advancement in policy reforms: (a) the first-wave countries are in the northern half of Central Europe, including our case study country the Czech Republic, with the supermarket share in food retail going from 10% in the early 1990s to 40-50% at present; (b) the second wave countries include most of southern Central Europe, with supermarket growth starting in the mid/late 1990s and reaching on average 30% today; (c) the third wave includes some of southern Central Europe and all of Eastern Europe, including the Russian Federation, our other case study example. In this third-wave area, supermarket growth started in the late 1990s and early 2000s, and has reached only about 5-10% of food retail, but is growing rapidly (Dries et al., 2004).

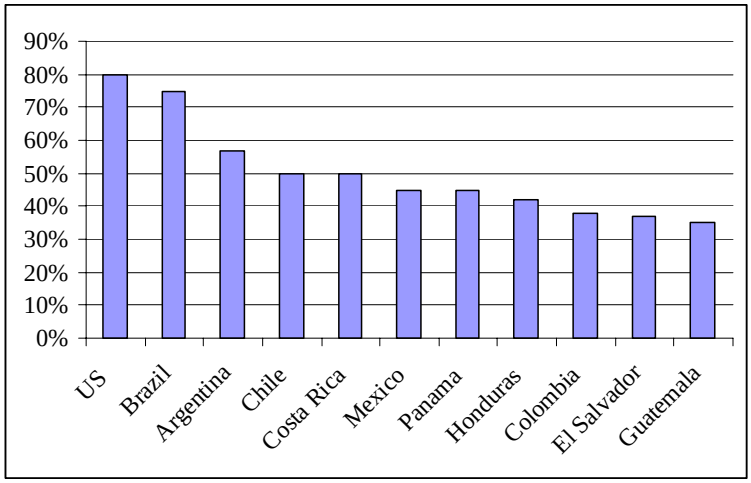
2.2 To put the above in international perspective, supermarket growth started in the US in the 1920s and in Western Europe in the mid-1900s, and has generally reached 70-80% of food retail today. The larger countries of South America underwent the retail transformation described in the first wave above, in the 1990s, and now stand at 50-60%. The first wave countries of CEE are closest now to the retail situations of, for example, Mexico, Thailand, and South Africa; the second wave to Ecuador, Guatemala, and Indonesia, and the third wave to India, Kenya, and Peru (the latter perhaps most like Russia or Romania in the sense that policy factors held back retail transformation, the potential demand for which was strong due to socio-economic factors). Keep in mind that all of these countries, including the US and Western European countries, started from the same base in the sense that the traditional retail system in all of them was made of small shops and open-air or central markets. Figures 1 and 2 below illustrate the comparative level of retail transformation in selected countries of Asia, Latin America and the CEE region.

2.3 The spread of supermarkets (again, a term used for simplicity to mean all large modern retail formats, unless otherwise specified) occurs fastest in processed foods (catching up more slowly in perishables such as fresh fruits and vegetables). Thus, their takeover of dairy product markets is usually much faster than fresh fruit markets.

2.4 Supermarket growth starts in large cities among the upper and middle income groups, and then the typical pattern we observe in CEE as well as other regions, is that supermarkets spread into lower-middle and lower income groups as they spread into medium cities and then small cities and even rural towns. There is a correlation between this diffusion and the stage or wave: in first-wave countries supermarkets have been pushing into small towns for several years,

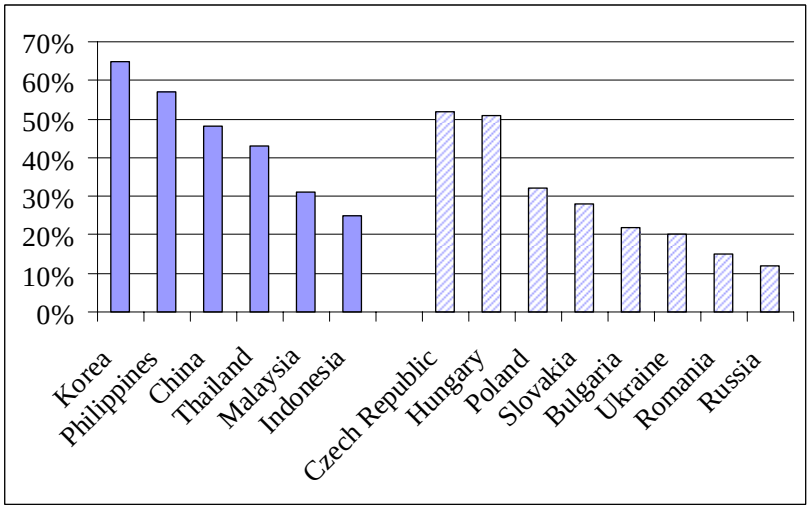
while in third-wave countries they are only just now pushing into smaller cities. In general, supermarkets tend to spread well beyond the middle class as they make the kinds of procurement system changes we note below, thus reducing costs and prices. And intense competition and relative saturation in the big cities and certain countries drives the spread of supermarkets into the successive concentric circles of expansion in space and over consumer segments in the CEE. This is accompanied by format diversification – from small supermarkets into hypermarkets and other formats. We refer to Annex 1 for a more detailed description of the spread of supermarkets to secondary cities in the Czech Republic and the Russian Federation.

Figure 1: Supermarket Share in Total Food Retail – Comparison between the US and Selected Latin American Countries (2002)



Source: Reardon, T. and J.A. Berdegué. 2002.

Figure 2: Supermarket Share in Processed Food Retail – Comparison between Selected Asian countries and Eastern and Central European Countries (2003)



Sources: Thomas Reardon, C. Peter Timmer and Julio A. Berdegué, 2003

(Asia) and Euromonitor (Eastern and Central Europe).

2.5 The rate of supermarket growth (often around 10-30% a year depending on the country) well exceeds GDP/capita growth, and so, while the size of the pie is increasing, supermarkets are quickly taking market share away from small shops, green markets, and vestiges of state stores. For example, our studies found that small dairy shops and dairy stalls in open markets in Russia are disappearing quickly (Annex 3). We cite data on the massive disappearance of small shops in the Czech Republic (Annex 1). While we do not have hard numbers on this, studies elsewhere (such as in Argentina) show that supermarkets tend to have a lower labour/sales ratio (and higher capital/sales ratio) than small shops, so this points to a probable decline in retail sector employment.

2.6 A key point is that the "traditional retail sector" that continues to survive is increasingly under pressure to imitate the supermarket chains in merchandising and procurement practices in order to increase quality and consistency and lower costs. That means that there is generalised change, even if it is led by a portion of the retail sector that creates a general change in the conditions facing the upstream segments of the agrifood system – processors, logistics firms, wholesalers, and farmers.

2.7 There are several key features of the supermarket sector in the CEE countries that are crucial in shaping the "transition impacts of retail change on the upstream segments of the food system". These include: (a) the multi-nationalisation of the sector, through rapid ingress of FDI in retail; while there are important domestic chains in various countries (domestic chains are leaders in Croatia, Slovenia, Russia, and others), foreign chains are crucial (mainly from Germany, France, the Netherlands, and the UK, but also from Turkey and the Baltics, and soon from the US with Wal-Mart's imminent entry into Russia); (b) the consolidation of the sector, with rapid mergers and acquisitions by larger domestic and foreign chains, helping them also to spread into new consumer segments such as small towns; and (c) the deep and rapid transformation of the product procurement system of food retailers, discussed further below, as it is a central factor in affecting conditions "upstream". (see Annex 1 and section 2 in Annex 3 for further elaboration on the process of multi-nationalisation and consolidation in the Czech and Russian food retail sectors).

2.2 The Post-Transition Evolution of Supermarkets' Procurement Systems[1]

2.8 The heart of the impact of the transition's effect on retail – on the upstream segments of the agrifood system – arises from the evolution of the supermarket sector's procurement system, in particular of the past 3-5 years. Since around 1990 and through most of the 1990s, the emerging supermarket chains tended to source in these ways:

(a) local and fragmented product sourcing – store-by-store, thus having wholesalers and producers deliver to the stores in their area;

[1] Section 2 in Annex 2 and section 3 in Annex 3 respectively provide more detailed information on the change in procurement systems for FFV in the Czech Republic and dairy products in the Russian Federation.

(b) heavy reliance on the traditional wholesale markets;

(c) spot-market relations with most suppliers, without contracts; and

(d) reliance on existing public standards of quality and safety.

2.9 In the past several years, supermarket chains have made the following fundamental changes to the procurement system, which we describe as the six pillars of change. The changes have been undertaken most rapidly among the 3-4 leading chains[1] in each country. The six pillars, as well as other key features of transformation of food retail procurement systems are presented in Figure 3, at the end of this section.

(i) The first pillar is a shift from local, decentralised procurement (buying products store by store) to **centralisation**. This means that the leading chains are investing in large Distribution Centres (DCs) and expecting deliveries by wholesalers and producers to the DC. Centralisation occurs more quickly in processed than in fresh products. Centralisation allows large reductions in costs (some estimates stand at 30 to 40%) by reducing coordination costs.

(ii) The logical extension is the second pillar: **regionalisation** of procurement, i.e. the establishment of a regional system with the catchment area for supply over several countries, delivering to a network of several DCs. An example of this is Ahold Central Europe.

(iii) The third pillar is **a shift from the use of traditional wholesalers to specialised/dedicated wholesalers** as agents of procurement for the supermarket. Supermarkets sometimes buy directly from farmers or other food producers, and sometimes buy via wholesalers. As supermarket sector development proceeds in the CEE, there tends to be a shift toward buying direct, through their own procurement departments, or having a direct relationship with some "channel captain" (supplier or wholesaler) that organises supply for them in a given category. In most CEE countries, however, the most common practice at this point is for a supermarket chain to source from a wholesaler who is specialised in a given category like fruit, and dedicated (dealing mostly with) a given kind of client, say supermarkets and exports. These specialised wholesalers might have offices in wholesale markets or operate outside of them, but the key is their nature, not their location. On the other hand, over time, the chains tend to use the general traditional wholesale market progressively less. The exceptions are where wholesale markets

[1] Note that smaller chains and chains in zones not yet under heavy pressure of retail competition tend to still use the traditional system of procurement. Their incentive to adopt the “six pillars” rises as competition grows and they need to find ways to cut costs and raise quality to survive; their capacity to adopt them rises as the size of their chain grows. One reason that one sees rapid consolidation, and the exit or purchase of smaller chains, is that competition suddenly thrusts them into dire need to adopt these changes in order to compete, but they lack the capacity. For example, building a Distribution Center (DC) is a major investment, and requires both the cash and a minimum number of stores to justify for an efficient level of throughput.

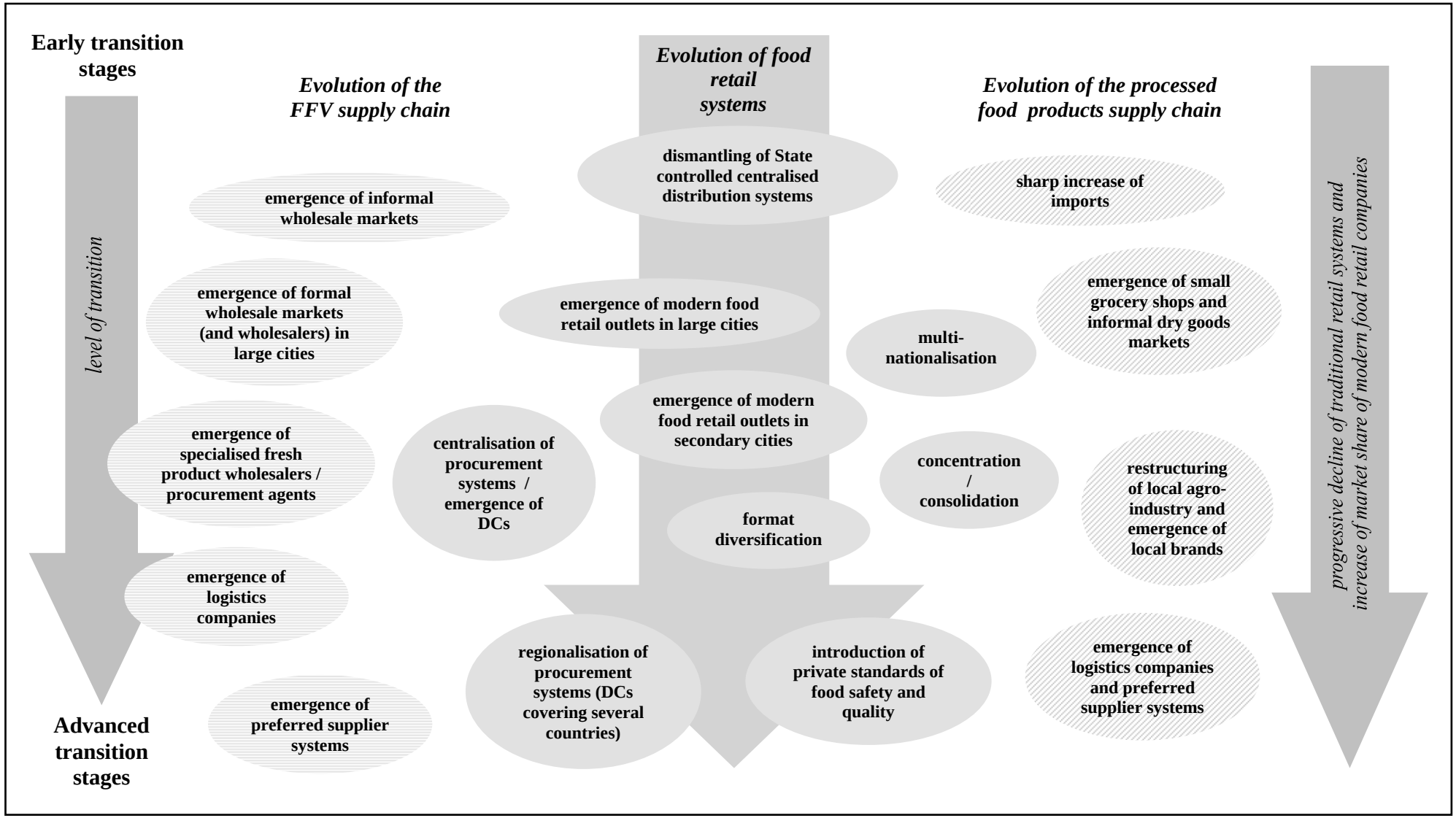
modernise sufficiently quickly and in specific ways required by the supermarket chains.

(iv) The fourth pillar is the **establishment of joint ventures with multinational logistics companies**, such as Tesco (UK) with ProLogis (US) in the Czech Republic. This allows immediate adoption of best practices in situations, common in CEE markets, of a dearth of local logistics firms applying state-of-the-art technology, in particular in food products. The procurement system is then handled by a tripartite arrangement with specialised wholesalers, a multinational logistics company that works out efficient relationships with suppliers and manages the DCs, and the supermarket chain. This triad is an emerging organisational approach in retail in various places like Brazil and China.

(v) The fifth pillar is the **shift from the use of spot markets to the use of preferred supplier systems** – which are lists of farmers and food processors with which the specialised wholesaler, acting on behalf of the supermarket(s), or the supermarket procurement office has direct contracts (implicit or explicit) that specify volumes, quality, timing, and price. This is emerging quickly and recently in the fruit sector in the Czech Republic and in the leading dairy processing firms (with increasing business to supermarkets) in Russia. This new arrangement is attractive to suppliers because it reduces market risk and raises producer prices, which in turn provides a propitious setting for asset-specific upgrading investments such as in the cold chain. It appears to be becoming more and more common for these arrangements to include either credit for inputs or the facilitation of credit through the collateral substitute of having a contract with a major buyer.

(vi) The sixth pillar is the **shift from informal standards or lack of public standards to the establishment of private standards**, first of quality, and eventually of food safety. This is accelerated, and directed, by the ingress of Western European chains and the progressive implementation of private standards used throughout the chain regardless of country. These are imposed on suppliers via the preferred supplier relationships; they gradually phase in terms of coverage, stringency, and monitoring. These are competitive tools in the retail sector, as well as ways to coordinate the consistency produced in the supply chains.

Figure 3: Key Features of Evolution of Food Retailers and the Supply Chains



3. TRANSITION IMPACTS "UPSTREAM" IN THE FOOD SYSTEM: EFFECTS OF THE RETAIL TRANSFORMATION ON PROCESSORS, WHOLESALERS, AND FARMERS

3.1 The empirical data and emerging trends (based on a review of the scant literature on this subject, and captured in the rapid reconnaissance surveys we undertook in the case studies and the farmer survey in the Czech Republic – see section 3 in Annex 2 and section 4 in Annex 3) point to supermarket buying practices and procurement systems having the following significant consequences for farmers/suppliers.

3.2 In general, the procurement system changes of the leading chains imply the following changes in conditions facing the gamut of suppliers upstream in the agrifood system, from processors to farmers: (a) centralisation and regionalisation favour suppliers who can deliver larger volumes on a more consistent basis; they also mean that local producers now have to compete with producers around their countries and in their regions; (b) the combination of the retailers' use of specialised wholesalers, large logistics companies, and preferred supplier systems using contracts and private standards favour the firms and farms that can deliver consistently on contracts, and have the capacity to upgrade their pre- and post-harvest technologies and commercial practices.

3.3 The most immediate and major effects of the above changes in requirements are on small and medium scale food processors. This is primarily because supermarkets have very rapidly penetrated processed food markets, and most quickly adopted the six pillars of procurement system change in those rubrics. Many of the small stores and market stalls that were the traditional buying base for small and medium processors are disappearing very fast. This is because they are in direct competition with supermarkets on price, quality, and packaging. In most urban markets in the majority of first- and second-wave countries, and now also starting to be seen in the third-wave areas, traditional retailers selling processed products are fast losing ground to the supermarkets. Small enterprises selling processed foods such as dairy products, flour, baked goods, beverages, jams, etc. to urban markets are selling to supermarkets or to competitors with supermarkets under cost and quality pressures.

3.4 For example, in Russia we observed that the leading supermarket chains are "rationalising" their preferred supplier lists for dairy products, which now include a combination of dairy product wholesalers and processors such as Danone in the major retail areas (Moscow and Saint-Petersburg) and traditional brokers outside those areas. The rationalisation includes cutting back sharply on the number of wholesalers so that just a handful of specialised wholesalers remains, and cutting back sharply on the number of dairy product processors in order to include only the main large foreign and domestic companies and a reduced number of smaller processing firms who, after meeting strict quality and safety standards, fill some niche in the product line of the supermarket chains. In the provinces, the chains are establishing specialised wholesalers, selecting from the lists of traditional brokers, and aiding them through bank contacts to upgrade to handle product lines that will become increasingly fresh. In turn, interviewing the dairy product processing companies who feel under cost and quality pressures from the

supermarket chains, we found that they are moving in the same direction as the supermarket chains in terms of the adoption of the pillars. In turn, that implies that they are selecting dairy farmers who are able to meet the requirements, and they are helping the subset of their suppliers with the greatest potential, to upgrade (such as by investing in cooling tanks on credit from the processor). Note the cascade of impacts of transition on the dairy products system in Russia – emergence of supermarkets, leading to cost and quality pressures on processors, impetus toward consolidation in the processing and wholesale sector for these products, which in turn leads to differentiation of dairy farmers and pressure toward concentration. That picture, however, is mixed because, in some cases, processors, in particular in the provinces, need to rely on smaller producers and so have a greater incentive to include them in their supplier lists and help them to upgrade. This was found in other work by Dries and Swinnen in Poland.

3.5 The impact on fresh product suppliers is coming more slowly, but our hypothesis is that it is inevitable as supermarkets penetrate the fresh products markets. The Czech case study showed that the impacts are already felt on the fruit suppliers. The impacts will be fastest in accordance with the waves of supermarket diffusion as noted above, starting with the first-wave countries. In general, the smaller and less efficient suppliers will be less able to cope with the procurement system change.

3.6 The challenge can be summarised as follows. The shift to preferred supplier systems means that there is a "toll gate" – a filter of judgement of producers that are either on the list or are not. That means, as supermarkets take over dynamic urban markets, that access to those markets is determined by the producers being able to meet the transactional and technological requirements implied by the retailer's requirements. Those requirements are embodied in standing orders to those on the list, and those orders require meeting private standards of quality and eventually safety, and certainly volumes and consistency. These can be daunting to small producers.

3.7 The opportunity can be summarised as follows: supermarkets represent efficient and powerful “market motors” to diversify products (e.g. a small shop has 100 SKUs of dairy products, and a hypermarket has several thousand), reduce costs to consumers, and extend modern markets. They thus help producers, as a group, to have bigger and more diversified markets. Moreover, supermarkets can directly, or more commonly through their specialised/dedicated wholesalers or processors that work with and for them, improve the returns and lower the risk to farming – through better prices, contracts, technical assistance, sometimes through credit, and often through transport.

3.8 The bulk of the evidence appears to substantiate that the rise of supermarkets, as a fruit of transition, in turn creates transition impacts in the food system that are positive, in particular with respect to improving the food economy for consumers and generally leading to an upgrading of the supply chains. This promotes greater competition, efficiency, innovation, consumer orientation, market expansion and market interactions in other sectors, and private ownership, as well as strengthening frameworks for markets, and aiding in transfer and dispersion of skills.

3.9 The issue for a government or donor is how to make the above processes as “inclusive” of small/medium processors and farmers, as possible. In the early stages, the above processes are not necessarily "excluding" of small farmers, as there is plenty of non-supermarket

market for them to access. The strains appear as the share of supermarkets edges up to the point where the access to desirable/dynamic markets is mainly controlled by the supermarkets, at least in majority – and that majority has become large enough so that non-supermarket channel players have to undertake cost and quality measures to compete with the supermarkets, and in so doing, present market conditions to suppliers similar to those of their competitors, the supermarkets. Donors and governments should work, even at the early stages when the challenge does not appear to be important but the opportunities are already visible, to upgrade farmers to make the inevitable transition. Programmes and policy measures to do so are discussed next.

4. POLICY AND PROGRAMME MEASURES TO MAXIMISE THE EFFICIENCY AND EQUITY GAINS FROM THE TRANSITION'S IMPACTS ON THE RETAIL SECTOR AND THUS ON THE AGRIFOOD SYSTEM

4.1 It is becoming popular, in Western Europe, to "persuade" large retail chains to modify their sourcing procedures in order to help small and local producers. For example, there is an emphasis on corporate social responsibility, "grading" retailers, and so on. It is reasonable to hypothesise that this kind of direct action persuading retailers to add social objectives to the logic of their procurement system change is mainly feasible in mature markets. In the latter, there tends to be an active consumer and producer lobby that pushes for these outcomes, and influences the market environment of the retailers. This approach is less feasible in CEE region for the time being. In any case, there are reasonable doubts raised even in mature markets as to whether such approaches significantly change outcomes for producers beyond some marginal effects.

4.2 The heart of programme and policy thinking in the CEE region should be the methods to upgrade small/medium farmers and processors to meet the requirements implied by the adoption by supermarket chains and their main processors and wholesalers of the six pillars described above. We group the measures by the categories of capital (human, physical, organisational, institutional) that need to be augmented in order for producers to meet the new requirements and reduce tensions between retailers and suppliers.

4.3 **Building Physical and Human Capital**. A first implication for suppliers, and thus for governments, development banks and donors, is the need to upgrade technology with asset-specific investments needed to meet volume, consistency, and quality and safety standards. Dairy processors in Russia said, "*our suppliers need new barns and cooling tanks, better breeds, and better cow nutrition systems!*". Supermarkets in Croatia said, "*our suppliers are in desperate need of greenhouses and cool chains!*". Thus, there is a crying need on the equipment and technological training side. At issue is how to pay for this. Supermarket chains in general do not like to give loans. They prefer to first select producers who have the requisite equipment. Then, if needed, they look for ways to help upgrade producers. They might hire technicians to train farmers, or ask their specialised wholesalers to do so as a condition in their contract. Then the issue comes to money for investment. We have observed that leading chains appear (as an emerging phenomenon) to favour contacting commercial or government banks and informing them of their suppliers' contract with them, which could then act as a collateral substitute or enhancement. We observed this in Croatia in the fruit sector and in Russia in the dairy sector. It is still incipient. This has both an efficiency and equity value. It appears that when chains come to the point of having to get involved in persuading banks or even providing loans, they have reached the limit of access to suppliers who can already meet their requirements – and so expansion requires moving into the next division of suppliers who do not have the needed equipment, training, and access to credit. Donors, governments and development banks have several options to aid in the investments in human and physical capital:

(a) provide low interest loans or transfers to make the investments;

(b) develop imaginative methods of working with banks, suppliers, and supermarkets to resolve the issue of collateral and perhaps the use of collateral substitutes, in particular where land markets are not yet fully developed;

(c) perhaps fiscal incentives should be explored for chains and specialised wholesalers to provide this assistance to smaller producers. This is being tried in Mexico, Chile, Brazil, and Thailand.

4.4 **Building Organisational Capital**. Supermarket requirements of volume and variety were the main driving force behind the establishment of Producer Marketing Organisations (PMO) for fresh fruit and vegetables in the Czech Republic. PMOs help to resolve the important problems of insufficient scale and lack of investment capital of small producers. Members benefit from the PMO's infrastructure for storage, sorting and packing, as well as from increased bargaining power vis-à-vis the major retail chains. There have been few studies of how and whether PMO's are adapting to the changing requirements of supermarkets. However, a recent study in Chile showed that 80% of these PMOs are now failing because mere market access combined with associatively was necessary but not sufficient – and major investments in organisational and managerial capacity were crucial to stay in the dynamic market. Donors and governments can provide assistance toward such investments.

4.5 Another crucial element of organisational capital is the organisation of the market. In particular, even though supermarkets are shifting over time away from the use of wholesale markets, in the (perhaps long) transition the latter will have an important role in determining the access of small and medium farmers and processors to the new market channels. It is thus important to assist the existing wholesale sector in adjusting to the needs of supermarkets. An example of this is the EBRD programme in Hungary which has helped the wholesale markets to upgrade their facilities to meet the needs of the supermarket chains. This has the added benefit of keeping alive alternatives for the small farmers by increasing the competitiveness of the traditional channels.

4.6 Another element of organisational capital is the development of business links between suppliers and supermarkets and/or specialised dedicated wholesalers. We did not observe much of this yet underway at the development programme level in the CEE region. However, in other regions, experiments of this type are underway, facilitating tri- or quadripartite relationships that enables the supermarket- marketplace channel participation by the small farmers. An example is found in Indonesia, where there is a combination of a small farmer organisation (Makar Buah), a supermarket chain (Carrefour), a seed/chemical company (Syngenta), a government extension programme, and a specialised/dedicated wholesaler (Bimandiri) in a fruitful combination aimed at marketing melons. Carrefour supplies the guaranteed market, Syngenta the financing, the wholesaler the intermediation and coordination. This kind of combination can also be accomplished through the action of a donor development project, such as the USAID/Michigan State University Programme Partnerships in Food Industry Development in Nicaragua, where a US university facilitates the market connections for small farmer organisations with the local supermarket chains. NGOs such as Techno Serve provide technical assistance, supermarket chains such as CSU and La Colonia provide the guaranteed market, and donor funds from USAID provide the financing. The project has a graduation policy where the small farmers' organisations

progressively take over the needed investments and then maintain the market link themselves (Weatherspoon and Membreño, 2004). In 2004, the Mexican government started a programme to institutionalise these sorts of relationships signed between the supermarket association (ANTAD), the Ministry of Agriculture (SAGARPA), and the Ministry of Economy. The programme orientates a portion of the existing training and investment funds of the Ministries to helping small and medium farmers meet the requirements of the supermarket channel (see Reardon 2004).

4.7 **Building Institutional Capital**. An important institution is a code of commercial conduct for commercial relations among supermarket chains and suppliers. In a situation such as Argentina in 2001, where the supermarket expansion had reached certain a point (about 50-60% of the retail market), there were very significant tensions between retailers and suppliers, affecting the political and economic climate of the country. Many processors and farmers went out of business as they could not meet the requirements discussed above, and the retailers had been pushed, through their very intense competition, to cut margins, extend payment periods, and so on. The government did not want to intervene directly, but gave the two sides an ultimatum, to establish a private code or face stricter regulation. The government instituted a private code that emphasised prompt payment, transparent contracts, and encouraged mutually beneficial schemes of upgrading, and instituted a method of adjudicating conflicts between retailers and suppliers. The results look very promising and a number of other countries are studying the approach. This would be very useful for the CEE region.

4.8 Another crucial institution is that of grades and standards. We noted above that retailers (and the processors that serve them) tend to adopt private quality and safety standards that exceed the public standards (such as “Eurepgap” in Western Europe). In general, these private standards are chosen by the chains as competitive instruments, and donors and governments would have little to do in their regard. However, it is common in other regions (but not yet evaluated in the CEE region to our knowledge) that there are gaps and disharmonies between public and private standards. To help the broadest set of producers begin to upgrade, it behoves the governments to examine and redress these gaps at a pace acceptable to producers. For example, the Brazilian government is at present moving toward adopting private dairy product standards as public standards in order to push producers (not now supplying to the modern sector) to upgrade (so as not to later be excluded) and to integrate the market for greater efficiency, and to help consumers.

CENTRAL AND EASTERN EUROPE

IMPACT OF FOOD RETAIL INVESTMENTS ON THE FOOD CHAIN

ANNEX 1

TRANSFORMATION OF THE RETAIL SYSTEMS IN THE CZECH REPUBLIC AND THE RUSSIAN FEDERATION

ANNEX 1

TRANSFORMATION OF THE RETAIL SYSTEMS IN THE CZECH REPUBLIC AND THE RUSSIAN FEDERATION

1. Introduction

1. Before the start of transition, retail and wholesale entities in the Czech Republic (at that time still Czechoslovakia) and the Russian Federation were mainly state-owned or cooperative companies and were organised as geographic monopolies, with little or no competition among institutions. Privately owned companies played only a minor role.

2. For example, before 1990, the retail system in Czechoslovakia was fully formal: no informal retail was allowed. Most food sales took place in State enterprises (Zdroj) whose shops were either broad line food shops or fresh fruit and vegetable shops. Besides the State enterprises, an important share of the food distribution was done via consumer cooperatives (Jednota) and through State-owned department stores (Prior). Consumer cooperatives were mainly in urban marginal or rural areas; thus, they were more concentrated in what would become Slovakia than in what would become the Czech Republic. The retail sector consisted of a mix of small supermarkets and small shops in urban areas, and small shops and cooperative sales outlets in rural areas.

3. In the early stages of transition, there was an initial retail privatisation. This was generally associated with the breakdown of the highly concentrated state system into separate units that soon started to merge and form many small private retail chains. This was mostly done with domestic capital; there were very limited FDI inflows in the sector during this period. Foreign investors encountered obstacles to enter the market due to unclear ownership structures, prohibition to participate in privatisation auctions, unclear privatisation of state enterprises, and unstable macroeconomic situations.

4. The few foreign retail chains that did make investments did so by buying newly privatised retail chains. For example, Ahold (Netherlands) entered the Czech retail sector in 1991 by buying the Mana chain; in the same year, Delvita (Belgium) bought the Sama chain of small supermarkets. Tesco (UK) entered the Czech Republic and Slovakia in 1996 by buying the former Prior department stores. There was as yet no move in this incipient multinational presence to diversify formats beyond supermarkets into hypermarkets or discount stores, or to move beyond the main cities into smaller cities or rural towns, non-metropolitan areas were still served by small shops, small new private chains, consumer cooperatives, and public plaza markets/bazaars, depending on the country.

5. The next stage started in the mid/late 1990s in the Czech Republic and only in very recent years in the Russian Federation. This period is characterised by:

(i) a dramatic rise in the retail sector share of large formats;

(ii) extensive investments by foreign retail chains and the rapid rise of large-formats in the retail sector, hence multi-nationalisation;

(iii) inter-country as well as intra-country supermarket diffusion;

(iv) concentration in the supermarket sector; and

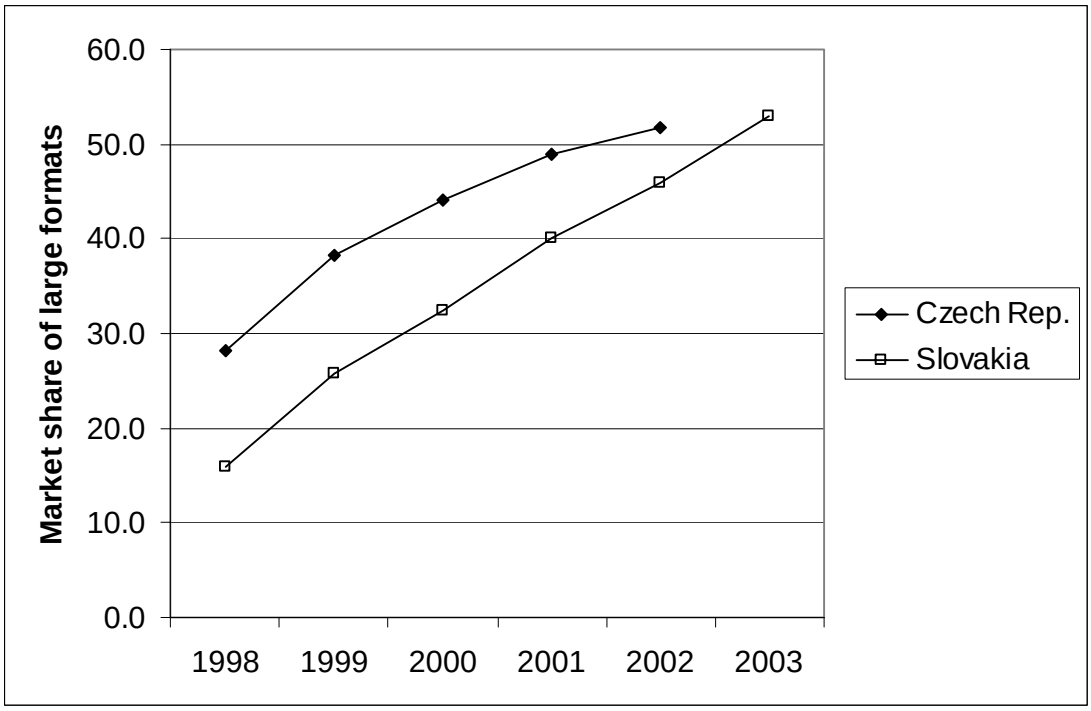
(v) important changes in procurement systems that then affect suppliers.

We discuss (i) to (iv) further in this section. (v) is discussed in Annexes 2 and 3.

2. The Rise of the Large-Format Retail Sector

6. Figure 1 illustrates how the share of the large-format retail sector (supermarkets, hypermarkets and discount stores) in total retail increased rapidly in the Czech Republic and Slovakia (starting at different times). For example, in the Czech Republic, this share has grown from around 30% of the total retail market in 1998 to more than 50% in 2002.

Figure 1: Change in Total Market Share of the Large-Format Retail Sector in the Czech Republic



Source: Shopping Monitor CE (INCOMA[1] Research).

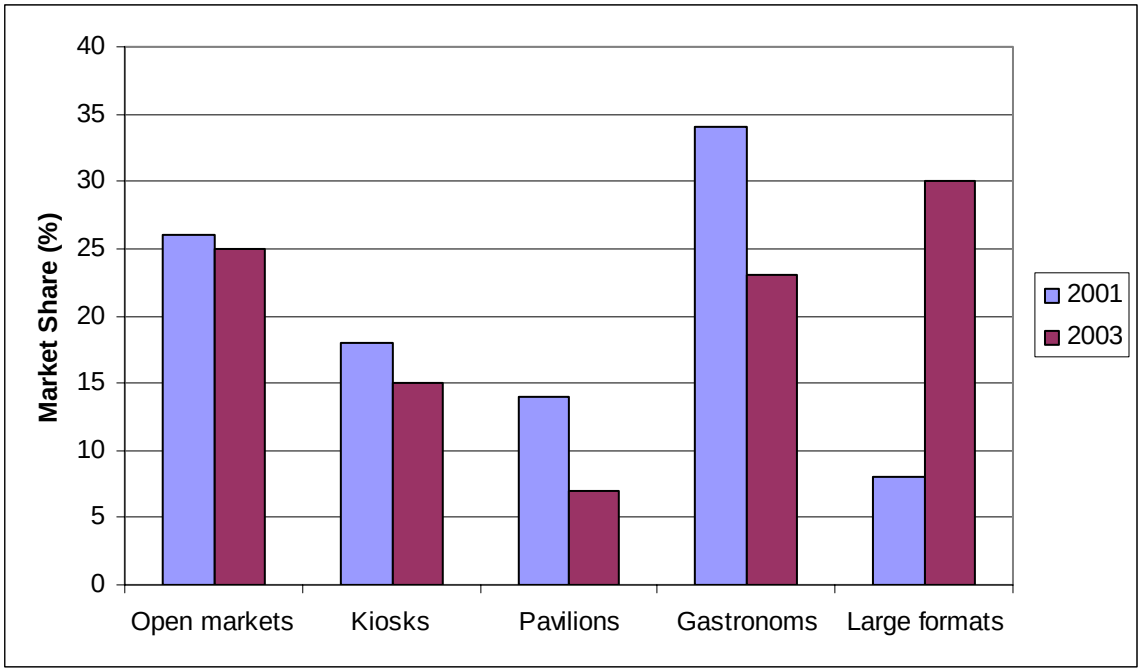
[1] INCOMA is a Czech consulting firm specialised in the area of food retail (see: http://www.incoma.cz).

7. Figure 2 shows how this development is not unique to Central European countries but that large formats are also the fastest growing retail format in Moscow. Between 2001 and 2003, the share of large formats in total food retail has increased from less than 10% to 30% of the Moscow market. At the same time, the market share of traditional retail outlets has decreased substantially.

3. Multi-nationalisation

8. A striking characteristic of the supermarket sector in most of the CEE countries is rapid multi-nationalisation in only the past five years. There is a great diversity of multinational retailers that have undertaken FDI in CEE. The motives for the entry of retailing multinationals in CEE include the fact that Western Europe offers fairly saturated, low growth markets in which most countries have planning restrictions on further out-of-town retail development, while the CEE retail sectors offered initially soft local competition, higher mark-ups on food, less constraining local planning, and growing markets.

Figure 2: Change in Food Market Share of the Large-Format Retail Sector in the Moscow Area

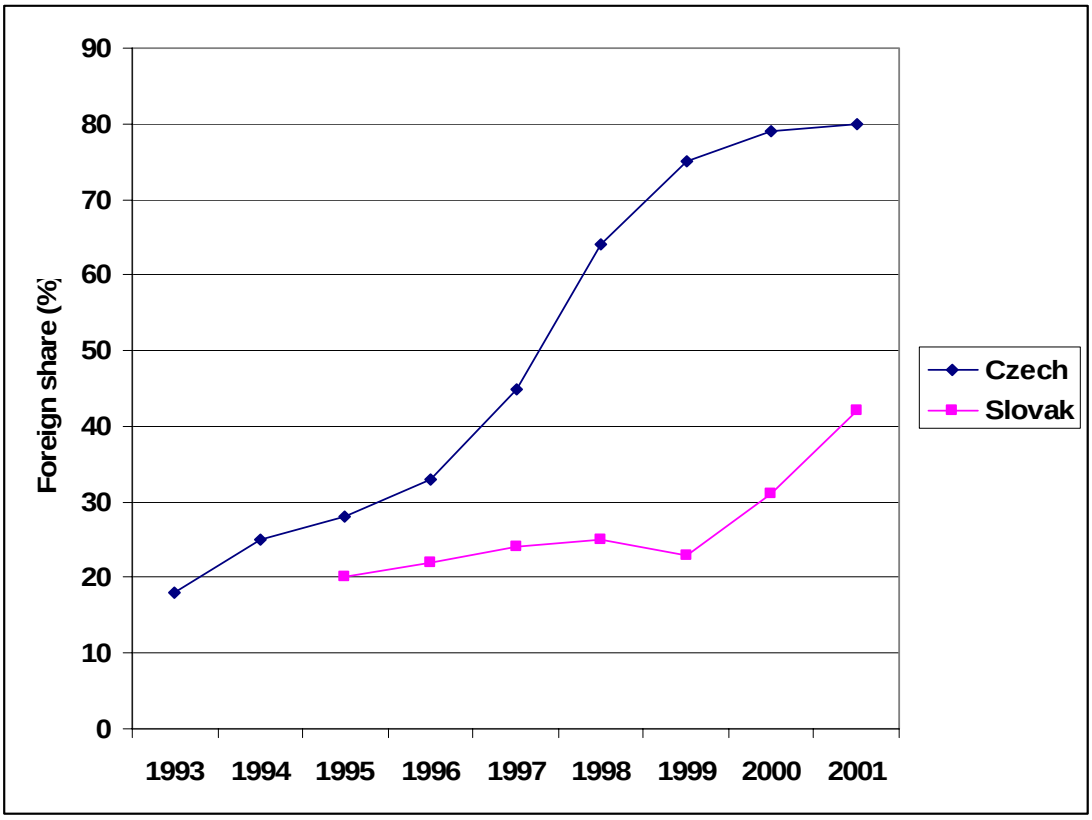


Source: IGD[1] (2004).

[1] IGD is a charity that brings together intelligence, opinion and experience from the food and grocery chain (see: http://www.igd.com).

9. The top ten retail companies in the Czech Republic in 2003 in terms of the value of total sales are all foreign owned[1] and include (ordered top down): Metro (Germany); Ahold (the Netherlands); Lidl & Schwarz (Germany); Rewe (Germany); Tengelmann (Germany); Tesco (UK); Globus (Germany); SPAR (Austria); Delhaize (Belgium); Carrefour (France). Figures 3 and 4 give an idea of the degree of multi-nationalisation of the retail sector in the Czech Republic and Slovakia. The share of foreign-owned retail chains in the 50 main companies in the sector is 80% in the Czech Republic where multi-nationalisation really took off in 1997. The share of foreign owned companies in total retail is about 35% in the Czech Republic. Given that supermarkets account for about 40% of retail, and FDI is almost exclusively in the supermarket sector, that means that about 70% of the supermarket sector in the Czech Republic is multi-nationalised.

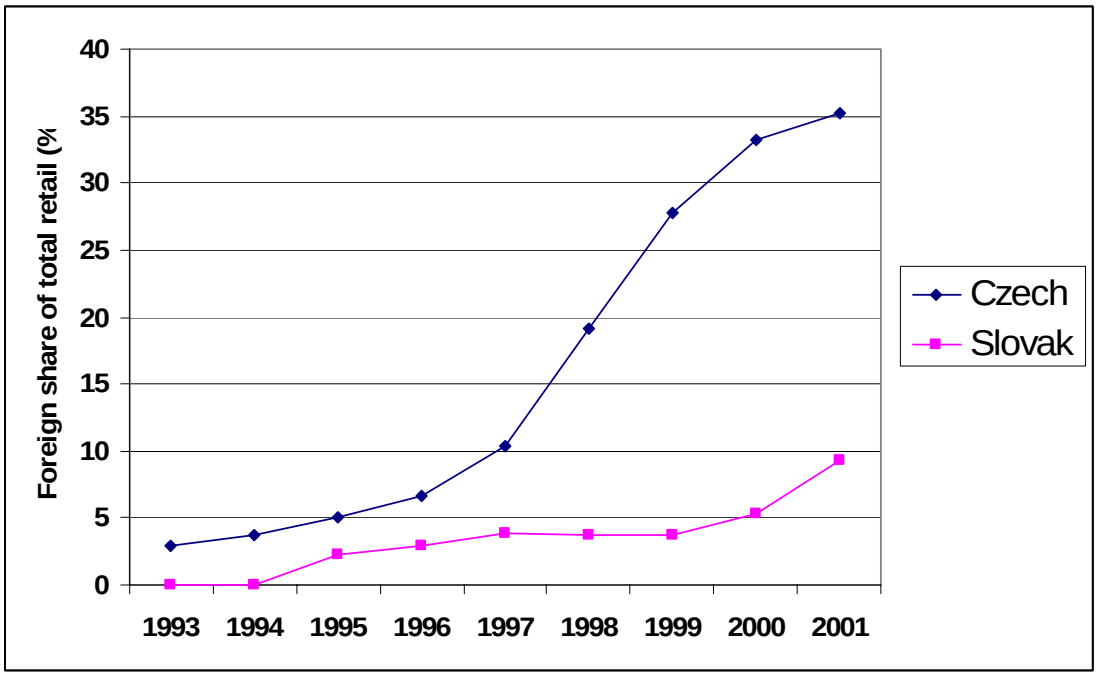
Figure 3: Share of Foreign Ownership in Top 50 Retail Trade Companies (%)



Source: Own calculations based on Shopping Monitor CE (INCOMA Research).

[1] This excludes Jednota co-operative organisations whose combined sales would place them in 9th place overall.

Figure 4: Share of Foreign Companies in Total Retail (%)



Source: Own calculations based on Shopping Monitor CE (INCOMA Research).

10. The first foreign investments in the retail sector in the Russian Federation were made by Migros Turk (Turkey) in 1997. Other major foreign retailers started their investments only after the financial crisis of 1998: SPAR, Metro and Auchan (France) entered the market in 2001; Edeka (Germany) made its first investment in 2003. Most FDI has flown into the retail sector of the capital but Metro is also a major player on the Saint-Petersburg retail market. In 2003, sales of these foreign owned retail chains accounted for 36% of the supermarket sector in Moscow; and for 19% of the supermarket sector in Saint-Petersburg.

4. Spread to Secondary Cities and then Small Towns

11. In the same way that foreign chains move away from competition in relatively modern-retail-saturated countries to less-saturated countries, the main retail chains are also moving their investments within the countries: both from large cities to smaller cities and towns, and from richer neighbourhoods to middle to lower income neighbourhoods. This is extending the effect of the supermarket revolution into the food markets of the poor, and into the countryside. This clashes with the conventional view that supermarkets are just a “big-city phenomenon” and a middle class trend. Many retail chains want to be the first hypermarket in a small town, effectively locking out competition as there is only a market for one major store.

12. For example, in the Russian Federation, we have seen Pyaterochka move from their base, Saint-Petersburg, to Moscow in 2001 and into the regions since 2002. Other examples are: Perekriostok, who moved from Moscow City into the Moscow region in 1999, to Saint-Petersburg in 2002 and into the regions in 2003; Ramenka-Ramstore (Migros Turk), who invested first in Moscow, moved to the Moscow suburbs in 2003 and invested in the regions in that same year; and Metro, who moved from Moscow into Saint-Petersburg and will be opening several stores in the regions in 2004.

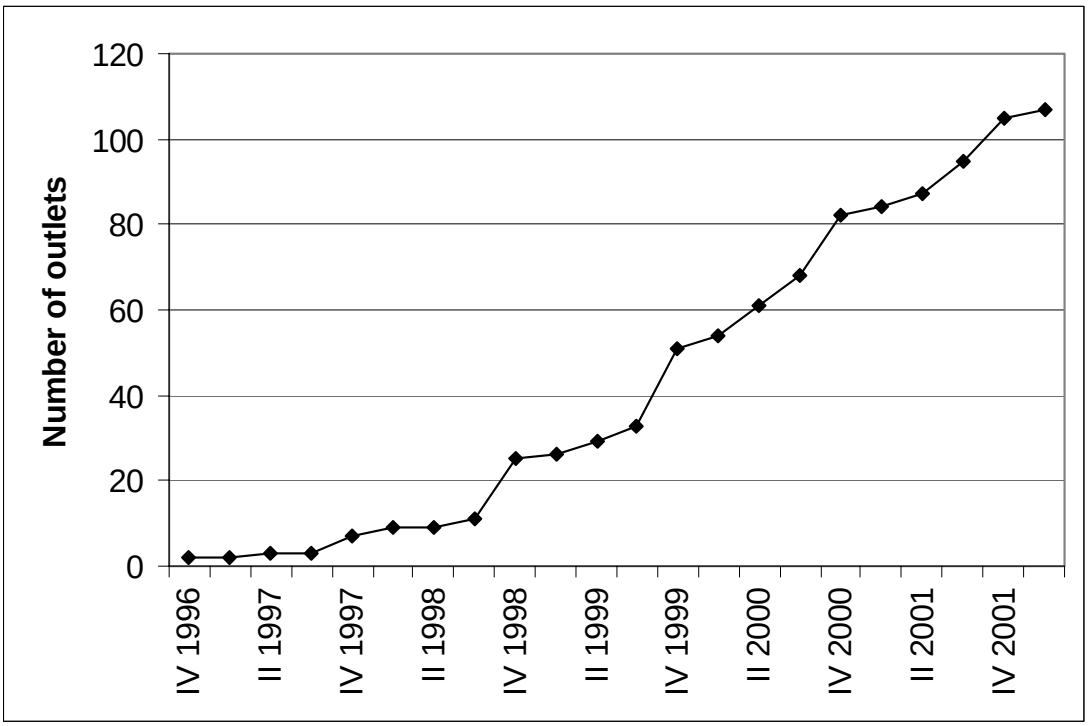
13. The dynamic dispersion of large-scale retail outlets throughout a country or a region is sometimes influenced by government policy or other socio-economic and cultural factors. For example, Auchan first invested in sales area in the Moscow region instead of moving into the city of Moscow because the administration is less complex in the region and it is easier to acquire land there. Similarly, the investment climate and public policy towards foreign direct investments may differ from region to region in the Russian Federation.

5. Emerging Consolidation

14. While the retail sector was very concentrated – but mainly public sector – before transition, then highly de-concentrated after privatisation and the proliferation of retailers in the 1990s, there is emerging evidence of a re-concentration – but this time private sector and multi-nationalised. This is thus a "U"-shaped pattern of concentration over time.

15. In the Czech Republic, the top five chains had 70% market share in the supermarket sector in 2002. Format diversification – away from small to large supermarkets, and into hypermarkets, discount stores, hard discounts, and convenience stores – is one of the weapons used to fight competition in a highly saturated retail market, as it helps to increase a chain's coverage of the market, drive down prices and drive up product diversity, and thus increase market share. Format diversification is in fact usually a sign that a supermarket sector is maturing. It takes "deep pockets" to be able to make investments in giant hypermarkets, and these have been mainly the reserve of foreign chains. Figure 5 shows how the number of hypermarkets in the Czech Republic has increased rapidly from two to over 100 since 1996.

Figure 5: Change in Number of Hypermarkets in the Czech Republic



Source: Own calculations based on Shopping Monitor CE (INCOMA Research).

16. The first modern formats to appear in the Russian Federation in the mid-1990s were discount stores followed by supermarkets and hypermarkets during the post-crisis period (IGD). To date almost all hypermarket development has taken place in and around Moscow and Saint-Petersburg, but both Ramstore and Perekriostok will develop hypermarkets in the largest regional cities in 2004. At this moment, large-format sales area of the 14 major retailers in the Russian Federation is composed of 10% hypermarkets, 41% supermarkets and 49% discount stores.

CENTRAL AND EASTERN EUROPE

IMPACT OF FOOD RETAIL INVESTMENTS ON THE FOOD CHAIN

ANNEX 2

IMPACT OF RETAIL TRANSFORMATION AND PROCUREMENT SYSTEM CHANGE ON THE CZECH FFV SUPPLY CHAIN

ANNEX 2

IMPACT OF RETAIL TRANSFORMATION AND PROCUREMENT SYSTEM CHANGE ON THE CZECH FFV SUPPLY CHAN

1. Introduction

1. The data presented in this section of the report were collected through qualitative interviews with different actors in the FFV supply chain: food retail companies (domestic and foreign owned supermarket chains); wholesale companies; FFV producers and producer marketing organisations for fruits and vegetables. In addition, we present results from a survey of 250 fruit and vegetable growers that was conducted in the spring of 2004. Respondents were randomly selected in the three main FFV areas in the Czech Republic (Stredocesky, Vychodocesky, Jihomoravsky) on the basis of a list of producers from the fruit and vegetable growers unions as well as membership lists from producer organisations. To increase the representation of the survey, a certain share of the observations was selected randomly in the areas where interviews were being taken, on the condition that these additional observations were not already present in the main list above.

2. Before turning to the evidence on procurement system change from the interviews and the survey, we first provide a brief description of the composition of the survey. The dataset is almost perfectly split between fruit (128 observations) and vegetable (126 observations) growers. About 65% of all respondents are family farms (39%) or registered sole proprietorships (26%). The rest are co-operative farms (9%), joint stock companies (9%), and limited liability companies (17%). The importance of small-scale/family farm operations corresponds to the actual situation in the FFV sector in the Czech Republic. For example in 2002, about 70% of all fruit growers in the Czech Republic cultivated less than 10ha of land (Van Kerckhove, 2003). Producer marketing organisations (PMO) are quite important in the Czech FFV sector (we will come back to this issue later) and relatively more so for the marketing of fruits than for vegetables. On average 22% of all respondents are members of a PMO – 30% of fruit growers and 14% of vegetable growers.

3. Fruit and vegetable produce is sold through a variety of marketing channels. The majority of growers in the survey (67%) sell at least part of their production on the local market. 45% of surveyed growers sell products through wholesale companies, while only 8% supply directly to supermarket chains. Supermarkets on their part buy the majority of their FFV products through wholesale companies (60%) and only 5% directly from growers. The remainder of the FFV produce in the stores is supplied by producer marketing organisations or through imports.

2. Changing Procurement Systems for FFV

4. The food product procurement systems before the transition reflected the degree of centralisation, collectivisation, and formality of the retail sector in each CEE country. For example in Czechoslovakia, where retail was centralised (in urban areas, in State retail enterprises), collectivised (in rural areas, in consumer cooperatives), and formal (no informal retailing was allowed in urban or rural areas) – the procurement system was the mirror reflection of those characteristics. Obchod Ovocem a Zelininou was the centralised procurement company managed by the State and was also the only company that was allowed to import FFV. Obchod

Ovocem a Zelininou operated five directories with distribution centres (DCs) in the different regions of the country, distributing to urban state retail enterprises and rural retail cooperatives alike. The company was obliged to buy 100% of FFV production of the state and cooperative farms. If this produce could not be sold as fresh products, it was brought to industrial processing and canning companies (again state owned).

5. The first half-decade of the 1990s brought the dismantlement of the state-run and collectivised components of the retail procurement system. In Czechoslovakia, privatisation meant the immediate sell-off of the five regional branches of Obchod Ovocem a Zelininou to private wholesalers at the same time as the break-up of state-retailing. Hence, over the 1990s, there was a proliferation of private food product general-line (by which here we mean not dedicated to one type of client or market niche, but potentially with product specialisation, such as in produce) wholesalers in the region to progressively replace the state- and collective- managed wholesale functions (it was estimated that immediately after the breakdown of the centralised system, there were about 300 private wholesalers in the Czech Republic, of which at this time only 12 remain)[1]. The new general-line wholesaler's bulked produce bought from a variety of sources, including cooperatives and individual farmers. Because the FFV production base was narrow in terms of product diversity and seasonality, with low productivity and quality, and with high transaction costs and risk, many of the new wholesalers placed great emphasis on importing FFV to supply the local market – in particular bananas and citrus and stone fruit from international markets. At the same time, some started small out grower schemes to assure a domestic production base. Gradually, toward the middle to end of the 1990s, many of these wholesalers began including the emerging supermarkets among their clients.

6. The rapid transformation of the retail sector through increased competition, large format stores and substantial FDI dictated the changes in the procurement system in the next stage. This transformation created the need to reduce costs, to have consistent volumes and standardised products, and to increase quality and product differentiation to gain merchandising advantage.

7. To respond to the need felt by the chains for alternatives to the existing wholesale system, and to pursue competition strategies of lowering costs while raising quality, leading supermarket/hypermarket chains in the Czech Republic have been shifting over the past few years toward the use of a new procurement system characterised by six key pillars: (1) shift toward centralised procurement systems; (2) shift toward cross-border procurement systems; (3) shift toward specialised/dedicated wholesalers; (4) use of global logistics multinationals to quickly improve procurement systems; (5) shift toward preferred supplier systems; (6) shift toward adding private standards.

[1] Estimate by Ir. Zika (Ministry of Agriculture, Czech Republic).

2.1 Shift toward Centralised Procurement Systems

8. There has been a marked and recent tendency to shift from per-store procurement to a centralised system (usually a central buying office for a general category like FFV and then one to several distribution centres (DCs) over the country to handle product movement).

9. This is done in order to reduce coordination costs, generate economies of scale buying in larger volumes, work with fewer wholesalers and suppliers per unit merchandised, and have tighter control over product consistency in meeting standards. Typically, chains make this move when they reach a certain volume threshold where it becomes markedly more efficient to shift to DC(s). Moreover, typically, a chain moves from a DC for a zone to a DC or set of linked DCs for a country in order to source over the country and get the cheapest and best quality products by having a larger supplier pool from which to choose.

10. In the Czech Republic, Ahold opened its first DC for FFV in 2001 and opened a second one in 2002. Delvita was operating a DC already by 1995, and opened a second in 2003. Tesco built its first DC in the Czech Republic at the end of 2003. However, not all leading chains have enough stores yet to warrant DCs: for example, Carrefour has its suppliers deliver directly to the hypermarkets; Globus (Germany) relies on specialised/dedicated wholesalers (Hortim, Vis, and Ceroz) to deliver to its stores. This new type of wholesaler, dedicated to supermarkets, is discussed more below.

2.2 Shift toward Cross-Border Procurement Systems

11. The logical extension which is now being taken by various chains in the CEE region is to move to cross-border sourcing – coordinating procurement over a chain's DCs in the set of countries in which it operates. These systems allow the procurement of the cheapest and best quality products from the various countries. This extends the set of suppliers available to the chain, and magnifies the advantages of a DC system noted above. This process is related to EU accession, which increases opportunities for cross-border procurement.

12. Central Europe, home of the "first wave" of retail transformation, is also the cradle of regionalisation of procurement. Ahold announced in October 2002 the formation of Ahold Central Europe (ACE), an integration of its operations in Poland, Czech Republic, and Slovakia undertaken over 2003. ACE is based in the Czech Republic, and merges "backroom functions" such as product procurement and administration for 400 Albert supermarkets and Hypernova hypermarkets in Central Europe with combined 2001 sales of approximately Euro 1.3 billion. The daily merchandising operations are managed by the local units (Ahold Newsletter, 2002). This integration is organised by category, so that there is an "ACE Fresh" for FFV procurement. Tesco, now the leading retailer in Central Europe, with 153 stores (53 Hungary, 66 Poland, 17 Czech Republic, and 17 Slovakia) has its administrative headquarters in Prague, although FFV procurement is still organised on a national level. Kaufland is building DCs in Slovakia and Poland (and already has one in the Czech Republic). Once the DCs are operational, importing products from Poland into Slovakia, for example, will also be simplified and suppliers that are delivering to the DC in Poland will also be used to supply the Slovakian market.

13. Moreover, to facilitate this integration, wholesalers from a given country are "expanding with" the expanding retailer in order to continue to service it over the countries in a region. For example, some wholesalers that had agreements with retail chains in the Czech Republic expanded their businesses to Slovakia once the supermarkets they serviced in Czech Republic entered Slovakia. Ceroz – established in 1991 and now the biggest Czech wholesaler in FFV, owning 8 DCs in that country – has built three DCs in Slovakia since 1998 because the foreign retail chains that were expanding their operations from the Czech Republic into Slovakia wanted to deal with the same suppliers with which they already had a business relationship.

2.3 Shift toward Specialised/Dedicated Wholesalers

14. The leading chains are shifting from traditional wholesalers and even from new general-line wholesalers to "specialised/dedicated wholesalers" that are specialised in a product category and dedicated to supplying supermarkets. That means that the wholesaler is more responsive to the quality, safety, and consistency requirements of supermarkets than are traditional wholesalers who aggregate products over many producers and qualities with little capacity for segregation.

15. There exist several degrees of integration between these new firms and the retail company. As private wholesalers emerge in the early transition period, they increasingly augment the share of their businesses from supermarket chains. Furthermore, the wholesaler shifts to having the majority of its business from a handful of chains; and at the same time, it adds services such as packaging and quality control that it did not do as a "traditional wholesaler." Sometimes these services are merely transport for purchases made directly by the supermarket chain.[1] In our interviews we found that these were considered to be "entry fees" to get the business of the retailer. As a next step, the now specialised/dedicated wholesaler moves from the mainly buying-on-the-spot market or from a list of customary suppliers, to starting up grower schemes where it contracts production that meets the specific grades and standards of the retail chain. It does this both to forestall the retailer from entering into direct relations with producers and bypassing it, and because it needs to undertake these schemes to meet product quality and safety requirements (more on that below).

16. In a parallel movement, we find evidence of growers that are extending their business to procure produce from other growers and initiating a wholesale business of their own. For example, the company Bramco Semice was established in 1994 and had two activities: growing vegetables and sales activities. The company was subsequently split into Agatha sro (growing activities) and Bramco sro (sales activities). Bramco buys potatoes and vegetables from Agatha and another large local grower, as well as from a number of other growers and imports. These other growers normally do not receive a contract except for the production of certain vegetables (cauliflower) because this type of production is highly labour intensive if a high quality end-product is required. The large growers (e.g. Agatha) are therefore unable to offer this product, while Bramco requires it to fulfil the product diversity requirements of the supermarkets that it sells to.

[1] e.g., bananas from Latin America that are delivered in the port of Antwerp and have to be transported to the Czech Republic, or tomatoes that need to get from Spain to Slovakia.

2.4 Use of Global Logistics Multinationals

17. A related trend is for leading chains to use the services of global multinational logistics firms (either in a joint venture or a business alliance). Thus large retailers induce a rapid transfer of world-class logistics technology into the local wholesale sector. This allows the leading chains to reduce their costs, become yet more competitive, further distance themselves from weaker local chains, and accelerate the consolidation process. In April 2003, Tesco signed an agreement with the US-based global multinational ProLogis for lease of a large (26,000 m^2) ProLogis DCs in the Czech Republic.

2.5 Shift toward Preferred Supplier Systems

18. The leading chains are shifting toward "direct" purchase from growers. We qualify "direct" in that most often this procurement channel is managed by the specialised/dedicated wholesaler as a "preferred supplier programme". This is done in order to select producers capable of meeting the quality and safety standards of the supermarkets and thus lower transaction costs for the chain both by lower search costs and by reducing the number of suppliers per unit sold. The retailer or the wholesaler acting on its behalf then provides incentives (negative and positive) to meet the retailers' requirements – such as via explicit or implicit contracts, lower risk, and sometimes price premia, as well as resolution of certain idiosyncratic factor market failures facing the producers. As an example of the latter, an interview with one of the leading banks in the Czech Republic showed that farmers who wish to apply for a bank loan will need to show that they have a contract with the buyer of their products. This contract then serves as a collateral substitute for producers.

19. Evidence from the grower survey showed that about 30% of all suppliers to wholesalers and 60% of producers that supply directly to supermarkets have a contract. We can distinguish two types of contracts. On the one hand, there are contracts that are specified long before the actual harvest of the products. These contracts are often longer-term (about one year) and are an indication for a grower to be on the buyer's preferred suppliers list. These contracts mainly include the minimum quality standards for the products that can be delivered. It seemed that the contracts with the supermarkets were slightly more demanding than those with wholesalers as the majority of the former contracts also included specifics on the penalties that could be applied in case of non-compliance and additional standards on product safety. On the other hand, additional contracts may be specified after the harvest, specifying quantity and quality of the products that are to be delivered, the frequency of delivery and the payment method and/or price.

2.6 Shift toward Private Safety and Quality Standards

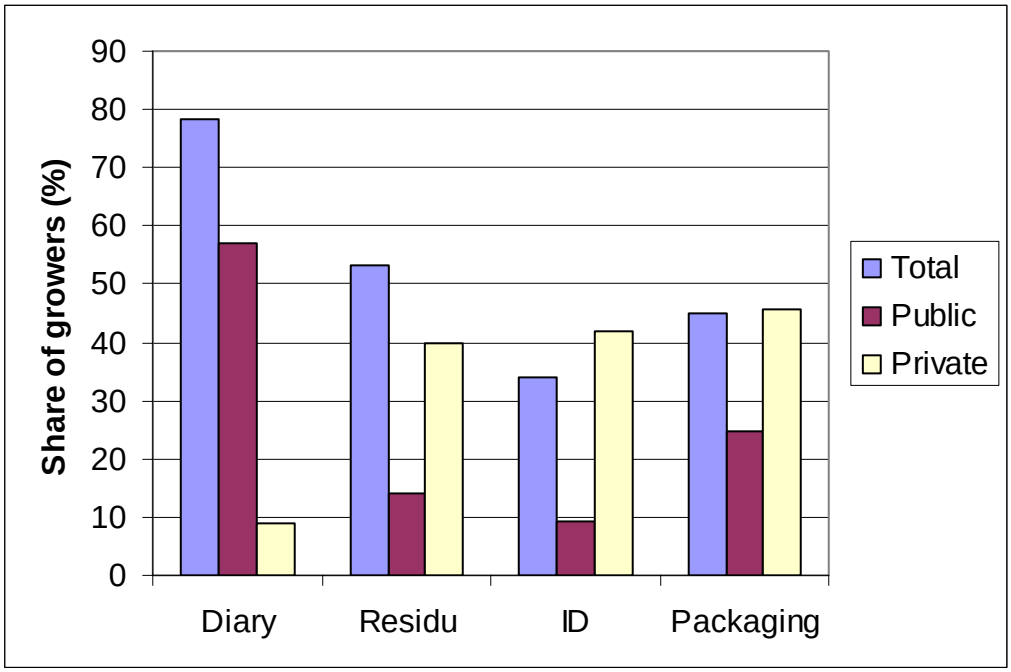
20. Leading chains are shifting toward higher quality and increasingly safe product through private standards imposed on suppliers. There are several reasons for this, as revealed in our interviews: (1) higher product quality and safety are being used to woo consumers, as competitive arms against the remaining small shops and markets; (2) standardisation reduces costs and allows more efficiency of product flow in the procurement system; (3) an important reason is to bring the attributes of local supply into conformity with private standards of European retailers, several of whom are also the leading chains in CEE (such as Tesco, Ahold, Carrefour, Metro); (4) centralised purchase (with better monitoring ability), qualified specialised wholesalers, and preferred supplier programmes of selected producers, raise the capacity of retailers to apply higher standards than is possible when buying from general-line wholesalers who buy from and sell to a wide variety of firms; (5) in general, public food regulations for the domestic market, whether they exist or not, are not easily enforced by governments in the region, so private standards and private enforcement are the main way that food safety at retail outlets is imposed, at least at present. In turn, large retailers are easy targets for liability should a problem be experienced by a consumer.

21. Food safety requirements for FFV production for the domestic market differ from country to country, with little variation between different retail chains. In the Czech Republic, public requirements are stricter than they are in Slovakia. For example, HACCP certification is officially compulsory for producers of FFV and storage facilities in the Czech Republic. In Slovakia it is not yet compulsory and the private retail chains do not require it either. Also, private initiatives concerning food safety requirements are more advanced in the Czech Republic than in Slovakia as we found some evidence that retail chains are trying to communicate food safety issues to their customers. For example, there exists an integrated fruit production label (SISPO) that was introduced by the Czech Union of Fruit Growers. Almost all interviewed supermarket chains indicated that they prefer to buy SISPO labelled fruit and the label is clearly identifiable on the shelves. At the moment integrated fruit production is still only a small share of total Czech fruit production but retail chains made it clear that in the future they will move to buying only SISPO labelled fruit on the domestic market. This could have important consequences at the production level because certain investments are necessary to become SISPO certified and for the moment mainly the larger and the better producers have switched from conventional to integrated production. However, apart from the controls placed on the SISPO producers by experts of the Union of Fruit Growers, and random sample checks by the public food agency on products in storage rooms and on the shelves of supermarkets, there are no controls on production practices and pesticide residues for local products that are sold in supermarkets. Both in the Czech Republic and Slovakia there exists a public BIO label for organically grown FFV. However, in neither country do the supermarkets adopt this label because customers are not willing to pay a higher price for these types of products.

22. Through the grower survey, we tried to identify how important the private standard setting is compared to public regulations or programmes. Respondents were asked what the driving force was behind the implementation of certain safety and hygiene and traceability indicators. We used four indicators: keeping a log of fertilizer and pesticide use; performance of residue analyses on harvested products; identification of the harvested parcel and date on boxes

used for harvesting; and identification of the farm on the packaging. Figure 1 shows what share of all growers had these indicators in place and furthermore, what share of those farmers did so because of either the buyer's wish (private standard) or government regulation (public standard). We see that almost all growers keep record of the applied fertilizers and pesticides and that this is done mainly to be in line with public standards. For the other indicators however we find that the main drivers behind the implementation of safety (residue analysis) and traceability measures are private initiatives. In other words, buyers of FFV are increasingly putting pressure on local growers to comply with private sector requirements which are more stringent than the public standards.

Figure 1: Public versus Private Standards for Product Safety and Traceability

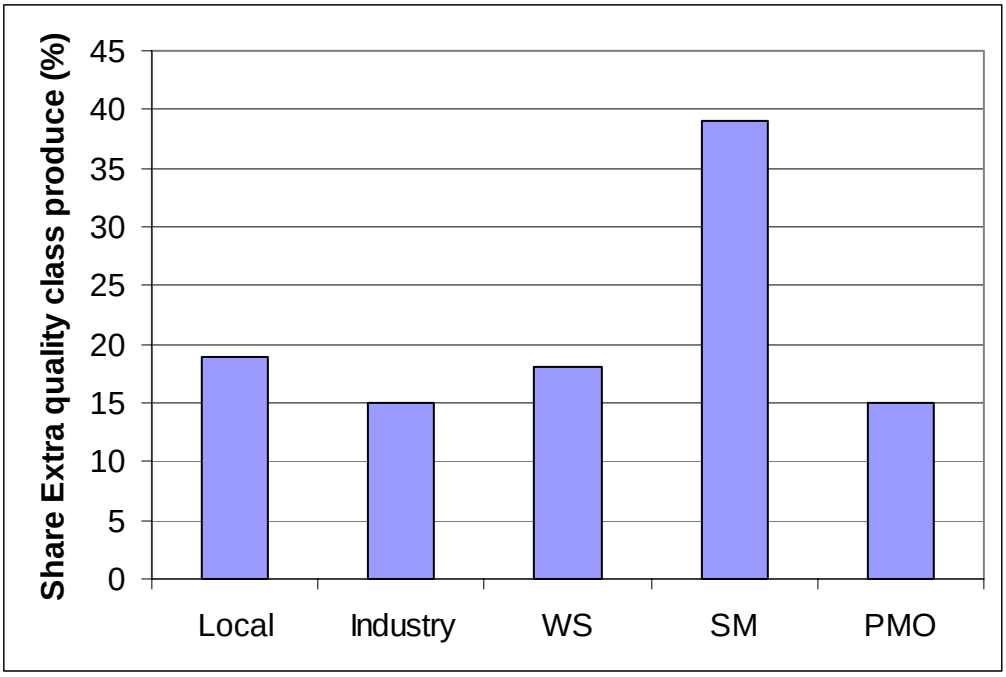


3. Implications for FFV Suppliers

23. FFV producers are affected by changing retail and procurement systems in several ways. As noted above, the implementation of higher standards for product quality and safety will make it difficult for producers with, for example, little knowledge or financial means for adequate crop protection to supply their produce to supermarket chains. Furthermore, the expanding nature of the supermarket chains and the centralisation of procurement favour large suppliers over small growers. On the other hand, supplying to a supermarket chain may involve substantial benefits for a FFV producer in terms of the substantial demand of the buyer, as well as the potential for solving idiosyncratic market failures that the grower might be faced with.

24. Figure 2 shows how the average quality of products from growers in the survey differs according to the marketing channel that is used. The quality of products supplied to supermarket chains is much higher than the quality of products sold elsewhere: the share of Extra class products sold to supermarket chains is almost 40%, while this share is below 20% for all other marketing channels. We should note that the average quality of produce sold through a producer marketing organisation is also very low (only 15% Extra class). We will come back to this issue later when we discuss the potential for PMO establishment. Furthermore, the survey shows that the quality of products sold to supermarkets is not only higher but also that there has been a continuous growth in the share of highest quality produce in the period 2000 to 2003 for growers that sold products to supermarkets in that period. On the other hand, growers that sold most of their produce on the local market have seen a significant decline in the average quality of their products in that same period.

Figure 2: Share of Extra Class Produce for Different Marketing Channels of FFV



25. From the survey we find that a lot of the growers have made investments in the last ten years to upgrade their farming operations. According to experts at VUZE (the research institute for agricultural economics in Prague), FFV producers will invest first in irrigation and storage facilities to improve and preserve the quality of their products and last in services like washing, sorting, packing and transport equipment. Most of these investments are made by using own resources. We found no evidence of forward credit or loans from the buyer of the products, and bank loan guarantees are given only rarely (and the few cases that we found included mainly the PMO and never a wholesaler or supermarket chain). This contrasts to the substantial buyer-supplier investment assistance that was found by Dries and Swinnen (2004) for the case of the dairy sector in Poland. Growers that supply their products to PMO or wholesalers seem to make significantly more investments than other growers, while producers that supply the local market

are making significantly fewer investments than growers that use other marketing channels. However, there is no significant evidence that farmers that sell their products to either wholesalers, PMO, or supermarket chains grow faster than other producers.

26. Because of the importance of small producers in the Czech FFV sector, and as it may be extra difficult for these producers to comply with the requirements from supermarkets in terms of quality and volume of delivered produce, we would like to conclude this section with a short review of the importance of Czech producer marketing organisations in the FFV sector.

27. There exist five PMOs for vegetables and 3 PMOs for the marketing of fruit in the Czech FFV sector. The PMOs for vegetables market only a minor share of the total vegetable production of the Czech Republic (15%), but between 85% and 90% of all products that are sold through the PMOs are bought by supermarket chains. The PMOs for fruit hold about 50% of the total fruit market and approximately 60% of their members' produce is sold to supermarket chains. The rapid changes that occurred in the food retail sector in the past decade (aided by financial support from the EU as part of the accession programme) have been the main driving force behind the organisation of farmers. Four out of five of the interviewed PMOs indicate that the main reason for their establishment was to gather sufficient quantity and product varieties to satisfy the requirements of the large supermarket chains.

28. The potential benefits of a PMO for its members include increased bargaining power vis-à-vis the buyer of FFV products and services provided by the PMO to its members. The growers in the survey that were members of a PMO received the following services: extension service (55%); storage, sorting, and packaging facilities (60%); information access (73%). Furthermore, the interviews with PMOs showed that some PMOs also assist their members to have facilitated access to inputs through a payment guarantee programme between the PMO and the input supplier. Finally, from an interview with one of the main banks in the Czech Republic we found that members of a PMO were also in a preferred position to apply for a bank loan because the PMO would provide some kind of payment certainty.

29. However, while PMOs help farmers to get organised and gain bargaining power, we should keep in mind that not all farmers may have access to the benefits of these organisations. First, almost all of the interviewed PMOs had some kind of requirement or preference that new members should comply with (not always an absolute requirement, or barrier to entry). For example, ZN Fruit screens all of its potential new members. In this process quality is the most important indicator: new members should have high quality production and are required to be certified with the SISPO label for integrated pest management. CZ Fruit and Litozel (vegetables) both stated that the varieties or assortment produced by new members should fit the requirements from the supermarket chains. In most cases new members that have storage, sorting or packaging equipment are preferred.

30. Second, even in the case of a small producer (or a producer with lower quality production) becoming a member of a PMO, it is not certain that the new member will gain automatic access to the benefits of supplying to the large supermarket chains. One of the PMO provided the example where the storage facilities of a few of its members are used to centralise products from all the members of the PMO. All products are then checked for quality and only the highest quality products are selected to be sold to the supermarket chains. Such a system of centralisation of products of different quality and then sorting and selling products to different

marketing channels according to quality may lead to various problems in the long run: high coordination costs and possibly lower prices for the better members compared to the case where these larger producers, with better quality products would sell directly (or as a sub-PMO) to the supermarket chains. Hence, PMOs may not prove sustainable in all cases.

CENTRAL AND EASTERN EUROPE

IMPACT OF FOOD RETAIL INVESTMENTS ON THE FOOD CHAIN

ANNEX 3

IMPACT OF RETAIL TRANSFORMATION AND PROCUREMENT SYSTEM CHANGE ON THE RUSSIAN DAIRY SUPPLY CHAIN

ANNEX 3

IMPACT OF RETAIL TRANSFORMATION AND PROCUREMENT SYSTEM CHANGE ON THE RUSSIAN DAIRY SUPPLY CHAIN

1. Introduction

1. This section of the report examines supermarkets and their dairy supply chain in Russia. The section summarises interviews with supermarkets, dairy product processors/manufacturers, wholesalers, dairy farmers, and other key informants in Moscow and environs in July 2004. We also reviewed the scant existing literature on supermarkets in Russia (mainly USDA GAIN reports since 2001 and several reports of consultancy companies like IGD and GFK[1]) and reports on the Russian dairy situation (USDA reports and several Russian reports). However, there was no existing literature on the procurement systems for dairy products of supermarkets in Russia, nor supermarket supply practices of dairy processors and wholesalers operating in Russia.

2. Our interviews took place over eight days in July 2004 with seven store walk-throughs to observe the dairy section (in a small shop, in an open "market", in a Pyatorochka, in two Ramenka stores (one hypermarket, one supermarket), in one Sedmoy Continent, and in one Auchan). Thirteen interviews were undertaken with the following:

(i) **Retailers.** We interviewed the main foreign chains: Metro (Germany), Ramenka (Turkey), Auchan (France), and Spar (Holland/Russia, the Russian stores of which were bought in August 2004 by Rewe/Billa (Germany) after our interview). We were unable to get interviews with the three main Russian chains.

(ii) **Dairy Product Wholesalers.** We interviewed two "niche" wholesalers mainly of imported products: Eurofresh and Selecta.

(iii) **Key Informants.** To get a general picture of the farm sector, we interviewed: the foremost agrifood economist in Russia, Prof. Eugenia Serova of Analytical Centre AFE; the Union of Dairy Producers (an association initiated by Wimm Bill Dann, the largest dairy firm – the Union is the main dairy federation of large processors as well as of others in the cluster); and ACCOR, the Russian Association of Farmers Enterprises and Agricultural Cooperatives.

(iv) **Dairy Product Processors/Manufacturers.** We interviewed a cross section of large, medium/large, and medium/small firms in Moscow in person (and by phone for those in Saint-Petersburg) – all selling to supermarket chains: Campina (Holland), Ostankinsky Molochy Kombinat (Russia), Wimm-Bill-Dann (www.wbd.com, Russia), Petmol (Russia, in Saint-Petersburg), and Baltijskoje Moloko (Russia, in Saint-Petersburg).

(v) **Dairy Farmers.** We interviewed one dairy farm, a large dairy-cum-vegetable farm (previously a *sovkhoz*) in Stupino, which supplies to Campina.

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[1] GfK is a consulting firm specialised in food retail research (see: http://www.gfkms.com).

3. Clearly such a brief reconnaissance can only provide some illustrations and hypotheses and broad points. However, a relatively coherent picture quickly emerged in the interviews, and we lay out here some clear and salient trends and patterns which were discernable. There were also some sharp dissimilarities between interviewees' responses on a few topics, mainly the prospects for growth in the various dairy farmer segments.

4. The questions covered are those of the general study of which this is a part, in particular: (1) what are the patterns and trends in the development of supermarkets in Russia?; (2) what are their procurement systems/practices for dairy products?; (3) what are the roles of wholesalers in the procurement system of supermarket chains?; (4) what are the processors'/manufacturers' practices for supplying supermarkets and procuring milk from farmers, including relations with farmers?; and (5) what are the marketing practices of farmers and what technological changes are they undertaking to meet the requirements of the supermarket channel for dairy products?

2. The Merchandising of Dairy Products in Supermarkets in Russia

5. This section first briefly covers general trends in the diffusion of supermarkets in Russia to set the stage for the discussion that follows; the statistical aspects are treated in the retail transformation section earlier in the report. Here, however, we bring out points that were emphasised by the dairy product procurement officers of the supermarkets, as well as by the processors, as being relevant to the expansion of dairy retailing via the supermarkets. We then discuss dairy product merchandising by supermarkets.

2.1 The Spread of Supermarkets in Russia

6. The share of supermarkets in overall food retail has increased dramatically in the past five years (since the economic crisis of 1998) in Russia. The overall share of supermarkets in national food retail went from nearly none to 10%, and that share is 30% in Moscow now. Sales are increasing at 30% a year.

7. Moreover, while there was some FDI before the 1998 financial crisis (by Migros Turk), there has been rapid influx of retail FDI starting in 2001. By 2004, Russia was listed in the recent report of AT Kerney (Burt, 2004) as the number one retail FDI destination in the world. Auchan, Metro, and Spar entered from 2001, Edeka in 2003, Rewe/Billa in 2004 (and bought the Spar stores in August 2004).

8. Moreover, Russian chains are moving into neighbouring countries –the Paterson chain, for example, is moving into Ukraine. We expect the regionalisation of chains (and their procurement systems) to accelerate.

9. Finally, several of the key foreign chains now in Russia, like MigrosTurk, Metro, and now Rewe/Billa, are already investing or plan to invest heavily in other countries in the region, so that one can expect the kind of regional presence of these chains (in retailing and procurement) that one finds of them in Central Europe. Correspondingly, there will probably be procurement links between the Central European and Eastern European operations, re-creating on a private

scale the kind of trade integration one had in COMECON, but now in the interior of procurement systems of major retailers based in Western Europe and Russia.

10. Finally, while the leading chains started in Moscow and then moved into the Moscow province before moving to Saint-Petersburg (or started in Saint-Petersburg), in the past two years, with acceleration in 2004 and planned in 2005 (all the retailers told us this), there has been a rapid penetration by the leading chains into "the provinces". The initial emphasis has been on the south-western and western area, more densely populated and wealthier than the central and eastern parts of Russia. Of course, there are also existing provincial-city based chains that are competing with the newly present Moscow-based chains that are moving into their provinces, which will tend to create a competitive push for both to fill up commercial space in the provinces.

11. This expansion is driven by several factors: (i) emerging strong competition among retailers, starting in 2001 with the entry of the foreign chains. This is competition which all feel will increase greatly with the already large and accelerating entry of FDI and massive investments on the part of the Russian chains (e.g. Metro, Migros, Auchan, and Pyatorochka which are all doubling their number of stores over this year alone). Many of the prime spots in Moscow are already filling up; (ii) it is difficult to get prime real estate in Moscow, and considered easier (administratively), faster, and cheaper to get it in the provinces; (iii) there is an initial flush of "easy profits" when one enters a very under-stored area – the same pull factor that creates FDI flows to Russia, or that has sent global retailers to developing countries in massive waves over the past ten years. This pattern of intra-country expansion is very familiar from Latin American patterns over the past decade (see Reardon and Berdegue, 2002).

12. The concomitant change in retail occurring with the spread of supermarkets is the decline of small shops and open markets. This has already demonstrably/statistically happened, and it is also a trend seen, felt, and expected very strongly by all the persons we interviewed. One milk processor told us that three years ago there were three open markets and one supermarket near his home in Moscow, while today there are three supermarkets and one open market; he said this is a microcosm of what we would see all over Moscow and now Saint-Petersburg, and we should expect it in the provinces soon. An important element emphasised in various interviews is that supermarkets are not just larger and thus more convenient to get a variety of products on one shopping expedition, but also much more diverse in product offerings for a given line – such as dairy products, discussed below – and, a crucial point, the supermarkets and hypermarkets offer products, in particular processed and semi-processed products such as dairy products, that are cheaper than one can find in small stores and open markets. It is perhaps only the informal sector with its very local sales in small towns that can withstand this onslaught for long. As the Russian Dairy Union told us: "*give that mode of sale one decade and it will disappear, but in the meantime it will continue to be a factor on the production and retailing side.*"

2.2 Supermarket Dairy Product Merchandising

13. Dairy products have traditionally been distributed in open market stalls or via small shops in Russia. In the Communist period, dairy products continued to be sold in this way in small towns and rural areas and in larger towns and cities were distributed in the State retail units in a very limited assortment. As the Ramenka dairy products procurement officer noted: "*before*

Perestroika two kinds of cheese were available – cheese with big holes and cheese with little holes, with the latter being the luxury option!". Smetana (sour cream), kefir (liquid sour cream/milk), fluid milk, powdered milk, and butter were the other main products, all traditional. There was no yoghurt, no flavoured dairy drinks, and no UHT milk. In small towns and villages, this limited line came from the private 1-2 cows of the private plots of *kolkhoz* and *sovkhoz* members and as part of the diversified production of the collectives that were also producing wheat, beets, cabbages, and so on.

14. These traditional products were simply sold informally among households or in the traditional shops and stalls. In cities of several hundred thousand, the product was collected and processed by government processing plants built in the 1940s and 1950s, many of which still exist in the provincial towns and cities.

15. Supermarkets entered the dairy market in what was at first a slow crawling climb, and then in the last two to three years, a rapid crescendo to the point where, according to the retail interviews, the dairy sales are growing as fast as overall supermarket sales, and in some cases even faster. That suggests that it is reasonable to conclude that supermarkets' share of dairy sales is roughly the same as their share of overall food sales.

16. There are several other indicators and causes noted in our supermarket interviews, of the rapid development of dairy merchandising in supermarkets.

17. First, the share of dairy in total supermarket sales has risen rapidly over the past five years. Ramenka noted that the current share of dairy sales in the provincial stores (such as Kazan) is only 5%, similar to how sales used to be a half-decade ago in Moscow, where the current share is 10%. Auchan noted a climb in the share of dairy in their sales in the past two years from 8 to 10%.

18. Second, an important reason for the increase in the share is the vast expansion of the diversity of products. While a very well-stocked small shop might have 400 SKU's (Shop Keeping Units, showing different types of products and brands) of dairy products, a typical supermarket would have 500-1,000 and a hypermarket 1,000-2,000. The increase in the diversity plus the increase in volume sold per product led to the increase in the share of total supermarket sales rising for the dairy category. A cascading set of demand- and supply-side changes drove the increase in dairy product that is key to the story of supermarkets and dairy in Russia.

(i) The first stage of the demand-side impetus for the rise in diversity came with the rise in affluence combined with the exposure through television to "western" products in the late 1990s and 2000s.

(ii) The first stage of the supply-side impetus for the increase in diversity came with the reduction of constraints on imports after perestroika and the easing in the 1990s; wholesale firms in Moscow and Saint-Petersburg began competing in the mid-1990s (more on this below) to bring in imported cheese and yoghurts, new products for Russians.

(iii) The second-stage of the supply-side impetus for the increase in diversity came with the financial crisis of 1998 and the strong devaluation of the ruble in 1999. The sudden steep increase in the cost of imported products drove the major processing companies in Russia to

expand their capacity and enter new lines to rapidly substitute for imports. The largest firm, the national firm Wimm Bill Dann, led the way in 1999 by adding a major line for producing yoghurts locally. As a result, Campina (Dutch), Ehrmann (German) and Danone (French), that had all been importing yoghurts, were immediately challenged to build their own local plants in 2000. This increase in supply reduced the price of these non-traditional products relative to traditional products.

(iv) The second-stage of the demand-side impetus came in 2001-2003 with the entrance of foreign retailers such as Metro and Auchan, and increase in FDI from Ramenka and the very strong riposte in competitive investment by Pyatorochka and Perekroistok, as noted above. Dairy product differentiation became a key competitive tool given the importance of dairy in the Russian diet. Moreover, there was considerable segmentation of the retail market with chains differentiating their merchandising and offer to appeal to different income strata.

(v) The third stage of the supply-side impetus to product diversification came in two ways – firstly from the development of specialised wholesalers/importers dedicated to the supermarket and hotel/restaurant trade (discussed below) who actively sought diverse products from France, Italy, and elsewhere. Secondly, the product-line diversification of their plants – such as Campina adding flavoured yoghurts, Wimm Bill Dann adding a number of juice/milk combinations, Danone adding healthy-drinks lines. The reason for this, as revealed in the interviews, is that the supermarkets wanted to reduce transaction costs (of dealing with numerous suppliers) by getting "one-stop-shopping" for a diverse line of products from few suppliers. As discussed in more detail below, the large processors were, and are, shifting their marketing over to focus on the supermarkets and create a "symbiotic" relationship where they can innovate and add value (moving toward shorter shelf-life, "fresher" products, which the supermarkets keenly want, as noted in all the interviews). At the same time using the dairy market motors represented by the supermarkets which have the cold chain, shelf-space, and customer throughput to be a big boon, in fact to be central, to the growth and success of the large processing companies in Russia. For example, Campina went from sending 15% of its sales to supermarkets in 2001, to 35% in 2004, and plans to be at 45% to supermarkets in 2005.

19. Thirdly, both wholesalers and processors told us that they see strong advantages of the supermarket/hypermarket chains from two perspectives. (i) They see the chains quickly beating the traditional retailers of dairy products due to product diversity, cost to consumer, and quality. Hence they are shifting (as we illustrate below) quickly toward the supermarkets, believing they are a good bet as clients who will help them grow their business. (ii) They see the chains as less costly business partners from the point of view of transaction costs. Supermarkets generally have annual contracts with their main suppliers (processors and wholesalers), and a supplier delivers a relatively large volume to a given chain and averaged fixed costs are thus much lower than for deliveries to many small stores.

20. Below we discuss the examples of the chains that we interviewed.

21. **Spar**. Spar is a "franchise" chain based in the Netherlands that has operations in many countries. In a given country, it tends to have some "owned stores" and then the rest are

franchise stores, for which it does not have financial responsibility. It provides training and certain common merchandising practices for the franchise stores, but most importantly provides procurement services (buying in volume and distributing from central warehouses) for various products, mainly non-food products and processed foods, but also, in some cases, perishables. Spar started in 2001 in Moscow, and in 2004 began expanding into the provinces. CIES[1] (2004) noted that Rewe/Billa (Germany) acquired the Spar chain in Russia in August 2004, after our interview, and stated that "*the Spar Russia managers stated that this came as a total surprise to them.*"

22. By July 2004, Spar Russia was doing centralised procurement of processed foods for the franchise stores. Two points that coincide with the general trends above are: (i) the share of dairy on average in the Spar stores is 8-10%, up from less than 8% as recently as 2002; (ii) the share of imports in total dairy sales is going down – it was 15% in 2002 and is now only 5%, due to cost-cutting and to a gradual shift toward fresher (lower shelf life) products. Interestingly, different from the general pattern, Spar de-diversified over the past three years from 2000 to only 800 SKUs in its stores. However, it is re-diversifying, but carefully evaluating the profitability of each SKU, and then introducing new products decided by their procurement group and the managers of the cooperating franchisees. Moreover, they charge the equivalent of a slotting fee for a determinate period– a half year – called a "guarantee fee", aimed at buffering the risk involved in the introduction of new SKUs.

23. **Auchan**. Auchan plans to have 15-20 hypermarkets through 2006 in the Moscow region and into the provinces through 2005. It is also planning small stores (supermarkets) for inner city penetration (a common move among the chains in Russia, and part of a general international trend of diversification of formats to penetrate denser inner city areas as competition intensifies). Again, several general trends are reflected in this case: (i) they reported that the dairy share of sales is steadily rising, reaching 5%/65 or about 8% today (food is 65% of the total sales of the hypermarkets while fresh foods in general are 20-25% of total sales, relatively high for hypermarkets); (ii) dairy product diversity is growing quickly at 10-15%; dairy products are now at 1,200-1,600 SKUs, thus already a very diverse section. The cheese section of this French chain is quite important, and as most of it is imported, the share of imports is 10-15%, relatively high. They have a strong goal to increase fresher dairy/short shelf life, so it is reasonable to assume that the share of imports will decline in the future. As did all the other retailers, they noted that their main constraint to increasing these products is logistical, as most of the logistics was built for moving ambient products, so the cold chain is very underdeveloped.

24. **Metro**. Metro is a German firm with large hypermarkets that began mainly as *cash & carry* stores, selling as wholesalers to small retailers. Metro has five hypermarkets in Moscow, and will have two in Saint-Petersburg by mid-July, then another hypermarket by the end of July in Jaroslav, then another in August in Kazan, then in September it will have two more in Dor and Volgorod. Hence, it is in an intensive store-opening phase in the western third of the country – following the Russian chain frontrunner, Pyatorochka, in basically doubling its stores in a year, an incredible growth. The Metro stores in Russia service hotels and restaurant buyers, small traders, and "complex business" and high-end consumers. The third category is growing the fastest. In order to service these segments, Metro needs to carry a very broad line of dairy products. They

[1] CIES is a global food business network, doing research and organizing events related to the food retail sector (see http://www.ciesnet.com).

reported to us that they have 4,000 SKUs (which includes a wide range of juices in their estimate), versus the second most diverse dairy section, in Sedmoy Continent, which services high-end clientele with 2,500 SKUs. Dairy is 10% of sales.

25. **Ramenka**. Ramenka is a Turkish chain that was the earliest foreign entrant in Russia, in 1997. It is now the third ranked chain, with 5 hypermarkets, 16 supermarkets, and 4 mini markets. A typical hypermarket has USD 30 million of overall sales. Typically 10% of sales are in dairy. That spells a large number of dairy products: we observed one store with about 1,000 SKUs of dairy (excluding juices and ice-creams) in the hypermarket, and 500-1,000 in the supermarket, covering half the wall of a huge store which measured 300 yards long and two yards high. The share in Moscow is at 10%. It's dairy sales are thus far less developed in the provinces, where for the new stores the share is about 5% This is because product diversity is not as developed on the demand side, and it remains difficult at present to get diverse supplies to the provinces at low transport cost (see below).

26. As with Spar, product diversity has followed a "U" curve over time. Starting in 1997 with a high share of imported goods and a diverse range, these items were reduced in number after the devaluation, and since then diversity has been re-introduced into the dairy section, with the addition of products that are profitable and the reduction of the import share.

3. The Procurement of Dairy Products

3.1 Domestic versus Foreign Sourcing

27. In general, retail procurement of dairy products over the past 15 years can be described as an inverted "U", or perhaps more accurately, an inverted "J" curve: after the communist period, but before the emergence of supermarkets in the mid-late 1990s, as noted above, most dairy products were local cheese, butter, packaged and fresh milk, smetana, and kefir. By the mid to late 1990s, wholesalers began importing significant volumes of cheese, butter and yoghurt. On the eve of the financial crisis of 1998/99, the great majority of these latter items sold in supermarkets were imported, mainly from France, Italy, Holland, and Germany.

28. However, as discussed further below, in the case of actions of specific processing firms, in 1998/99 there was a sharp devaluation of the ruble, causing imported dairy products to be much more expensive. Moreover, our interviewees noted that tightened border controls and increased administrative requirements for importers of food products have made the import of dairy products more difficult in recent years. According to the interviewed distributors, this was relatively more problematic for the smaller importers with often irregular and smaller shipments crossing the border.

29. The response to these changes was that processors in Russia started to produce yoghurts, some butters, and some non-traditional cheeses within Russia, opening plants in 1999 and then increasingly in 2000 and onwards. This shift in production started with Wimm Bill Dann and spread to several other large processors, including large foreign companies such as Campina, which had primarily been importing. This led to a sharp reduction over the past five years in the share of imports among total dairy products sold by supermarkets: today, the dairy product

assortment of an average supermarket or hypermarket consists of 5% imports for milk, yoghurts and traditional Russian dairy products, and 15-20% imports for cheeses.

30. The cases of specific products are as follows:

– Yoghurts were introduced into the Russian market by foreign dairy companies, as the product was not produced on Russian soil during the Communist period. As early as 1992, Campina, the Dutch dairy company, started importing yoghurts from its German production site into the Russian Federation. In the second half of the 1990s many of the foreign owned dairy companies that had been importing yoghurts into the Russian Federation (including Danone, Campina, Ehrmann, and several others) invested in local production facilities. Since then, the share of yoghurt imports has decreased significantly.

– Cheeses continue to make up a large part of total dairy product imports. This is due to the fact that local cheese production is underdeveloped and, furthermore, as consumers (mainly in Moscow) are becoming wealthier, the demand for specialty cheeses from France, Italy, and so on is increasing. Cheeses are mainly imported through distributing companies (see cases below). Smaller distributors mainly focus on importing a small but very specialised assortment of cheeses, while larger distributors try to import a very diverse assortment (often also including other fresh products such as meats, frozen bread, jams, etc.) to minimise transaction costs for their customers and allow one-stop-shopping. Larger distributors are also sometimes known to buy specific cheeses from the small distributors to complement their own assortment in case the customer has a special demand.

31. The upshot is that cheese production for supermarket chains is a growing (potential) opportunity for local producers. For example, one of the chains noted that there is scope for import substitution, in particular for cheeses, at least if viewed broadly as cheese production from CEE in general. They noted that in 2001 they were importing the French cheese "President"; but last year they began importing the same cheese from President plants in Poland, selling at 30% lower price, thus enlarging the market for this cheese. They see this as evidence that imported cheese product can be produced in the CEE region and need not always be imported from Western Europe. This kind of "import substitution" aimed at cutting costs is on the minds of many of the chains. One chain noted, "*we want independence from imports.*" Most also noted that there are substantial "import substitution" opportunities for local suppliers to produce the types of products, mainly cheeses, that are now imported – and also to locally process (for example, slice and package) cheese for the consumer and food service markets, via *cash & carry*s such as Metro, as well as via supermarkets. There is some evidence of emerging "knock-offs" of high-end cheeses by local producers. It is likely that luxury fine cheeses from Western Europe will continue to be imported, but the middle- and low-end cheese imports, just as with yoghurts in general, will be produced and sourced locally in the short- to medium-term.

3.2 Shift toward Centralised Procurement Systems

32. Most supermarket/hypermarket chains in Russia have a central warehouse to store non-perishable products and manage inventory. This centralisation mirrors a general tendency in supermarket procurement systems in many countries (Reardon et al. 2003). In some cases this warehouse is built and owned by the retail company (e.g. Perekriostok), while other retailers rent warehouse space and storage facilities. However, in all cases, fresh and semi-processed products, including dairy products, are still delivered directly to the retail stores by the suppliers.

33. Several factors still inhibit the centralisation of procurement for dairy products in Russia – even in Moscow where the threshold volume is already being reached by the leading chains. In all our interviews with retailers, interviewees emphasised that fresh logistics (for fresh and semi-processed products) is a major constraint to centralisation. They noted that Russian food logistics had been geared, even in Moscow, and more so in the other areas, toward frozen and dry/processed products. Since it exacerbates the lack of adequate infrastructure (fixed and mobile) to handle perishables, interviewees noted that road congestion is a major problem in food logistics in Moscow and Saint-Petersburg. Outside of those areas there are major transport costs, but resulting more from long distances, poor roads, and so on.

34. This is a common problem elsewhere in the CEE region (as well as in Latin America and East/Southeast Asia) and several large chains in Russia are doing what many leading chains in other regions are doing: turning to multinational logistics companies that have set up shop in Russia to alleviate these constraints. For example, Auchan (and Danone) use the services of F&M Logistics[1]. The latter has a distribution centre near the Moscow airport space, from which Auchan rents (one of several warehouse spaces it rents). The interviewees in general complained of insufficient logistic company services in Moscow, but even more so in other major cities and provinces. This is a major challenge which needs addressing in order to help both retailers and suppliers and thus consumers and food sector growth.

35. The retailers provide three paths for resolving the above bottleneck. First, they rent space from logistics firms, as noted above. Second, they are planning to build fresh and semi-fresh product DCs (distribution centres) as soon as possible, several noting they plan to do this as early as 2005. Third, they require processing firms and wholesalers to deliver dairy products directly to the stores – and thus they try to keep the supply chain for fresh products as short as possible, dairy processors and distributors having the responsibility to deliver their products on time and in good quality to each of the retailers' outlets in the city. However, this situation is not ideal for the retail companies because it creates high administrative and labour costs to unload trucks and perform quality controls throughout the day.

36. Moreover, unlike in Central Europe, there are as yet no cross-border distribution systems set up by the chains, at least not for dairy products. Even within Russia, the developments in the retail sector are at a relatively early stage and there is no cross-regional procurement system yet in place. The supply of similar dairy products throughout different retailer outlets (even over different regions) is made possible by the dairy companies' regional distribution system and

[1] F&M (Faure & Machet) Logistics, a French firm that started in 1994 in Russia, built a large distribution centre/warehouse near the Moscow international airport in 1998, partially funded by EBRD (EBRD, 1998).

logistics. For example, Wimm-Bill-Dann operates 26 branch offices (sales offices) in all the main cities in Russia. Campina uses a regional logistics network (operated by different distributors in different regions) that covers the whole Russian territory. Danone complements its Russian assortment with imported products from other operating countries (for example, France).

3.3 Shift toward Specialised/Dedicated Wholesalers and Direct Supplies from Dairy Companies

3.3.1 Change in Supermarket Procurement Systems for Dairy Products

37. Supermarket chains in Russia tend to source dairy products in one or more ways: (1) from wholesalers who in turn source from processors; (2) directly from second-stage processors (such as Wimm-Bill-Dann, a large Russian dairy company), perhaps with the help of a logistics provider.

38. There have been two general changes over the past 3-4 years, initiated by the leading domestic and foreign chains (with the second and third tier chains still using the more traditional procurement systems (reliance on general wholesalers): (1) a shift from general to specialised wholesalers; (2) a shift from wholesalers to direct sourcing from second-stage processors; and (3) a reduction in the number of suppliers whether wholesalers or processors.

39. These changes are undertaken by the leading chains to reduce their transaction costs (by dealing with fewer suppliers) while maintaining product diversity (by keeping both larger wholesalers and processors that can assure “one-stop shopping” for a diversity of products, such as Wimm-Bill-Dann and Danone), and by retaining niche wholesalers (such as those for high quality foreign cheeses) and processors with either a high-quality product (such as Campina) or with the ability to serve a provincial location difficult for their other main suppliers to supply.

40. We observed in store visits, however, that there is still significant brand/product overlap where there are a number of brands for similar products, implying that retailers consider that consumers are looking for brand diversity. At the same time, retail interviewees noted that they now seek to reduce unneeded redundancy, thus reducing the number of suppliers, while maintaining the brand and product type diversity sought by consumers. Following an international trend, this puts pressure on “surviving” suppliers to either handle a large volume of diverse products or to focus on quality niches and upgrade to protect that turf. We observed these pressures and these strategies in supermarket suppliers that we interviewed.

41. This implies stiff pressure to add new product lines and diversify. In interviews, we observed and heard plans for increasing convergence in product line and quality among the frontrunner suppliers. For example, Wimm-Bill-Dann introduces juice/milk beverages, and the other frontrunners quickly tool-up to provide their own brands of these beverages.

42. Moreover, we already noted above that domestic producers follow importers by producing imported products such as yoghurt locally, which then sets off a stampede to locally produce these products. Moreover, the high transport costs outside of western Russia tend to limit

these "procurement system rationalisation" tendencies to western Russia, in particular in the larger urban areas.

43. Illustrations from our retail interviews are as follows:

(i) **Spar**. Spar was buying dairy products from 10 companies two years ago, and today only deals with three main (such as giants Wimm-Bill-Dann and Danone that together have 15% of the whole national market) and two secondary distributors/wholesalers. The five companies that were retained showed the best results in terms of delivering scheduled supply, order satisfaction, required documents in place, and the fresh range of products.

(ii) **Auchan**. Auchan has two groups of producers; a handful of large suppliers (the biggest processors in the country, domestic and foreign) for at least 50% of their supply, with the other 50% coming from the rest of their suppliers; and a mix of wholesalers and smaller processors. Of the latter, some 10-15% (of the total) comes from small producers. They explained that this is useful in order for them to stay flexible and not get locked into (and thus suffer from the bargaining power of) only a few suppliers. An example of a small/medium processor is Delva in Voronzh (we need to verify the town name). Delva became "strong enough" to be on the suppliers list, but "*Delva has low costs but poor logistics – which is a typical and major problem in sourcing from processors in the provinces.*" Note that several Auchan suppliers informed us that Auchan pays its suppliers 2-3 weeks after delivery in Moscow, but only one week after delivery in the provinces, further indicating supplier constraints in the provinces.

In addition, Auchan is moving fast toward its own "private label" (a general trend in Russia as elsewhere). Starting in late 2004, it will put out bid to register suppliers and 10 can bid.

(iii) **Metro**. Metro is expanding its preferred supplier list as it quickly adds stores, from 500 suppliers in 2001 to 800 in 2004 (this is for the whole food section). However, they noted that their goal is to focus on having their "core suppliers" in various food categories on which they rely for supply growth in the future. 80% of their suppliers are "core"; they have that set of key (preferred) suppliers present in all their stores. In the dairy category those include the main processors in the country - Wimm-Bill-Dann (Russian), Ehrmann and Hochland (German), Campina (Dutch), Danone (French) – it is "*easiest with few suppliers.*" They source all their yoghurt from a few big yoghurt producers (named above); they buy their smetana (sour cream) and fresh milk locally, while UHT can be local or from national producers.

Metro noted that there are significant problems of packaging and logistics in expanding to more suppliers and to the provinces, as well as in substituting for imports of cheese. They noted that there are only a handful of logistics firms, and these are concentrated in Moscow; very few are in food products, although a decade ago there were none in food, so the emergence of even a few now, though far from adequate,.is a boon. They also noted the dearth of processors adequate for their needs. In particular, they now do in-house cheese-slicing as the value-add they offer to their diverse clientele; they noted that there are big opportunities for suppliers to perform these services were they to have

adequate equipment, as Metro is striving to outsource all processing activities. Metro (as is the case with the other retailers) does not help suppliers upgrade (through loans or grants); at most they respond to queries by banks requesting creditworthiness evaluations of the suppliers who are seeking loans.

(iv) **Ramenka**. Ramenka noted that they have 50 suppliers at present, half direct suppliers and half distributors/wholesalers, and they are soon going to cut to only 30 suppliers. They informed us that they plan to retain the larger processors and cut many of the wholesalers, and retain the small/medium firms who prove themselves very good at particular niches, which they can deliver consistently.

44. They rely mainly on the handful of large national processors for most of their dairy products, and only use the local processors for a few products (such as local fresh milk and smetana). An important point to note is that the national processors are expanding along with the main chains such as Ramenka, following them into provincial cities/towns and serving them there. They noted that Wimm-Bill-Dann followed the new wave of supermarkets (such as their store) into Rostov to supply the chains there, buying a local plant and bringing in their product from the Moscow region. They fear, however, that the substitution of “imports” from Moscow into the provinces is too slow in coming. This is because they feel that there is underinvestment in upgrading provincial suppliers to meet the needs of the chains that are now rapidly moving into the provinces, and that there will be a substantial excess demand for dairy products in the regions and therefore strong opportunities for investments by suppliers. The high transport costs from the Moscow region and this rapidly developing excess demand explain the rapid move of Wimm-Bill-Dann and a few other large processors out into the provinces, buying and upgrading the facilities of the provincial processors.

45. Ramenka (as well as a number of the other leading retailers) are also working with specific suppliers on contract to develop private label products, which already constitute 9-10% of their dairy sales. For example, they contract Parmalat in Belgorod to this end. Most of the retailers consider this the "*wave of the future*," following European trends.

3.3.2 Wholesalers Adapting to Supermarket Procurement System Change

46. The dairy products wholesale sector is composed of four groups: (i) general wholesalers who buy processed products from imports or domestic production and sell to all retailers; (ii) specialised wholesalers, specialised in a given product such as cheese, dedicated to some retail segment such as supermarkets and/or hotels/restaurants/institutions (HRI) or to a specific processor such as their import agent; (iii) general fresh milk traders that collect from farmers and sell to processing plants; and (iv) agent-collectors for specific processing firms.

47. As noted in the first subsection to this section, the leading chains (as opposed to the second-tier chains which continue to use the traditional wholesalers) are shifting from sourcing from the traditional wholesalers of milk products toward direct sourcing from processing and use of specialised wholesalers in western Russia and agent-distributors of the main processors in the other provinces.

48. In the next subsection we treat the issue of the processors and what they are doing to gear up to supply the supermarkets directly. In the present subsection we focus on specialised wholesalers. In Russia this means mainly imported products because there are few specialty dairy products produced in Russia. Diverse yoghurts and juice milks are bought from large processors directly. The main imported product is cheese, and most cheese is imported. Bulk or commodity cheese is imported by general wholesalers, of which there are half a dozen.

49. Our interviews revealed that a number of the specialised importers started as general importers and then focused on a specific line, such as the cases of Eurofresh and Selecta described below. Several are distributors for large foreign companies; Freshline has a contract with Nestlé (which produces no dairy products in Russia, only chocolate) and with Danone (to import, not to distribute Danone local products). Molokomir also imports Danone products. Eurofresh imports Danone products from France, and Nestlé products from Germany, and supplies to supermarkets and to HRI.

50. The respondents told us that the specialised import sector is fairly concentrated, with half a dozen main players and a number of less central players catering to the small niche markets of specific segments, in particular in HRI. An example would be high quality parmesan cheese imported for Italian restaurants. There has been a rapid and strong increase in competition in the wholesale sector over the past 4-5 years and, as noted above, retailers are under pressure to cut wholesalers from their lists and stay with only the most competitive. Moreover, for the wholesalers retained, we were informed that they are expected to perform additional services for the retailers such as tracking inventory, sales, and customer data. That is, following an international trend, retailers are beginning to expect distributors – in particular of the imported category – to play the role of "channel captain." Beside the information constraint that specialised importers resolve for retailers, they also resolve the high transaction costs (as perceived by all the respondents) of moving products over the border. The wholesalers told us that it is much easier to move larger volumes over the border, and that argues for aggregating over several retailers and creates significant economies of scale of importers, hence the concentration observed.

51. The following is an example of such a specialised wholesaler:

– **Selecta**. Selecta is a quality-cheese importer that started in Moscow and then moved recently to the Saint-Petersburg market. They estimate that this is a small niche, affordable to only 15% of the Moscow region consumers and 5% of national consumers. They note that the Moscow market (leading changes in the rest of the urban markets) started to develop for imported products in 1994. At that time, a number of "commodity import" wholesalers emerged. There was no significant "high-end market" yet in the mid-1990s. At that time, there was stiff cost-price competition among these wholesalers, of which Selecta was one, and Selecta moved into the "quality-products" niche in the late 1990s. They noted that five years ago, there was far less product differentiation in the dairy product market in general and the cheese market in particular. Hence (as we noted above) the surge in product diversity has accelerated over the past 2-3 years, driven by the surge in supermarket development. Their own business shifted nearly completely from an emphasis on small shops and open markets in the late 1990s to supermarkets (the great majority) and some HRI by 2004. In 2003/4 their sales have been growing at 30-40% a year, and as they informed us, "*growing along with the growth in supermarkets*" – especially aided by the

coming of foreign chains seeking quality and diversity. Yet the coming of the foreign chains was a "*double-edged sword*" as business conditions toughened, and as the (foreign) chains introduced slotting fees and longer payment periods to suppliers.

3.3.3 Processors Adapting to Supermarket Procurement System Change

52. Almost all the interviewed dairy processing companies have an increasing share of their sales going to the large-format retail sector. At this moment, the share of sales of the leading processors to large format stores ranges on average between 20% and 35% both for Moscow and Saint-Petersburg based dairies, and is rising. This share is much higher now than five years ago when sales to this retail segment were almost non-existent in Saint-Petersburg, and the share of these sales in total dairy sales ranged between 5% and 10% in the Moscow area. In general, however, even in the small sample of processors we interviewed, there is a sharp inverse correlation between firm size and share of sales going to supermarkets; this is to be expected based on our points above about the "rationalising" of supplier lists being undertaken by the leading chains.[1]

53. The determinants of the shift by the leading processors toward marketing their dairy products to the supermarkets, thus displacing their sales to traditional retailers directly or via wholesalers, are as follows (gleaned from comments in interviews with both processors and wholesalers). Despite the costs and requirements of selling to supermarkets – slotting fees (introduced by foreign chains circa 2002 and taken up as well by leading domestic chains) and delayed payment (usually for several weeks), volume, delivery, packaging, and quality requirements, and even requirements for inventory management and analysis – there are substantial advantages for suppliers, such as: (1) being able to sell far greater volumes per transaction than to small retailers (and thus reduce average fixed costs); (2) having a rapidly growing market as chains expand both in Moscow and Saint-Petersburg and also into the provinces – being in a preferred supplier relation then gives easier/privileged access to this new market; (3) having the opportunity to diversify product lines (vastly, compared to the traditional retail market), with attendant value-added opportunities; (4) many of the leading chains and leading processors and wholesalers are in (yearly) contractual relations that reduce risk and transaction costs for both sides.

54. Shifting toward supplying supermarkets has important implications for suppliers in terms of investments, new practices, and marketing strategies. Below, based on interviews, we illustrate these for the cases of two leading processors, the leading Russian firm (and market leader), Wimm-Bill-Dann, and a market leader in yoghurts, the Dutch firm Campina (an international cooperative based in Holland).

[1] The interviewed dairy companies differ in terms of total daily milk deliveries. Campina (Moscow), the only foreign owned dairy company in the sample, has an average milk supply of 170 ton/day; Wimm-Bill-Dann, the largest dairy in Russia, owns 21 different processing sites around the country and three more in Ukraine, Kyrgyzstan and Uzbekistan, with a combined daily milk supply of about 4000 ton, of which about 1500 ton is supplied to the two Moscow-based factories. Petmol (Saint-Petersburg) has an average daily milk supply of 400-450 ton. Baltijskoje Moloko (Saint-Petersburg), was taken over by Wimm-Bill-Dann in 2002, with a daily milk supply of 150 ton. Finally, Ostankinski Agrikombinat (Moscow) process about 400 ton of milk per day.

55. **Wimm-Bill-Dann (WBD**). WBD started as a private firm in 1992, leasing land from the (public sector) Lianozovo Dairy Plant in Moscow, and began selling orange juice in Russia and other CIS countries. In 1995 they acquired a large stake (during privatisation) in the plant, acquiring majority control in 1995, and began dairy production; in 1996 and 1997, they acquired majority stakes in the Moscow Baby Food Plant, the Tsaritsino Dairy Plant and the Ramenski Dairy Plant; in 1998 and 1999, they began to expand into regions outside Moscow, acquiring dairy plants in Novosibirsk, Nizhny Novgorod and Vladivostok; in 2000 and 2001, they acquired majority stakes in dairy plants in Bashkortostan and the Krasnodar region in Russia, as well as plants in Kiev, Ukraine and Bishkek, Kyrgyzstan; in July 2001, they completed the acquisition of an additional 15% interests in Lianozovo Dairy Plant and Tsaritsino Dairy Plant; and in July and August 2001, they acquired 100% interests in dairy plants in the Altaisky and Voronezh regions of Russia. In 2001, WBD "went public" with an initial stock offering. By 2003/4, 75% of their output is in dairy products, and the rest in juice. They have joint ventures with Cargill (US) (on the juice side) and Tetrapak (Sweden). By 2004, WBD produces for all price segments and is by far the largest dairy products firm in Russia, with 54% of the Moscow region market and 11% nationally (far beyond the next competitor).

56. In 1995, WBD had 3 plants, and by 2004 has 25 plants in 21 regions of Russia, plus Ukraine, Kyrgyzstan, and Uzbekistan (the latter three entered in 2001, 2003, and 2004 respectively). Five of their plants have ISO certification and two have EU certification for EU exports. WBD has 26 trade branches and marketing offices. They are rapidly expanding regionally (buying regional plants and selling regionally) and internationally.

57. WBD's product diversity is extensive, with 1100 SKUs of dairy products (they only had 300 in 2001…) and 150 types of juice. They noted that they sell 170 SKUs of dairy products to an average supermarket client, 200 to a hypermarket, 100 to (smaller) discounters, but only 80 to small shops; they noted that a typical supermarket has about 500 SKUs of dairy products, and a small shop, only 130 SKUs – reconfirming the general point above about the great product diversification in the dairy sector that was induced by the rise of supermarkets.

58. Their plants are very large by Russian standards, with the largest (the one we visited) at 1200 tons a day, and another in Moscow with 500-600 tons/day. They handle 4,000 tons of milk a day, 1500 tons of which come just from the Moscow region. Compare 4,000 tons a day today with 1,300 tons a day just five years ago, and one gets the image of a company growing exceptionally quickly.

59. Four points are to be noted regarding the distribution of WBD products. (i) While WBD increased their production volume 3-fold over the past five years, their sales to supermarkets increased 20-fold, indicating a sharp shift toward supermarkets and away from traditional retailers. They informed us that 20% of their sales to supermarkets are "direct" and the other 80% are via wholesalers. The latter figure was 93% five years ago; they indicated that there is a clear tendency to shift to direct contracts with supermarkets away from the intermediation of a wholesaler, reaching a majority of direct contracts in five years. (ii) WBD is facilitating (mainly through establishing contracts) the "conversion" of wholesalers in the provinces with which they had loose relationships into "WBD commercial agents" linked to their distribution offices in the provinces. WBD encourages these agents to make investments. Beside the contract, the other "carrot" is the hope of bank loans for upgrading, facilitated by the contract with WBD acting as a

collateral substitute or at least as a collateral augmentation. (iii) By 2005, they will have their own Distribution Centre (DC), and they noted that the future is "DC to DC" (as one finds in Western Europe and the US), with a processor sending from its DC to the supermarket chain's DC. (In our interviews we heard that Danone already has two DCs in each of the Moscow and Saint-Petersburg areas – it is leading the way on this trend – combined with the use of L&M Logistics for the distribution from the DCs, as in the other cases; but in the provinces, Danone uses agent-distributors, as do the other leading companies). (iv) While WBD has a strong national brand, it is also adapting to the desire of supermarket chains to have private label products; for example, WBD produces a private label dairy product for the Tandermagnit chain in the southwest of Russia (Tandermagnit is a chain of 600 small stores with 400 sq metres each, a Lidl-like format of chain discounters.)

60. WBD obtains its milk from four sources: (1) about 25% of its milk input comes from 130 companies, with about 400 cows per company on average, most of these in the Moscow region; (2) another 25% is from their contracted collectors who collect from a number of 20-30 ton companies, 100 km or more away; (3) the third 25% comes from processors (with which they have standing relations) in provinces 300-500 km away, who send trucks with fresh milk to them; (4) the final 25% are from transporters who sell them milk in what is essentially a spot market relationship.

61. WBD noted that it wants to move away from the least contractual and monitorable arrangements (sources (3) and (4) above) toward channels (1) and (2), and toward contracts with preferred suppliers. This also implies supporting the farmers providing milk in the first two channels. WBD noted to us that there is a severe problem in Russia with access by processors to a stable supply of milk throughout the year – there is extreme seasonality of supply (a problem emphasised by all the processors we interviewed). Yet WBD must deliver consistently high-quality products to its clients, maintaining consistent volumes throughout the year for supermarket chains. The implication is that dairy farmers supplying WBD need to upgrade their equipment and practices. There is little government assistance to farmers, and it is very difficult for farmers to get loans from commercial banks for equipment and building upgrades. WBD is therefore essentially forced to help the farmers who supply it with milk (at present only a subset of those in channels (1) and (2)), or at least a subset of those who are under contractual obligation to deliver. WBD provides credit for feedstuffs, and invests in equipment (cooling tanks, separators, and trucks) for the farmers and discounts the cost from their payments to them.

62. It is noteworthy that WBD emphasised that it is facing supply constraints both for the Moscow market, and also for all of Russia as it continues to expand into the provinces. These constraints are due to seasonality of supply (i.e. low supply in winter), inconsistent quality from channels (3) and (4), and simple inadequacy of volume. They (and the others interviewed) noted that there is evidence of milk market integration that is making it harder and harder for them to simply travel further from Moscow to find cheap milk to supply their plants. Over the past three years, they have been forced to go further and further from Moscow to find milk (resulting in the growth of channels (3) and (4)) – with prices becoming more and more similar across the provinces as processors from Moscow and Saint-Petersburg compete for milk from more than 500 km distant (whereas three years ago they were able to source nearly all locally). Labour costs, reduction of the cow herd, feed prices, and transport cost hikes have also increased prices from the supply side.

63. An important trend noted by WBD is the purchase of *kolkhoz* and *sovkhoz* by commercial farmers and speculators. This perhaps points to a trend towards dairy farmland concentration. At the same time, WBD itself is purchasing local processing firms in the provinces and putting in all new equipment ("*When we purchase them, they are really only just "walls"*.") to upgrade and produce direct in the provinces, for the reasons discussed above.

64. **Campina**. Campina opened its office in Moscow in 1996 and then started importing yoghurt via 5-6 large wholesalers in 1998. The sharp devaluation of the ruble in August 1998 acutely increased domestic prices of imported products; yoghurt was especially hard hit because it is consumed like a normal commodity (unlike luxury imported cheeses). WBD rushed to invest in a plant to produce yoghurt in Russia (for the first time), and Danone (building two factories, one in Volga and one in Chekov in 1999) and others, including Campina, followed suit in order to stay competitive in the Russian market. Campina built its Stupino plant in 2000. Such investments are large, because unlike the relatively inexpensive venture of buying local plants and upgrading them to produce fluid milk and kefir, yoghurt plants require greenfield investments.

65. Also in 2000, they began to shift away from the use of large wholesalers toward building their own distribution network in Moscow and the provinces, in order to reduce the risk of stock-outs in the chains (as supermarkets are very keen on maintaining their core brand assortment at all times, stock-outs are a major competitive error). They also began to seek direct relations with supermarket chains, as do others (such as WBD and Danone); this is the mirror of the strategy noted by the supermarket chain interviewees… As Campina interviewees put it, "*We want to reduce our yoghurt as a wholesale product and increase it as a retail product! If we just go through the wholesalers we don't control the process and that adds link time and cost.*"

66. As all the companies interviewed told us, most of the "retail action" started about 3 years ago, when foreign retailers entered and competition grew by leaps and bounds, and chains looked for a diversity of dairy products as part of their merchandising competitive strategy. And, as they noted, supermarket chains prefer "one-stop shopping", and only WBD and Danone can offer this at present in the dairy products line. So, the fact that Campina is under competitive pressure to keep the diversity of their product lines visible and accessible to the chains at all times was another driving factor in their moving away from general wholesalers toward their own specialised/dedicated wholesalers/agents. As they put it, all stores have to have some of all three yoghurt categories: Danone, WBD, and "imported yoghurts" (made locally, but by foreign companies that were previously importing, such as Campina). The specialised/dedicated wholesalers have contracts with them – so that Campina (and other large processors) was wedged between two sets of contracts, one with the chains, and the other with their wholesalers.

67. Moreover, Campina noted that it will be increasingly important for them to participate in private label programmes of retailers; they are, for example, in negotiations with Pyatorochka over such an arrangement. At the same time, Campina finds it crucial to maintain and build their own national brand presence; they noted that besides the large expense of initial plant and upgrading and adding new product lines to keep up with or lead the constantly diversifying market, Campina (and other leaders) have to make large outlays for advertising – a key "entry requirement" in the modernised dairy market. This is partly because the Russia dairy market is a "market of innovation where one needs to constantly wow consumers with new products and quality – while maintaining competitive prices."

68. Now we focus on Campina's production side. Campina built its plant in Stupino (about two hours outside Moscow) in 2000. The plant produces yoghurts, and is adding lines for beverages to stay up with market changes. Over the past four years, they have tripled their plant throughput, and have gone from six to 18 milk supplying farms. Campina has obtained third-party certification for private standards of quality and safety – including ISO 9001 – and is now getting the British Standards Institute HACCP certification. Yoghurt is a demanding market and, as noted above, requires major greenfield investments in new plant – obviously an entry barrier for all but "deep-pockets" firms. They informed us that there are very high transaction costs in setting up such plants in Russia; public standards are extremely strict and enforced; they needed the permission of 27 government institutes and 450 technical passports obtained over several years; it took them 1.5 years to get permission to obtain their boiler and to shift from oil to gas. They noted how strict the enforcement of the regulations are by indicating that a Danone plant had been (temporarily) closed in full production due to a violation of one of the (relatively minor) rules.

69. Campina noted that the milk supply conditions were inadequate at the start of 2001, with even the large farms (such as their largest supplier with 2400 cows) bereft of cooling tanks and with old facilities. They noted that it is hard, if not impossible, for farmers to get credit from government or commercial banks to make upgrades. Starting in 2001 they began financing (as an input credit, pre-financed with the help of Rabobank) cooling tanks for the farms – as well as supplying training, quality control, and Dutch cows. Both to control quality and to provide an incentive, they also instituted annual contracts with the farmers (from whom they buy directly). Most of their 18 farmers are local, although some are in other areas; their closest relations (in terms of assistance) are with the six large farms near the Stupino plant. The payoff to Campina was that their preferred suppliers' production went from 36% second class milk to 9% second class in only four years, and from 6% to 55% premium; the assistance costs were thus weighed against search costs for quality product.

70. Campina focuses on large farms because they feel that working with small dairy farms, such as the 1-2 cow operations, is not realistic or cost-effective, as the smaller farms have huge problems of seasonality of supply and inadequate equipment. Instead, they have 18 preferred suppliers producing 180 tons of milk a day, with individual suppliers ranging from 7 tons a day, to 10, to 20-25, with the biggest supplying 32 tons/day. They noted that the smaller ones on their list are near the "threshold" of minimum volume and investment required to work with a large processor like them. Even their larger suppliers suffer from seasonal fluctuations in their supply that they would like to reduce from the current 20-30% to 15% over the next year or two. To that end, Campina initiated a Stupino Dairy Nutrition Project, helping with feed and fodder and training. Such training and service is not provided by public extension.

71. They pay a 20% price premium for the premium milk. They emphasised the price competition (due to inadequate supply) which started in 2003, and which even escalated to a price war with other processors to woo the good farmers (who are in excess demand…). The ideal is to do what they perceive WBD is doing, which is to obtain/build plants in the provinces where it is easier to find suppliers, and cheaper to buy land and build plants. Campina is starting to follow this path, purchasing an (antiquated) plant in Rostov, which they have found costly to upgrade to the needed level.

72. One of the main implications of the above discussion of WBD and Campina, reinforced in our other interviews, is that there are significant entry barriers and survival requirements for processors in the new "supermarketised" dairy products market in Russia. This spills over into pressure on farmers to upgrade to be in turn preferred suppliers to the leading processors. That pressure is of course far greater in western Russia and less in central and eastern Russia, but we expect, over time, market integration and the spread of supermarkets and large processors to spark a rippling out of these trends to the provinces.

73. We discussed these trends with the Russia Dairy Union, in their offices in Moscow. The Union has 70 members, the processor members of which process 35% of all Russian milk. The Union comprises all the large processors, as well as other members of the dairy cluster, including makers of ingredients, equipment, and packaging. The Union was started on the initiative of WBD. Three points were made in the interview:

(i) First, the above competition and attendant upgrading pressures, with a key driving force being the rise of supermarkets, have induced a rapid consolidation of processors – from 3400 in 2000 to 1800 in 2004. They believe that this has cascaded to the farm level with a 15% decline in milk producers. They note that the "agricultural sector" is simply "not ready" for the giant changes on the demand/industry side, with inadequate farm-level infrastructure and lack of government support in the form of subsidies combined with soaring costs such of, for example, feed, land, and labour.

(ii) Second, the Union noted that local governments in the provinces are helping processors to upgrade. They are interested in helping local sources of milk products to develop for spreading supermarkets - with low taxes and rental rates for local processors, subsidies for construction, and more easily obtained permission for new land. These governments are also luring supermarket chains into their towns with similar measures, and squeezing street markets out with regulations.

(iii) Third, the Union felt that the large commercial farms (such as the 2400-cow supplying Campina in Stupino discussed above) and the tiny operations of 2-15 cows still in the informal sector, will be the survivors in the next 10 years They felt, meanwhile, that the middle-sized operations of, say, 200 cows, of which many *sovkhoz* form a part, will decline due to inefficiency and lack of specialisation, being bought up by larger farms or speculators. The Union noted that the large and middle-sized operations have half the milk output, and the small have the other half. The first half supply at present the bulk of the processors, while the small mainly sell informally in the towns and villages. While the leading processors do and will continue to focus on the large farmers (they are the ones receiving the assistance from the processors at present), the Union surmises that the local provincial processors will use milk collection agents to buy from the many small producers who still form half of milk output.

74. We should note that the latter point is considered highly debatable by a number of the processors that we interviewed. Several felt that there was little future for the small/informal operations, because of the high transaction costs they represented for processors and the inconsistent quality. One processor noted, "*if they become profitable and temporarily more important to local processors, governments will tax them and their cost advantage will disappear*." There was also controversy among the respondents as to the fate of the middle-sized

producers; while most agreed that there are enormous pressures on them to invest in upgrading and pressure to sell out to urban speculators and larger firms, they also have diversified operations that allow them to manage risk and to "hang on."

3.4 Shift toward Private Standards

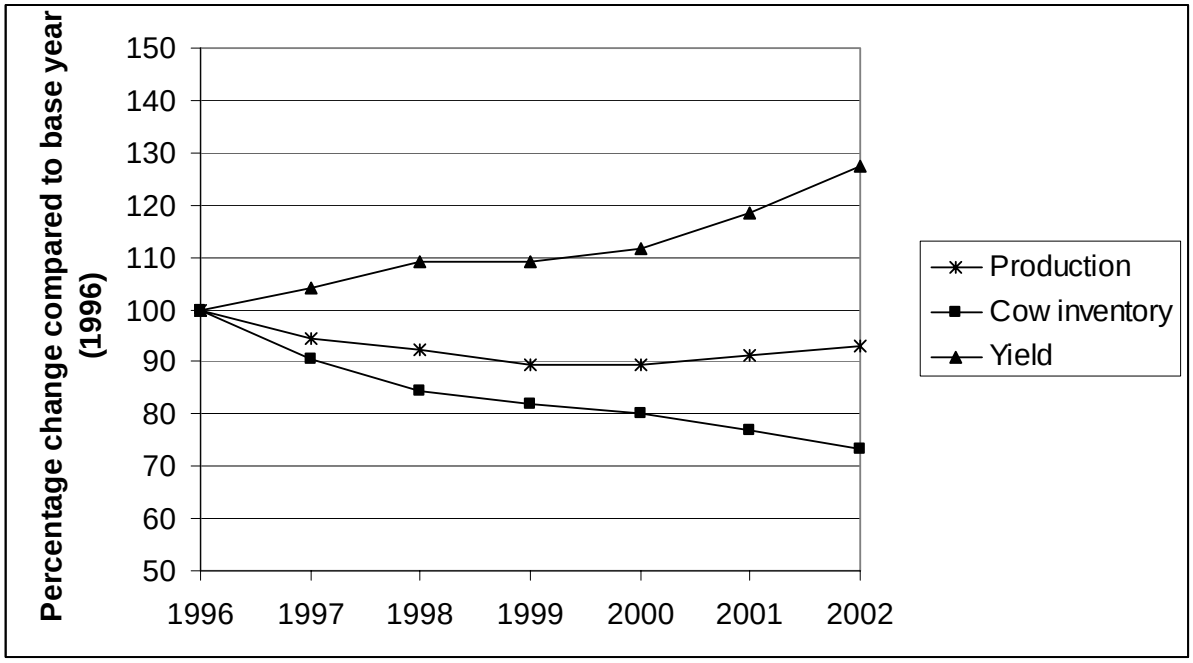
75. According to some of the interviewed retailers, their volumes are not quite large enough to dictate demands to suppliers, with the exception of general requirements such as: the delivered product should not have passed 70% of its expiration period; products with damaged packaging will be returned to the supplier; and products will have undergone required certification (public regulation). Distributors and processing companies, on the other hand, argue that large retailers implement a strict quality control system and sometimes have specific demands in terms of assortment (for example to differ from competing retail chains), or packaging. Combined with the retailers' policy of shelf fees and regularly lowering prices due to promotional discounts, this puts extra pressure on suppliers. Again, logistics play a crucial role here. As mentioned earlier, the perishability of short-shelf-life dairy products prohibits the transportation of these products over long distances. Moreover, according to some of the retailers, dairy processors in remote areas are unable to comply with retailers' demands of hygiene, packaging and preparing pallets for transportation.

76. Another important factor that is being introduced only recently by the large-format retail sector is the private label for dairy products. Ramenka (Ramstore) is one of the first large retailers to have introduced private label dairy products, e.g. the "Ramstore milk". This UHT milk is only sold in Ramstore's Moscow based outlets because transportation of the product to other regions would diminish the product's cost-advantage and make it uncompetitive with locally produced milk. Auchan has also put out a tender for companies to start producing a number of Auchan private label dairy products. The tender is open to dairies that already have products in the Auchan assortment and that, according to the retailer, will be able to meet the requirements.

4. Implications for Dairy Processing Companies and Milk Producers

77. First, there is a severe problem, which is growing quickly, of a simple excess demand for milk volume; we predict this will exacerbate with the demand-side pressures as supermarkets act as market motors building demand for dairy products. In 2002, the Russian Federation had a total milk output of 33.5 million ton. This is equal to about 23% of the total milk output of the EU-25 (and 27% of milk output in the EU-15 in 2002). Figure 1 shows how the dairy cow herd has continuously decreased since 1996. At the same time, milk yields have increased, but not by a quantity sufficient to offset the negative effect of the decrease in the number of cows on total milk production. There does, however, seem to be a stabilisation of total milk production occurring in most recent years.

Figure 1: Change in Milk Production, Dairy Cow Inventory and Milk Yields since 1996



Source: Own estimates based on Serova (2004).

78. Second, rising demand channelled and spurred by supermarkets and leading processors working symbiotically will require more efficient dairy farms. In addition, the more efficient producers will be the ones listed as preferred suppliers and will be in a privileged position to survive and prosper in the face of the consolidating industry. Experience from other countries such as Brazil shows that during such changes in retail and processing, there are enormous cost-side pressures on dairy farms and the inefficient among them exit in large numbers; that could happen in Russia in the next half-decade. Average milk productivity in the Russian Federation was 2800 kg/cow/year in 2002. This is considerably lower than average milk yield in the EU(15), which was 5400 kg/cow/year in 2001, i.e. almost twice the level in the Russian Federation (Serova, 2004; USDA, 2003). However, the low level of average milk yield hides an important duality in the Russian dairy sector. About 50% of total Russian milk output is produced in small-scale (owning one to two cows) family farms. Most of this milk is used for home consumption or sold on the local market, while less than 15% of this family farm milk output is bought by milk traders or the local processing sector.

79. The dairy sector consists of large-scale farms (most of them with mixed production systems) with an average of 200 to 3000 cows and with about 80% of their milk production destined for the processing sector. However, duality also exists in the large-scale sector. Many of the former collective and state farms are in need of substantial financial means to make on-farm investments in technology (and breeding material). Those that do not have access to these financial resources are often characterised by a decreasing number of animals and deteriorating productivity and milk quality. On the contrary, farms that do have the financial means (either through foreign or domestic inflows of capital) are rapidly growing to be the dynamic backbone

of the Russian dairy sector with high average milk yields and significant improvements in milk quality.

80. Fourth, the rapid development of the supermarket sector is an extremely important factor affecting the speed and nature of dairy sector change in Russia, and that importance will only increase over the next 5 years. Besides increased requirements in terms of consistency of deliveries etc., the large-format retail sector is also providing important opportunities for distributors and dairy processing companies that deliver to them. For example, Eurofresh (a Russian distributor of specialty cheeses) points at the increased possibilities to introduce new products through the supermarkets, vis-à-vis traditional shops, which have a smaller total assortment and shelves that are often fully saturated. Auchan claims that there is still room for further development of the assortment compared to the number of SKU of dairy products in supermarkets in Western Europe and the dairy assortment is currently expanding by 10 to 15% annually. Argo Group and Petmol make a similar point and claim that the large format sector offers important opportunities for advertisement and promotion. Furthermore, Campina sees the higher efficiency of delivering to supermarket chains compared to traditional stores as their main advantage. This higher efficiency is realised through unified standards, the same assortment and a single control system over all the retail company's outlets and, furthermore, by the demand for large quantities, which brings down the average cost of deliveries.

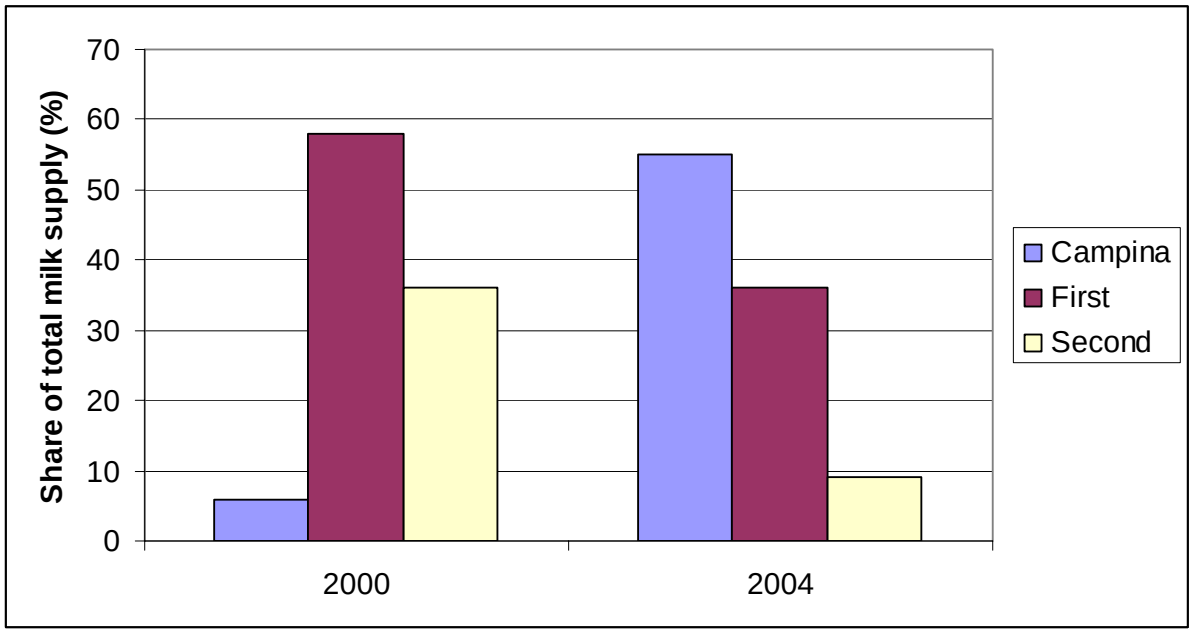
81. Apart from the current challenges and opportunities that are posed by the large format retailers on their suppliers, we should also take into account possible future challenges or bottlenecks. As was evident from the interviews with the main retail companies, we can expect an enormous expansion of this sector into the regions.[1] The question that comes to mind is how this will affect the dairy sector and especially, if the dairy sector will be able to satisfy the growing demand for dairy products that is created with this rapid expansion of the retail sector.[2]

82. It is worthwhile here to turn back to the structure of the Russian dairy sector, in particular its duality. The Russian dairy sector is categorised by a small dynamic segment of dairy farms that have access to the necessary financial means to invest in upgrading their production technology and a large share of highly inefficient farms that are unable to make these investments. In order to fulfil their private quality requirements, the main dairy processing companies located in the Moscow and Saint-Petersburg areas have stimulated the upgrading of the dynamic dairy segment. For example, of the interviewed dairy companies, Wimm-Bill-Dann (and Baltijskoje Moloko since its take-over), Campina and Petmol facilitated investments in cooling tanks on their supplying farms. These investments were then paid back through milk deliveries. The investment programmes have had a dramatic impact on milk quality improvements on the farms that benefited. For example, Figure 2 shows how the share of milk in the highest quality class has increased from a mere 6% to 55% of total milk supplies to Campina in only the last four years.

[1] For example, Metro announces eight additional store openings annually starting this year.

[2] Large format retail outlets do not just substitute for market share lost by traditional stores; they create additional demand for products as they offer a larger range of products than the traditional shops (that focus mainly on cheaper and fast-rotating products).

Figure 2: Share of Milk Supplied to the Campina Factory in Stupino in different Quality Classes*



* The Campina quality class includes milk complying with Campina's international quality standards as well as Premium milk (the top quality class in the Russian classification system).

83. High quality standards are crucial to guarantee long-shelf-life dairy products. But the assistance programmes offered by dairies to their suppliers have been implemented mainly by the main dairies in the Moscow and Saint-Petersburg area.[1] As a result, the dynamic dairy sector is concentrated for a large part in these two regions. Increasing demand for the products of the dairy companies that work with the dynamic milk producers may be complicated by the fact that there is high competition for milk in these regions and, furthermore, that the observed increase in milk yields is insufficient to offset the decline in the number of dairy cows. For example, many of the interviewed dairy companies claim that they now have to buy milk from as far as 500km away from their processing facility (a fact that seems to translate into the equalisation of milk prices over large distances). These factors make it unlikely that these frontrunner dairy companies, and the dynamic milk producers, will follow a pattern of exponential growth similar to the main retailers over the next few years.

84. However, there are factors that suggest that the phenomenon described above may be less dramatic. We should not forget that Moscow (and Saint-Petersburg) is quite different from other regions in the Russian Federation. Consumers in other regions are unlikely to be accustomed to many of the dairy products found on shelves in Moscow supermarkets and will demand (at least initially) other types of dairy products than those demanded by (wealthier)

[1] We should note, however, that there is also an important inflow of investment capital into the agricultural sector from other sources as speculators have taken an interest in buying agricultural land and investing in production facilities.

consumers in Moscow. As a result, large format retailers are likely to offer a smaller range of products (Ramstore estimates that dairy sales will make up only 5% of total sales in its supermarkets in the regions, while they are good for 10% of sales in its supermarkets in Moscow). On the other hand, the dairy product assortment will be adjusted to consumer tastes and preferences in the regions. For example, it is likely that there will be less high-end dairy products like flavoured milk drinks, blue cheeses etc., while there will be more room for locally produced traditional dairy products like kefir, pasteurised milk, etc. (even up to 20 to 30% of the total assortment). The latter will also be necessary to keep prices low as consumers in the regions are much more price-sensitive than consumers in Moscow.

CENTRAL AND EASTERN EUROPE

IMPACT OF FOOD RETAIL INVESTMENTS ON THE FOOD CHAIN

ANNEX 4

TRANSITION IMPACT OF FOOD RETAIL INVESTMENTS IN EU AND EU ACCESSION COUNTRIES

ANNEX 4

TRANSITION IMPACT OF FOOD RETAIL INVESTMENTS

IN EU AND EU ACCESSION COUNTRIES

Countries: Bulgaria, Croatia, Czech Republic, Estonia, Hungary, Latvia, Lithuania, Poland, Romania, Slovak Republic, Slovenia.
Examples of EBRD Projects: VP market in Lithuania, Getro in Croatia, Cora in Hungary and Romania, Intermarché in Poland, Kesko in Estonia, Mercator in Slovenia, Merkur in Slovenia, Rema in the Czech Republic, Boliari in Bulgaria, Migros in Bulgaria, Billa in Romania and Bulgaria, etc.

Transition impact challenges	**Market development challenges/expectations**	**Operational response to achieve transition impact**	**Possible transition impact benchmarks**
Increasing competition which should lead to better quality (value for money), efficiency, innovation and customer orientation of other companies through competitive pressure.	• Modern retail formats (i.e. supermarkets, hypermarkets, discounters) are still below 60% of total food retail and highly concentrated in large cities. • Large hypermarkets, including shopping malls with hypermarket anchors, are approaching the concentration levels seen in some Western Europe markets but some regions are still less developed than others. • Modern retail format in rural areas/smaller cities (i.e. below 50,000 inhabitants) are not well developed. • Food retail market is still fragmented and consolidation is to be expected. The market share of top 5 players is on average	• Select retail investments targeting secondary cities and smaller towns. • Promote format diversification and select investments aimed at introducing new and innovative food retail formats such as hard discounters, compact discount hypermarkets, etc. • Finance new, smaller formats with most effective price and cost strategies, which business concepts are based on increased efficiencies in purchasing, logistics, technology and distribution and require very specific skills and know-how. • Select retailer that spreads modern retail techniques in the local market, like internet shopping,	• Number of new retail outlets in medium sized/smaller cities where penetration of modern retail distribution has been the lowest so far. • Total market share of a particular format and number of players in this format (e.g. more than 30% market share of hypermarkets with 4-6 players). • Lowering of the cost of the food basket while maintaining the quality of such basket (e.g. discounters). • Increase labour productivity measured by increase in sales per employee. • Increase in the quality of the consumer service measured by tangible benchmarks.

Transition impact challenges	**Market development challenges/expectations**	**Operational response to achieve transition impact**	**Possible transition impact benchmarks**
	below 35% compared to 62% in UK, 61% in France or 78% in Germany. • Consumers rank the issue of price as the primary factor in their store selection process. • Growing wealth and car ownership makes out of town location accessible for consumers for the first time and this has an effect on the catchment area necessary for certain formats. • More companies are expected to import from existing EU markets after the removal of import duties for the new EU countries and will compete with local suppliers for retailer listings.	product guarantees, consumer credits, loyalty tools or other added services. • Promote the introduction and expansion of the private label value range or organic food range in order to meet the customer's demands. • Promote sharing of lessons – through EastAgri - with other IFIs that invest in retail or wholesale market infrastructures.	• Benchmark for consolidation of the retail sector (top 5 have more than 50% market share). • Benchmark for competition in the market (top three retailers do not have more than 50 per cent market share) • Percentage of private label sales of a retailer operator. • Introduction of a specific label for, or expanded sales of, organically grown products. • Spread of modern retail techniques in the local market. • Improvement in product variety as measured by the range of SKUs offered by the Company.
Market expansion. Stimulation of market behaviour through the upstream and downstream linkages, including best practice relation between various parts of the retail market chain, leading to quality improvements (particularly on suppliers side), and increased efficiency (particularly in distribution channels).	• Quality, reliability, food safety and traceability are still issues for many local suppliers and not in line with Western European standards (all of the above for fresh fruits and vegetables, dairy products and meat products). • Local suppliers are often unstructured/too small/in financial difficulties and need support with	• Bank investments focused on strengthening backward linkages. • Select retailers that are focusing on high quality and safe product offerings through standards to be imposed on suppliers which are as close as possible to the ones imposed in Western Europe (e.g. ISO, HACCP, etc.). • Support retailers that are offering	• Shift toward higher quality and increasingly safe product offerings through standards to be imposed on suppliers, as measured by the increasing percentage of local suppliers which (will) implement ISO and HACCP standards. • Shift toward preferred supplier systems in order to select producers capable of meeting the

Transition impact challenges	Market development challenges/expectations	Operational response to achieve transition impact	Possible transition impact benchmarks
	quality improvements/technical advice. • EU accession and increasingly regional structures have an effect within the industry for sourcing, supply and distribution. • Improvement of infrastructure makes integrated distribution networks workable. • Smaller formats and discount formats require greater effort to rollout than larger formats as a large number of sites and more complex logistics and distribution must be organised**.**	their suppliers on-time payment and training in quality and hygienic standards. • Financing of retailers with a high degree of local food offering which has a direct and positive effect on the local producers. • Promote preferred supplier systems in which the retailer will support the local supplier in meeting quality and safety standards on the basis of a preferred relationship. • Promote private labels as these provide good opportunities for small- and medium-sized local suppliers. • Promote retailers that source and distribute on an increasingly pan-regional level, provide local suppliers with new, cross-border, supply and distribution channels and establish integrated supply chains with a central distribution infrastructure. • Promote the use of third party pan-regional logistics operators which provide greater efficiencies.	retailers' quality and safety standards (number of producers/growers on the retailers preferred buyer list). • Promote technical assistance to local suppliers by providing training and possibly input materials/equipment. • Percentage of local food offering. • Shift toward direct purchase from growers/producers, decreasing importance of wholesalers (% of total COGS) as main distributor. • Introduce modern procurement system based on (i) centralised procurement system, (ii) shift toward cross-border procurement systems, (iii) shift toward specialised/dedicated wholesalers, (iv) use of global logistics multinationals, (v) shift toward preferred supplier systems and (vi) shift toward adding private standards. • Number of local suppliers taking advantage of exporting their products to other countries through the retailers' cross-border procurement system.

Transition impact challenges	Market development challenges/expectations	Operational response to achieve transition impact	Possible transition impact benchmarks
			• Shift toward lower margins between producer and consumer prices as a measure of overall efficiency of distribution systems.
Frameworks for markets. Development of essential institutional infrastructure according to the best international practice (particularly permits and licences and public consultation).	• Legal environment is supposed to be in line with EU standards but implementation may be lagging. • Legislative environment is still relatively relaxed with few restrictions on opening of large formats.	• Actively encourage public consultation for new retail developments.	• Make public consultation a conditiona of EBRD financing. • Select retailers that follow best international practice in terms of environment, health and safety standards.
Transfer and dispersion of skills which are new to the economy. The sector as a whole needs to adopt new skills and technology, thereby increasing the productivity of the supply chain, meeting international quality standards (particularly service standards) and decreasing the prices of the average food basket offered by the retailers.	• The labour intensive nature of modern retail may have a positive impact on employment, both for less skilled workers and highly specialised experts and managers. • Potential local tenants in shopping malls or large hypermarkets may lack modern retail skills and may need some training/support from shopping mall operators.	• Promote retailers that provide training to thiers suppliers and support their suppliers in achieving international quality standards. • Support foreign investors with relevant skills and knowledge not available in the investee country (e.g. for a new format) which will be directly transferred to local management, employees and suppliers.	• Implement training for suppliers/other parts of the market chain.
Demonstration of ways and instruments to finance activities. Some financial instruments used by	• Banking sector is relatively developed but retail investments need maturities of sometimes	• Local suppliers that wish to apply for a bank loan often need to show that they have a contract	• Introduce new financial product/its replication in the market.

Transition impact challenges	Market development challenges/expectations	Operational response to achieve transition impact	Possible transition impact benchmarks
the retailers in international markets are not available, particularly to local companies.	more than 10 years which is not readily available in the local market. Local suppliers still have limited access to commercial credits.	with a retailer. This contract then serves as a collateral substitute for producers. • Larger contracts, new supply channels and preferred supplier systems will directly benefit the suppliers. • Retailers providing fair payment terms will be preferred.	
Setting standards for corporate governance, financial reporting and business conduct. The standards of corporate governance and business conduct are often poor, particularly in the less advanced countries. This is a transition challenge central to many projects with local sponsors in other sectors as well.	• Although improved over the last 10 years, many local retailers still have lower standards for corporate governance than their Western European peers.	• Implementation of best practices according to Western Europe standards in terms of corporate behaviour (minority shareholder rights, contractual relationship with suppliers, etc). • Select retailers that follow best practice and strict guidelines in acquiring land and obtaining permits. • Select retailers that follow best international practice in terms of environment, health and safety standards, including requirements for packaging and transportation.	• Introduction/adaptation of environment, health and safety standards according to EU or World Bank standards in construction and operation of each store. • Introduction of SAP or other sophisticated MIS. • Introduction of IFRS accounting. • Adoption of most modern IT technology in inventory monitoring and cost management. • Specific corporate governance changes. • Introduction of new and improved packaging and transportation technologies.