# RURAL FOOD COOPERATIVES
# SUPPLIER/DISTRIBUTION ISSUES

## FINDINGS & RECOMMENDATIONS

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### Background & Scope of Investigation

Across the U.S., wholesale food distributors, manufacturers and retailers are experiencing massive industry consolidation. The cooperative food sector, particularly natural foods wholesalers, is susceptible to the same threats (and opportunities) resulting from widespread industry integration. Indeed, in the past decade, the number of retailer-owned natural foods wholesalers has dropped precipitously, with only two remaining players.

The most recent departure was Blooming Prairie Cooperative Warehouse (BP), the Midwest's major coop wholesaler supplying large and small stores in urban and rural areas. In fall, 2002, BP sold its assets to United Natural Foods, Inc. (UNFI) in a financial transaction that distributed hundreds of thousands of dollars in accumulated member equity. The sale also elicited strong reactions from coop retailers, ranging from enthusiasm about the potential economic benefits of negotiating with a publicly-traded natural foods distribution company to serious concerns about over-reliance on a single source of supply.

Approximately one-quarter of North Country Cooperative Development Fund's (NCDF) loan volume is to retail food coops; of this total, slightly over half (54%) is to borrowers located in rural areas. Understandably, many are concerned about their economic future. Will this group reap benefits from the BP sale in terms of the same (or, better) level of service and lower cost of goods? Can they (or, should they) rely on UNFI as their primary wholesaler? What are the implications for NCDF's loan portfolio and for future underwriting decisions to existing and new borrowers located outside of major population centers?

The purpose of this study is to address these and other questions concerning existing and potential supplier relationships for rural food coops in the Upper Midwest. Specifically,

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- What changes are taking place in the operating environment for rural food coops?
- How do rural coops view their supplier/distributor relationship(s)?
- Are there viable alternatives to UNFI as primary supplier?
- How might rural food coops successfully position themselves for the future?
- How can these findings inform NCDF's lending activities?

## Methodology & Limitations

During the last two weeks of May and the first three weeks of June, I conducted telephone interviews with 26 people directly involved in, or knowledgeable about, food wholesaling and retailing, with a particular emphasis on the natural foods sector. For context, I also interviewed experts about broader trends in retailing in U.S. rural communities.

About 25% of the interviewees were conducted with store managers in rural and geographically remote stores in the Upper Midwest, with annual sales ranging from a low of $150,000 to a high of $2 million. The balance were experts on rural affairs as well as food industry professionals engaged as consultants, wholesalers (natural foods and conventional), financial advisors and investors.

Although this study is by no means exhaustive nor does it purport to be "scientific", it synthesizes the multiple viewpoints and oft-expressed feelings of worry, fear, and excitement currently circulating in the natural foods industry, particularly among small, rural food coops.

The list of the interviewees and details of each conversation are strictly confidential; specific comments are highlighted in italics.

## Part I Findings

Four consistent themes emerged from the interviews:

1. The Rural Context
2. UNFI as Primary Supplier: Catalyst for Change?
3. Competition: The Threat of the "Big Box" Stores
4. Small is (Still) Beautiful: Getting Back to Basics

### 1. The Rural Context

First, the concept of "rural" means different things to different people. The Federal government defines rural as an urban area <50,000 people; others consider rural communities in terms of distance from a population hub, usually 70-100 miles.

Yet, population size or spatial distance aren't always useful determinants of what is rural: higher speed limits that decrease the amount of "drive time" between places, spiraling home prices that force buyers to live far outside the city limits and other socioeconomic factors have brought the "country" closer to the "city". In short, the current lexicon is inadequate for expressing nuances between "rural", "small town", and "geographically remote."

In the Upper Midwest, which is characterized by a handful of large natural foods stores in urban areas, "small" is often synonymous with "rural." While it is certainly true that many small coops are located in non-metro areas, many of these communities can no longer be thought of as rural.

Consider the towns of Cambridge and St. Peter (home to MOMs and St. Peter Food Coop) 70 miles and 50 miles, respectively, from the Twin Cities. Population growth and changes in commuting patterns and lifestyles have transformed these formerly rural communities into ex-urban suburbs. In many so-called rural communities, a frequent comment heard was: *"People here don't consider us rural. We're just a small town"*. Along the same lines, a food coop located in Duluth (pop. 90,000) may be geographically remote but is obviously not rural, even though it is small as measured by industry standards of sales volume and square footage.

Several individuals underscored the obvious point that small, rural and geographically remote stores continue to be at a disadvantage for accessing better pricing due to greater industry consolidation and the quest for cost efficiencies:

- *"It is clear that if fuel costs are an issue (which they are), wholesalers will start to look at what is most productive and they will either tack on a surcharge or cutback on service from 2x/per week to 1x/per week. This is making coops and non-coops very nervous."*
- *"Most wholesalers are looking at how to consolidate operations and driving more volume through their warehouses… delivery fees are going up because they are closing divisions and they will have to serve (them) from a further distance. There is tremendous pressure on wholesalers' gross margins."*

A related point is that the future of rural food coops must be viewed against the backdrop of the changing (or, perhaps "changed") face of rural America. One rural economist conceptualizes rural communities as a series of "spatially connected" neighborhoods: the same retailing changes that took place in urban areas 20 or 30 years ago (e.g., local corner grocery stores, to supermarkets, to strip shopping centers, to shopping malls, to mega shopping centers) are also taking place in rural America as small communities are aggregated by large retailers who form retail trade hubs drawing from multiple rural communities.

The long-term outlook for rural and geographically remote stores is tied to one's perception of whether the proverbial glass is half-empty or half-full. Consider the following comments:

- *"Rural towns are dying on the vine. They are fairly isolated and their market is small"*
- *"The dominoes that are aligning do not align well with rural America"*
- *"The issue is larger than just retail food coops. Basic services in rural areas are going elsewhere. Everything moves to the hub and then the hub gets taken over by chains"*

The individuals that express the "half-empty glass" perspective are skeptical about the long-term survival of rural stores, in part, because they think that the mangers are "out of touch" and keep themselves socially isolated:

- *"There are many stores that are removed from metro areas. Their success depends on their ability and wiliness to admit that they need relationships and to constantly renew these relationships"*

- *" There isn't enough cohesiveness among (all these) coops. They are out there by themselves and there is no linkage of communication "*

- *"It's a certain type of personality that runs remote rural stores. They don't get it. Stores that are better situated demographically get pushed early on….. "*

Those who are more optimistic about business opportunities in rural areas are bullish on the short and long-term outlook.

- *"All the stores in remote areas are thriving. It's the awareness of consumers about natural foods and it's because in the small towns, they are the only game in town."*
- *"I'm optimistic in the sense that the future for a rural coop is a bit brighter than just a rural food store because of the sense of ownership. The coop nature is very important"*
- *"We can exploit that fact that we are remote since we have little competition"*
- *"I have a realistic perspective. I think the isolation makes us a hub for anything halfway to anywhere"*

Why is the definition of "rural" important? First, within the context of this study, the issues of food distribution and supplier relationships cannot be reasonably analyzed without serious consideration of distance and volume. Distribution logistics are affected by myriad factors: volume of truck load purchases (one vendor, one truck), number of drops per truck (the fewer the better), miles traveled (as measured by revenue per mile), number of SKUs carried, frequency of drops, amount of purchase, travel distance in the warehouse to pick the order and so forth.

Second, as noted in subsequent sections of this report, the so-called tension between small and large coops seems to be less about size and location and more about how the individual store manager (and/or Board of Directors) is engaged (or not engaged) in issues at the local, regional and national level. Finally, the critical role of technology cannot be overstated. Sophisticated advances in distribution technology and logistics are pushing changes on a national and global level. Ubiquitous Internet usage is bridging geographic distance and reducing rural coops' isolation.

**2. UNFI as Primary Supplier: Catalyst for Change?**

Not surprisingly, there are strong, mixed views about the BP sale to UNFI. Some believe that the sale will benefit the country's retail food coops, regardless of sales size or location. From this perspective, food coops will be able to harness their collective purchasing power to force down cost of goods and increase margins. "T*he way to secure our competitive future is to have a contract with UNFI to lay claim to the purchasing dollars of the coops in exchange for low prices"*

For many, the sale also underscores the critical timeliness of NCGA's efforts to strengthen the retail food sector. With a strong primary supplier, NCGA can more effectively advance its agenda to develop national promotion and marketing programs, support store expansion, highlight industry "best practices", and provide other forms of peer services.

Many industry observers believe that smaller food coops will benefit most from the UNFI relationship even if the larger stores are "leading the charge":

- *"The smaller coops are going to benefit most from the national bargaining contract. They will never have the same margins as a Whole Foods, but they will get better pricing"*
- *We are on their (the large stores) coat tails to some extent, and the good stuff trickles down to us. Any purchasing agreement will be fueled by their volume"*

Relatedly, many small rural coops regard the UNFI's status as their primary supplier as a *fait acompli.*

- "*Our only choice used to be BP and we still have only one choice, which is UNFI."*
- *"For 90% of the coops, the sale didn't change the dynamics"*
- *"We don't have any other alternatives, and we see lots of risk, but we can't really manage the risk."*
- *"It's hard enough to get someone to come up to where we are. We can't trade one supplier off the other, so why bother?"*

There are also varying opinions about the degree to which small food coops were better served by BP. Several store managers of small, rural coops as well as industry experts expressed the view that BP's ownership structure was of particular benefit to them, and that they were offered more choices than they would have had otherwise, as voiced by these comments:

- *"If you are a cooperative that owns the warehouse, you have more options and that's why ownership in BP made a difference and had some policy impact."*

- *"My theory is that you can't trust the future of coops to people who don't democratically control their capital.*

- *"If you believe in coop principles you are duty bound to remain a cooperative and expand on the idea of Blooming Prairie rather than assume that it was destined to fail"*

Indeed, among many in this group, there is a sense of "loss" or "nostalgia" about BP's demise, particularly about the annual membership meeting which offered food coops, large and small, urban and rural, a recurring networking opportunity.

Others voiced suspicion and concern about the UNFI sale and the loss of control in the context of the ownership structure:

- *"We have to be concerned about service because we don't have much competition to bounce off of each other, just UNFI"*

- *"It's nuts to put our eggs in the UNFI basket… What if UNFI changed their corporate culture or changed its strategic plan and decided that it would open to a buyout by another company who wanted to own the supply chain of the natural foods arena?"*

Yet, some expressed doubt that BP ever truly represented the interest of its smaller members. As one person said: *"I think the sale was a good thing. We didn't have much control over the warehouse when we owned it. It was perception, not reality."*

Most participants also pointed to major trends in the food wholesale industry, all of which are leading towards massive consolidation. UNFI itself is beginning to implement changes as it rolls out its national distribution strategy and seeks to solidify operations. Industry participants commented that changes at UNFI are having or, will have, a particularly negative impact on small and rural cooperatives. For example,

a) There are reports that UNFI is changing its ordering policies from "eaches" to cases and 6s and 12s. This will affect most of the smaller and rural stores since they have less shelf space and backroom storage and can't move inventory fast enough.

b) Some interviewees report that UNFI has stopped delivering Root& Fruits products in outlying areas
c) Certain products are available in the Iowa warehouse but not the Minneapolis warehouse; a transfer fee may be assessed if a coop wants to order the item(s)

Finally, even though nearly all the coops interviewed consider UNFI to be their primary supplier, some coops and industry participants report interest in cultivating a strong secondary supplier, an alternative primary supplier and innovative distribution approaches that may be equally or more price competitive for the rural and geographically remote stores.

These ideas include identifying a central drop off, batch and bill, mail order, freight handling agreements, and purchasing agreements with small independent food wholesalers that serve rural areas or conventional food coop wholesalers. CCCGA is also trying to cultivate multiple relationships with coop wholesalers including Roots & Fruits, Frontier and Tucson Cooperative Warehouse. Each of these ideas needs to be further investigated to determine if they are truly viable. See Part II, Recommendations for further details.

## 3. Competition: The Threat of the "Big Box" Stores

For rural food coops, the threat of competition from Wal-Mart and other "big box" stores is looming on the horizon or, has already arrived. The "big box" stores (e.g., Super Valu, Wal-Mart, Target) are carrying some of the same items carried by food coops (e.g., vitamins, natural foods) and at significantly lower prices.

Right now, the threat appears to be greater in the urban and suburban areas, all of whom face multiple competitors, including independent grocery chains that are also expanding their natural foods and organic lines.

While it appears that some of the rural and geographically remote stores have a slight advantage now, this competitive edge is eroding, especially as Wal-Mart expands its strategy of positioning stores between two or three small population centers to create market demand and pull market share from multiple locations. Consider these comments:

- *" Wal-Marts, Krogers, they are all taking market share from each other and the independents. Smaller stores don't have the clout"*

- *"Their (*i.e., small stores) *customer base is being siphoned off by Wal Mart"*

- *"Wal-Mart is selling stuff at a lower price than we (the coop) pays for it!"*

- *"Cost is a major consideration. There isn't much loyalty to a store. It's all about where customers can get a better deal"*

The good news is that, despite the competitive threat, all general managers interviewed report that sales volume is up. As detailed in the next section, many industry observers believe that the small rural stores have a distinct advantage over the large superstores, if they chose to exploit it.

## 4. Small is (Still) Beautiful: Getting Back to Basics

A consistent view was expressed that rural and geographically remote stores have a competitive advantage (a) because of their location and (b) because of the value- added characteristics of shopping at food coops (e.g., the store's ambience, consumer education, varying member participation levels). In short, small is still beautiful and many participants encouraged the small coops to exploit the differences between themselves and their larger competitors.

- *"This* (i.e., big box stores) *is the reality and you have to deal with it. When it comes to coops, we get to enjoy the fact that we are owned by our communities and someone worked very hard to get us here and keep us here. It is the everyman's store"*
- *"Power bases are centered in urban areas, you can get a more complete line (of organics and natural foods) but in the rural areas, this is the only place there is a grocery store picking up natural goods, so there is real competitive advantage"*
- *"Strategy for survival is to compete on customer service, education, make the shopping experience fun and exciting, these are things we can do."*
- *"We really need to compete on customer service, selection and product choice that is, product where there isn't a large demand, like specialty foods"*
- *"We can exploit the fact that we are (small) and remote. We have little competition.*

A related issue is that, to successfully make the most of these competitive advantages and, managers of the small rural stores need to change the way they operate locally and interact regionally and nationally within the natural foods industry. A consistent comment heard was that "*small rural stores are not interested and invested in the larger industry picture*". Some interviewees suggested that the rural or remote location gives rise to, or holds strong appeal for, a certain manager profile: one who isn't too interested in becoming involved with the larger industry picture or natural foods "politics", who may have a "frontier" perspective, consider him/herself to be self-reliant, or may not be that interested in communicating. Consider these comments:

- *"The personalities in small stores… they just don't get it"*
- *"Remote stores are falling into disrepair"*
- *"It's a damn near fatal flaw that they (*i.e., small stores) *are always trying to reinvent the wheel; their store is not that different"*
- *"There isn't enough cohesiveness among all these coops. They are out there by themselves and there is no linkage of communication"*

Yet, for every perceived "Lone Ranger" store manager, there is another example of a store in a comparable location that is managed by an active participant in the natural foods scene: e.g., *"The only reason we are plugged in is because I go and meet these people; otherwise, we've been isolated for 25 years"*.

Some interviewees point out that the natural foods retailers are dominated by the larger stores and that the smaller stores needs' are overshadowed and neglected. Moreover, small stores themselves often lack the human and financial resources to participate in industry conferences, hire consultants or avail themselves of the industry expertise used by the larger, urban stores in store design, marketing, and operations support.

While this may be true, a constant theme also heard was that the smaller stores can exploit their smallness by greater cooperation:

- *"Small stores could get together and be a strong force; they have strength in numbers."*
- *"Small coops could become a force within NCGA; we have to figure out how to create a track for smaller stores and how they get our needs met"*
- *"It's bull----about their not having the resources and enough people. These coops spend money every day; there is lots of access to scholarships and other funds"*

Finally, consistent with the theme of "small is still beautiful", several industry experts expressed the idea that coops should increase number and types of products that cannot be purchased elsewhere—e.g., more organic and locally produced items and more fair trade products.

- *"We need to encourage local foods and local producers"*.
- *"We have to compete on … selection and on product choice where there isn't enough demand for specialty foods*
- *"I see the logic behind developing small scale distribution in the development of local food products. Small coops could start to offer their customers they can't get anywhere else"*
- *"There is a natural, value-added agriculture market"*

In short, there is interest in getting back to some of the very reasons that people formed natural foods coops in the first place: to reduce reliance on food that is mass produced and distributed by global companies <u>and</u> to encourage local production and distribution.

## Part II Conclusions & Recommendations

There are at least five general conclusions to be drawn from the foregoing observations:

1. The acquisition of BP by UNFI is not an isolated event or unique to the natural foods industry. Consolidation trends in wholesaling and retailing are taking place in every facet of the food industry and are likely to continue. This new wave of integration and consolidation activity brings with it many challenges and, many opportunities as well. Affiliation with a strong national wholesaler will be especially critical for securing a retailer's future success. In rural and geographically remote areas, the impact of several factors--- a store's distance from a major hub and its average purchasing volume on cost of goods, availability and frequency of supply and other distribution logistics--- cannot be overstated. <u>Unaffiliated</u> small food coops (and non-coops) are more likely to face cost increases and lower quality service than those <u>affiliated</u> with a national purchaser who can negotiate competitive pricing and offer ancillary benefits (e.g., national promotions, branding).

2. Despite obvious threats from "big box" stores, rural food coops have a unique market niche and natural competitive advantages (e.g., friendly shopping atmosphere, consumer education, membership benefits, personal service) that they are not sufficiently exploiting.

3. There are alternative distribution options and alternate wholesalers for stores located in rural and geographically remote areas that ought to be examined. For the rural or geographically remote stores, alternative distribution options could include central warehousing, batch and bill, mail-order, cash and carry, and freight handling. Alternative wholesalers (to UNFI) that may be attractive options are traditional cooperative food wholesalers (e.g., Unified Western Grocers) that serve independent grocers or smaller regional wholesalers (coop and non-coop) such as CertCo or Russ Davis.

4. Some smaller stores (rural or non-rural) will be unable to survive in the future due to competitive pressures. Management style may be a contributing factor to a store's long-term success, particularly for those located in rural and geographically remote areas. The "Lone Ranger" approach is likely to fail in the long-term because such managers and their Boards are "out of the loop" in terms of industry best practices. Even if the retailer isn't using state-of-the art practices (e.g., computerized inventory

management, electronic ordering, point-of-service sales, etc.), the wholesaler will be; this imbalance will create restrictions on future growth.

Conversely, managers and their Boards who participate at the local, regional and national levels, who are up-to-date on industry practices, and who use effective communication techniques for bridging "spatial" distance are more likely to be successful in positioning their stores for long-term growth.

5. Finally, (and related to # 4 above), it appears that the current dialogue taking place among natural foods retail coops is less about location (i.e., "rural" vs. "urban") and more about differences with "big" and "small" stores and underlying trust issues between them.

Based on these conclusions, my overall recommendation is that NCDF expand its important leadership role on behalf of rural and small food coops. Specific activities that NCDF might consider include all or some of the following:

A. **Encourage quarterly or semi annually meetings targeted to smaller stores** For many interviewees, the UNFI acquisition of BP (and the end of the annual membership meeting) also ended of a regularly-scheduled and eagerly anticipated occasion for networking and exchanging of ideas. Whether these forums are directly led by NCDF or Midwest CGA or some other entity is irrelevant. Rather, it is critical that every rural or geographically remote store manager become part of the "circle", so that they do not become isolated from their fellow store managers.

   Many interviewees spoke about the difficulty that managers of smaller stores face in getting away to attend meeting and the cost of such meetings. Video conferencing, Webinar technology, rotating meeting location and other creative, cost effective approaches should be considered. Most importantly, participation will increase if these meetings are perceived to have real value and use.

B. **Encourage retail food coops to align with local buying clubs** Buying clubs represent a purchasing volume that, in the aggregate, may contribute to lower cost of sales. Several interviewees encouraged greater cooperation and alliances between rural food coops and local buying clubs. For instance, the retailer could become a distribution hub for the buying club. Or, the retailer could encourage buying clubs to increase sales through special purchases. In short, in the current competitive environment, retail food coops should make more effort to expand sales to buying clubs.

C. **Investigate alternative distribution approaches & wholesaler options** As noted in # 3 above, several interviewees offered interesting ideas about alternative distribution approaches for food coops that are geographically distant from a major hub. Evaluating the feasibility of these alternatives was beyond the scope of this study. Each of these ideas (e.g., central warehousing, batch and bill, mail-order, cash and carry, and freight handling) should be rigorously examined from a distribution logistics standpoint. Also, as noted in # 3, there are viable alternatives to UNFI as a national wholesaler. For example, Unified Western Grocers, Inc., (a $3 billion coop food wholesaler with 2,000 independent grocery store members) carries 90% of UNFI's products. Regional wholesalers who specialize in rural stores (coop and non-coop) are also possibilities, although their long-term survival may be in question.

D. **Support Customer Surveys & Market Studies** Two related themes that resonated during the interviews were that "small is (still) beautiful" and "get back to basics". The messages embedded in these remarks, in my view are that:

- Food coops ("large" or "small") are still small players relative to their competitors (i.e., big box stores, grocery chains, etc). It is this very characteristic that make food coops different, and that store managers should exploit; and
- Food coops were once at the forefront in selling products that couldn't be found anywhere else (e.g., organic foods, natural vitamins, grains, nuts, etc. in bulk). Today, many of these so-called "unique" products are standard fare on the traditional retailer's shelves.

Some (not all) food coops are facing serious and potentially threatening competition from stores who are carrying similar products. Since it is unlikely that these coops can compete on price, they need provide a higher level of service and reclaim their customer niche. By intensively studying their local market and surveying customers, store managers can get an accurate picture of why customers shop where they do, what they are looking for from the local food coops an, most importantly what should the food coop be doing to secure their members' continued loyalty and patronage?

Ideas that surfaced during the interviews included: (1) a crossover strategy make sense (e.g., broadening the coop's product line, transforming the rural food coop into a coop general retailer) (2) stores might focus on local buying strategies (e.g., produce, specialty items such as honey, jams and jellies) (3) there may be a market for fair trade products or environmentally friendly products and (4) the store's shopping atmosphere could be a plus. In short, coops should pursue local marketing and purchasing strategies that will further differentiate them from their competitors, and more effectively exploit their unique market advantages.

E. **Encourage every coop to become an NCGA member** Finally, every food coop, regardless of size or location, should become an NCGA member.

There is a palpable sense among people I interviewed that "we missed the boat" in the mid-1980's to develop a national purchasing system and, further, that natural foods retailers are operating in a "live or die" environment.

As noted in Part I, there are conflicting opinions about whether food coops were better off with BP, or whether the UNFI purchasing agreement will result in lower pricing. Regardless of ones' ideology or viewpoint, it is clearly evident that there is power in numbers: the more purchasing volume that NCGA brings to the table on behalf of its member retailers, the more negotiating leverage its members will wield. Given the competitive environment and the record-breaking consolidation trends taking place in the entire food industry, it is incumbent upon every food coop to participate in strengthening the retail sector by supporting a national purchasing program.