Title: NFU submission of evidence to the proposed merger between Sainsbury's and Asda

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NFU Response: Proposed merger between Sainsbury's and Asda

The National Farmers' Union of England and Wales (NFU) is the UK's largest farming union; which represents 55,000 members in England and Wales including 46,000 farming businesses.
Our trade association is the largest farming organisation in the UK, providing a strong and respected voice for the industry and employing hundreds of staff to support the needs of NFU members locally, nationally and internationally. We work with departments across government, including agriculture, rural affairs, environment, energy, climate change, science, business, employment and transport issues. Our aim is to direct policy into real economic opportunities for farming, rural diversification and job creation. The NFU champions British agriculture and horticulture, campaigning for a profitable and sustainable future for our farmers and growers.

Executive Summary

The NFU wish to take this opportunity to provide the Competition and Markets Authority (CMA) with information and analysis in order to aid its investigation into the feasibility of the proposed merger between J Sainsbury Plc (Sainsbury's) and Asda Group Ltd (Asda)

NFU members have raised key concerns regarding the following areas:

- Consolidation and a substantive lessening of competition could affect consumer choice in the long term
- The proposed merger could impact quality and innovation of products to market
- Risk of anti-competitive behaviour
- The proposed merger could impact to Small and Medium Enterprise (SME) businesses

Within this submission, the NFU Confidence Survey of 2018 and 2016 demonstrates that confidence from farmers in the opportunities for a productive and profitable industry is falling.

Furthermore, the NFU consulted with its members, with regards to the proposed merger between Sainsbury's and Asda. 90% of members were highly concerned about "abusive market power" and the resulting impact this has on their farming enterprises.

The NFU have demonstrated that both Sainsbury's and Asda businesses fundamentally operate differently, and have historically invested differing funds into research and development, particularly within fresh food. As part of the CMA investigation, the NFU requests there to be an assessment of the historic and future investment plans to protect the availability and product innovation that consumers ultimately benefit from.

The NFU have also raised concerns regarding consolidation within the UK retail sector and highlights this is at a highly advanced state currently. Any further consolidation is likely to be a key concern to our members and a risk to the interests of consumers or suppliers.

Ultimately, the NFU wish to see a fair, innovative and sustainable retail environment that allows the whole supply chain to deliver for consumers and businesses alike

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Introduction

Farmers and growers are the foundation of the grocery supply chain and have a significant impact on the products that reach the end consumer. Competition, product availability and innovation are fundamental aspects of the supply chain that ultimately impact the interests of the shopper and the consumer.

Within the analysis of the proposed merger the NFU believe it is crucial to analyse both the retail market and upstream supply chain.

The NFU has considered the following areas as part of this assessment:

- Consolidation and a substantive lessening of competition affects consumer choice in the long term
- Impact to quality and innovation of products to market
- Risk of anti-competitive behaviour
- Impact to Small and Medium Enterprise (SME) businesses

It is clear the majority of members have concerns to some degree regarding the future of the industry and their business should the proposed merger be approved. 70% of members, asked by the NFU, stated that they are highly concerned about the proposed merger.

1.0 Differences in sourcing, approach and culture of the two businesses

The NFU is clear that it views Sainsbury's and Asda as direct competitors, with both entities operating on a national basis, selling similar products (in some cases the same branded products) in comparable store locations and store formats. This view has been supported by the CMA's own research showing 80% of stores of each retailer face direct competition from one another.

Sainsbury's and Asda are clearly direct competitors and have historically had a different approach to retailing. The brand identity and cultures of the two businesses are very different. Sainsbury's wishes to win on quality and fresh food, whereas Asda focuses on lower prices. The bringing together of these two positions presents a significant challenge. The proposal of simply continuing to operate two separate retail businesses would not overcome this and it is probable that the industry would see the brands digress in opposite directions at the expense of suppliers.

This alternative approach has been echoed through the businesses way of supporting British agriculture. Over the past 9 years, Sainsbury's has claimed to invest over £18 million in research and development in order to aid British farming to be more sustainable and efficient for the long term. This arguably has helped broader agriculture as well as Sainsbury's direct supply base.

One such group is the Sainsbury's Dairy Development Group, which pays a dedicated pool of farmers a cost of production price for their milk. This has been seen as a market leading initiative, launched in 2007. Sainsbury's are also very clear on their sourcing policy for core agricultural products and source fresh eggs, potatoes in own-label crisps, fresh chicken, fresh pork, sausages, fresh turkey and duck, fresh and smoked farmed salmon and the milk in own-label cream, dairy ice cream tubs, butter and block cheddar from 100% UK sources.

Although Asda have set up their "*FarmLink schemes*"[1] within four key commodity areas, the objectives of these groups are not based around research and development. There is little information published on Asda's sourcing policy for key agricultural products, particularly pork, chicken and lamb. Currently, Asda do not have a dedicated farming supply base within any sector.

[1] https://sustainability.asda.com/farmlink-schemes

Both businesses use their reach to encourage direct suppliers to invest with a view of seeking competitor advantage of their own-label branded products. It follows, therefore, that there should be an assessment of the historic investments in this area by both businesses and comparisons should be made of the understanding of future investment to protect the availability and product innovation that consumers ultimately benefit from.

Where these two retail brands invest in differentiating themselves, it is likely that investment will be lower than when the two businesses existed separately, partly because they are no longer competing with themselves. This is likely to lower range choice, innovation and availability of products for the consumer.

Bringing together these two businesses poses significant challenges with choosing a supply chain model that fits both businesses and establishes ways to be able to achieve the desired £500 million cost savings whilst maintaining the values of each business.

2.0 Consolidation and a substantive lessening of competition within the grocery sector

The consolidation of buyer power as a result of this proposed merger may lead to further compounding of risk exposure that primary producers already experience in business. The NFU believe there is significant potential for this merger to increase the risks and costs which are passed up the supply chain to primary producers.

The following demonstrates a number of key areas of concern for the NFU, and its members, in relation to the effect the merger may have on the agri-food supply chain and primary producers. Through previous correspondence with the CMA in relation to this merger, the NFU have highlighted the following concerns:

- There is increasing consolidation businesses within the supply chain, reducing competition and hence increasing buying power. This can lead to a power imbalance between intermediaries versus farming businesses;
- The power of intermediaries has increased in the years since the Competition Commissions investigation of 2008[2]. Through consolidation, many businesses have increased their market power which they have been able to assert over suppliers and to a lesser extent, retail customers. This is particularly true for brand owners as evidenced by media stories in recent years;[3]
- Risks and costs are being passed down the supply chain to primary producers, who have little ability to mitigate these. This in turn limits the ability for farming businesses to operate efficiently, innovate, invest and adapt to market demands. A substantial lessening of competition in the upstream supply chain could be a result of this.
- A substantial lessening of competition in the upstream supply chain can lead to a lack of transparency downstream, due to abusive market power practices. Such examples of this currently are unclear trading terms. This in turn leads to a lack of confidence in the future of the farming business to invest and innovate, ultimately leading to a long term lack of innovation and consumer choice.

Consolidation of businesses within the agri-food supply chain has changed significantly in the last few decades, ultimately increasing buying power.

[2] https://www.gov.uk/cma-cases/groceries-market-investigation-cc
[3] https://www.bbc.co.uk/news/business-37639518

To give context, competition within the agri-food industry is reducing across the board. Generally, farm business numbers across all farming enterprises are in decline. Between 2012 and 2017, the number of farm holdings in the UK has decreased by 2% from 222,000 to 217,000 (DEFRA, 2018)[4].

The NFU Confidence Survey 2018 demonstrates that confidence in the opportunities for a productive and profitable industry is falling. This survey found farmer confidence, for both short term (<1 year) and medium term (1-3 years), were both negative, at -6 and -12 respectively. A lack of confidence in primary production can lead to multiple outcomes including:

- Reduction in producers desire to invest and innovate
- Lack of productivity, efficiency and product innovation
- A reduction in the range of product available to the consumer at a less competitive price

The general trend toward consolidation throughout the grocery supply chain is particularly true within the processing sector, which mirrors the consolidation within the retail sector. Consolidation at the processor level can bring benefits for farmers and for consumers, but it can also reduce the lack of choice for consumers in terms of product development, availability and innovation. With a reduced processing supply base farmers also have a reduced choice of who they supply.
This effect is most clearly represented within the dairy processing and manufacturing sectors. The number of dairy enterprises has fallen from 400 in 2012 to 367 in 2015 (AHDB, 2017)[5]

A prime example of this was in 2016, when Müller acquired the liquid milk division of Dairy Crest, leaving only two major players in the UK fresh liquid milk market – Arla and Müller.

Any further consolidation of business, within retail or the supply chain may further concentrate the market and reduce primary producer’s ability to run sustainable, profitable businesses. There is also a real risk that further consolidation will mean businesses will become bigger. A number of members had significant concerns regarding the impact this has on food miles and the environmental footprint of their business. Consumers are becoming increasingly conscious of these two elements in their food purchasing habits.

2.4 Risk of anti-competitive behaviour

The NFU consulted with its members to identify their biggest concern regarding this proposed merger. 90% of members were highly concerned about “abusive market power” (NFU Survey, 2019).

The general concern focused around the pressure members will face to further reduce their margins in order to be competitive. Members supplying retailers directly commented that it would be expected, following the merger, the new entity would re-tender with a view to de-list suppliers to bring about consolidation of the new entities supply base and to find cost saving efficiencies. Whilst the tender process is typical for retailers, the lack of competition as a result of this merger will leave members subjected to further vulnerability if de-listed, particularly where a significant proportion of the business is with one or both of the parties involved.

Porter’s Five Forces of Competition[6] define competitive rivalry by an equal balance of; supplier power, buyer power, threat of substitutes and threat of new entry into the market. The strategy of the food industry is now focusing on consolidation within the market, in turn leading to an increase of intermediary buying power.

[4] https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/741062/AUK-2017-18sep18.pdf
[5] https://dairy.ahdb.org.uk/market-information/processing-trade/uk-processors-data/uk-processors-data/#.XIfKmSj7S70
[6] https://www.strategicmanagementinsight.com/tools/porters-five-forces.html

For example, we have seen instances, such as the acquisition of Dairy Crest and Wiseman Dairies by Müller plc. By having the market dominated by large key players, this can result in smaller players being at a disadvantage whilst also severely limiting the threat of any new entrants into the market.

Although the Groceries Supplier Code of Practice (GSCOP) works well to regulate abusive market behaviours of UK grocery retailers, it is yet to be seen how an increased competitive retail marketplace has an impact on the ability for GSCOP to stop future abusive behaviours. It is well understood by businesses within the supply chain, that winning contracts with retail customers and maximizing service opportunities is a priority to win market share. As a result, the supply chain becomes increasingly competitive, to the detriment of primary producers, who are the foundation of the grocery supply chain and therefore ultimately consumers.

The most significant challenge our members face is focused on the effect of buyer power within supply chains, pushing risk and costs onto primary producers who have limited ability to mitigate these.

Primary producers in all sectors face similar challenges:

- Lack of transparency
- Unreasonable notice to changes in supply agreements
- Unreasonable costs of doing business, not defined in any supply agreements

2.5 Unfair risks and costs within the supply chain could lead to higher consumer prices

The annual NFU Confidence Survey conducted by the NFU in 2018 looks at the long term outlook for farming across all agricultural sectors. 732 NFU farmer and grower members were interviewed via telephone (463) and online (269). It monitors farmers' confidence, and other issues that may impact agricultural businesses, such as current business profitability and future production levels. Confidence is critical for all businesses, as it is an early indicator of profitability and influences investment and production intentions.

In 2016, the NFU surveyed member's experiences of abusive behaviours, through the Confidence Survey (see annex two). Businesses reported they were unlikely to survive, due to unsustainable profit margins. There is a reported increase in bank loans, including overdrafts over the last two years, indicating that many farm businesses remain under pressure. Coupled with this, and as reported in the 2016 Confidence Survey, one in seven respondents reported unfair commercial practices in their supply chains over the last 12 months. The top three common issues across all agricultural commodities in 2016 were (Figure 1):

- "Lack of price and deduction transparency" with 29% suffering,
- "Delays in payments" at 23%
- "No transparency of supply requirements" at 23%

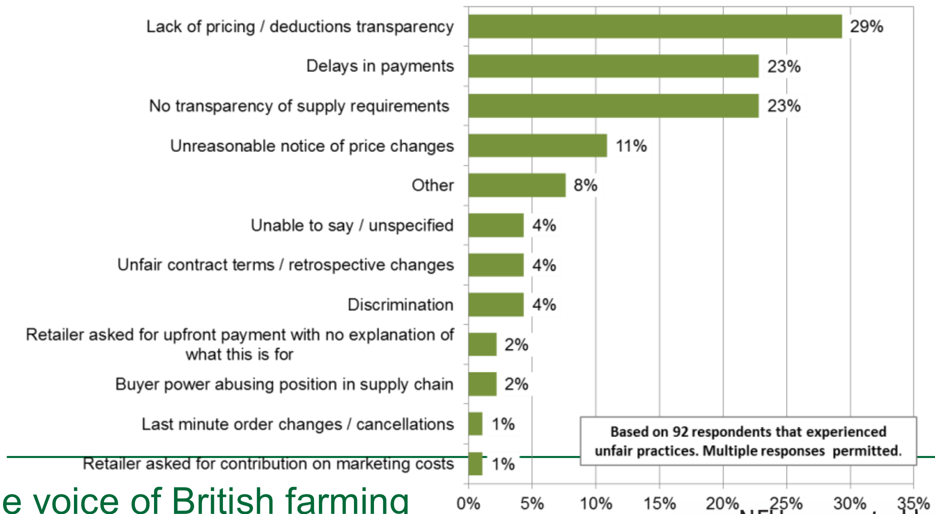

Figure 1: Types of Unfair Commercial Practice.

This survey highlights that abusive market behaviour is of great concern to primary producers. Unfair commercial practices pushing risk and cost onto farming businesses has a significant impact further down the supply chain, not only through the ability to manage cash flow and product availability, but in the long-term if these practices continued putting pressure on farming businesses, primary producer's ability to invest in business efficiencies reduces and therefore are at a higher chance of leaving the industry.

An imbalance of buying power in the supply chain and unfair trading practices of intermediaries can lead to small parties, such as British farmers and growers losing out, ultimately effecting consumer availability, innovation and choice.

3.0 Impact to quality and innovation of products to market

The importance of innovation and quality is widely understood by all within the food and farming industry. Innovation and quality can, if executed correctly, deliver value back to businesses and producers.

However, creating innovation and improvements in product quality requires certain favourable conditions, such as a healthy balance sheet, if it is to produce realisable improvements.

This highlights a widely understood notion across the food and farming industry, in that, from farm to shelf there is a distinct lack of margin or profit.

A distinct lack of margin or profit leads to barriers preventing improvements to quality and for innovation investments in new or existing products. As the use of technology within the supply chain grows, the challenge for businesses to invest could be compounded further with significant upfront financial capital requirements involved. Any further pressure on the supply chain to reduce costs has the potential to bring these concerns to the fore and restrict innovation and availability.

3.1. Grocery Market Analysis

Analysis of the 2016/17 financial statements of the major supermarkets (where available) has been undertaken and includes Tesco Plc, J Sainsbury Plc, Asda Group Ltd, Morrison's Plc, Aldi Stores Ltd and The Co-op. The accounts of Lidl UK GmbH are not available. Key accounting ratios have been used as part of this analysis to aid understanding of company by company performance. Each of these is shown below.

GROUP ACCOUNTS £m	ASDA	SAINSBURYS *	TESCO	MORRISONS	ALDI	CO-OP
Supermarket:	ASDA	Sainsbury's	TESCO	Morrisons	ALDI	co op
Year to:	31/12/2016	11/03/2017	25/02/2017	29/01/2017	31/12/2016	31/12/2016
Total revenue (ex. VAT)	£21,666.3	£26,224.0	£55,917.0	£16,425.0	£8,744.4	£9,511.0
Operating profit	£845.3	£642.0	£1,017.0	£468.0	£211.4	£148.0
Operating margin %	*3.9%*	*2.4%*	*1.8%*	*2.8%*	*2.4%*	*1.6%*
Profit before tax	£791.7	£503.0	£145.0	£325.0	£214.9	(£132.0)
PBT margin	*3.7%*	*1.9%*	*0.3%*	*2.0%*	*2.5%*	*-1.4%*
Net profit	£657.2	£377.0	(£54.0)	£305.0	£252.2	(£134.0)
Net margin %	*3.0%*	*1.4%*	*-0.1%*	*1.9%*	*2.9%*	*-1.4%*

* Includes six months of results following the completion of the purchase of Home Retail Group (Argos, Habitat etc) in Sep. 2017.

Figure 2 Key financial indicators of the UK's major supermarkets

Some other statistics relating to the major retailers are shown in Figure 3.

OTHER STATISTICS	ASDA	SAINSBURYS *	TESCO	MORRISONS	ALDI	CO-OP †
Supermarket:	ASDA	Sainsbury's	TESCO	Morrisons	ALDI	co op
Year to:	31/12/2016	11/03/2017	25/02/2017	29/01/2017	31/12/2016	31/12/2016
Number of UK supermarkets	642	605	3,400	498	726	2,532
Number of UK convenience stores (if known)		807				
Employees (UK)	145,000	181,900	310,000	132,000	31,000	70,000
Weekly customers (m)	18			11		
Weekly transactions (m) *		26	79			

* Indicates the total for Tesco Group which includes overseas subsidiaries

† Group results which includes funeral care, banking, insurance etc

Figure 3 Key statistics relating to the major UK grocery retailers

Figure 2 shows the key financial indicators of the supermarkets. In terms of turnover, Tesco is by far the largest at £55.9bn double that of its nearest rivals Sainsbury's (£26.2bn) and Asda (£21.6bn).

In 2016/17 Tesco made an operating profit of £1.02bn, with Asda reporting £845.3m and Sainsbury's £642m. Operating margins are low within this sector, with profit obtained from high levels of turnover.

However there are differences – Asda is the most profitable on an operating margin basis at 3.9% followed by Morrisons (2.8%) and Sainsbury's (2.4%). Tesco has the smallest operating margin at 1.8%. The level of operating profit margin is affected by, amongst other things, pricing and the levels of cost efficiency.

Trends in operating margin using Sainsbury's and Tesco as comparators are shown in Figure 4.

There has been a general decline in available margin, particularly in recent years. This reflects the ever increasing competitive squeeze of the retail sector.

HISTORICAL DATA	2009	2010	2011	2012	2013	2014	2015	2016	2017
Operating margin %									
J SAINSBURY PLC	2.8	3.0	3.2	3.9	3.8	4.2	0.3	3.0	2.4
TESCO PLC	4.1	4.0	4.1	5.9	4.2	3.7	-8.4	2.0	1.8

Figure 4 Operating margin (%) for both Sainsbury's and Tesco

This key analysis demonstrates the already highly competitive environment of the retail sector within the UK. With low operating margins, as shown in the NFU's analysis demonstrated above, retail businesses are on a continuous drive to differentiate against the market in a bid to maintain margins and turnover. A significant proportion of the major retailers are shareholder owned, who require a certain return for their equity investment. Should those returns not be maintained then investors are likely to take their funds elsewhere. At all costs, retailers will avoid this scenario.

It follows, therefore, that the focus tends to be on the supply chain to find marginal efficiency gains. This continuous squeeze leads to secondary consequences for agri-food businesses both in the intermediary and primary ends of the supply chain.

Financial analysis Plimsoll reported[7] that 125 of the UK's 500 largest food manufacturers were already considered to be in "financial danger". A further 73 businesses were in the "financially vulnerable" position of making losses. This report highlights the critical balance of the UK food industry, before any further pressure on margins as a result of the proposed merger.

7 https://www.fwi.co.uk/business/small-suppliers-hit-hardest-by-asda-sainsbury-s-merger

3.2 Investment concerns

The food and farming business environment is unstable with uncertainty in the future. This has been demonstrated above by the low operating margins of the retail sector, coupled with the critical lack of financial stability across food businesses within the supply chain. With this in mind, farmers and growers and retail suppliers may consider reducing investment to improve their businesses balance sheet.

Businesses in the farming and food sector are often cited for failing to invest in product innovation and productivity. It remains true that uncertainties in the trading environment and return on investment are the biggest barriers to this. NFU members report regularly on the continuous squeeze of their margin for gains in the supply chain and as a consequence this erodes members' investment capability to improve quality, range and ultimately the sustainability of their businesses. Particularly in the case of own-brand suppliers when faced with fewer selling options and a risky trade environment, it is almost certain that they will narrow their focus in the short term and seek fewer opportunities to differentiate that might seek to secure range and innovation wins.

The results of the NFU survey showed that 74% of members were concerned that any further downward pressure to supply at a lower price point will be a challenge for investment.

Members highlighting this concern also identified that any reduction in price is unlikely to be passed onto consumers. Currently, Sainsbury's and Asda already price match Aldi and Lidl who are currently price leaders. This suggests price will be driven down across the retail spectrum and not solely from pressure from the new entity. This is unsustainable.

For farming businesses, investing in product quality and production efficiencies is critical in order to achieve the price point and quality expectations of UK consumers. This investment could be in technologies such as better varieties that deliver a better eating quality or in equipment such as photographic graders capable of removing defect produce before it is packed. Due to the concern highlighted around pressure on price, 74% of members feared that investing in their business will be a future challenge and that it would be likely that plans to invest will be reduced by 30% on average as a result of the merger.

As previously mentioned, Sainsbury's have historically invested significant funds in their supply chains to improve product quality and productivity. However, there is a real concern that this may not continue. When members were asked about the impact that a lack of investment had to their business, 41% of members viewed that product quality could suffer, with 45% suggesting business productivity could suffer and 19% thought consumer prices would be affected.

These factors need careful consideration to protect the range, choice, availability, competitiveness and interest of consumers. Increased price pressure along a supply chain which is already very competitive is likely to have a detrimental impact on suppliers' ability to invest and innovate. Ultimately this could lead to consumer harm. Furthermore, this could also drive a material reduction in competition within the supplier base, compounding such harm.

3.3 Product Innovation

It is widely understood that retailers monitor closely their performance against their competitors. A significant amount of product innovation comes directly from assessments of how retailers are performing in a particular category or even in a particular product line. A large proportion of product innovation is driven by processors, manufacturers or packers within the supply chain in a bid to remain competitive. Retailers will also look to provide differentiation of a product, through changes in specification or quality aspects by embedding values in how that product has been produced, i.e. free range.

Competition in this space is critical to help fuel the investment for product innovation. A substantial lessening of competition within the retail market could directly influence the innovation and availability of new and existing products to consumers.

Based on feedback received from members, we believe this would translate into an overall reduction in choice through reductions in range, or delays in launching new products. This has the potential to lower quality for consumers in the short and long term.

4.0 Impact to Small and Medium Size Enterprises Businesses

The Office of National Statics in 2019[8] reported 99.95% of farmer and growers within the UK are classified as small or medium size enterprises (SME's). Whilst the large majority of these farmers will not be supplying Sainsbury's or Asda directly, their businesses are at a greater risk of any impact of instability within the marketplace, due to the size of their businesses.

As we have identified within the above, there is the potential for the proposed new entity to impose excessive risk on reducing upstream margins to the detriment of suppliers (particularly SMEs) and ultimately consumers. When the takeover was announced in April 2018, Sainsbury's and Asda committed to reduce the price of some everyday items by 10% as they aligned group buying prices and suggested a cost saving of £500 million through targeted synergies.

Whilst Sainsbury's Chief Executive Mike Coupe has confirmed there will be no impact to small suppliers as result of the merger, we are unclear as to what this would mean for indirect upstream business, particularly for those who are producing 'everyday items', which we would expect to include (core basket items is yet to be defined) milk, eggs, chicken breast and beef mince. All of these markets are fundamental parts of British agriculture.

Members of the NFU have highlighted that the erosion of margin within these sectors and therefore the potential long term viability of consumers being able to access British 'every day' items is at stake. From the members surveyed by the NFU in January 2019, 74% think it is likely that investing in their businesses will be a challenge if the merger were permitted to progress. In addition we have already seen a decline of 1,260 (12.1%) dairy farmers from 2014 to 2019 (AHDB, 2019)[9]. This additional pressure has the potential to heighten this further.

When members were asked regarding the likelihood of consolidation within the supply chain, 86% said it was likely (NFU Survey, 2019). Consolidation within the UK retail sector is at a highly advanced state and further consolidation is likely to be a key concern to our members and a risk to the interests of consumers.

There are concerns from NFU members that if suppliers are asked to cut prices by up to 10% to stay on the Sainsbury's and Asda supply chain, then some small companies could go out of business, many of whom produce some of the most innovative products within the market.

Conclusion

The NFU have reiterated and demonstrated the key areas of concern on the impact this proposed merger will have to its members.

It is likely, in our members views that the new entity will further consolidate the grocery supply chain in order to find cost and efficiency gains as a means to deliver the price savings for consumers. A further

[8] https://www.ons.gov.uk/businessindustryandtrade/business/activitysizeandlocation/datasets/ukbusinessactivitysizeandlocation
[9] https://dairy.ahdb.org.uk/market-information/farming-data/producer-numbers/uk-producer-numbers/#.XIeds3d2u70

consolidation of the grocery supply chain could have the potential to impact product availability and choice for consumers in the long term, as product quality and innovation becomes less of a priority for agri-food businesses and primary producers. Our evidence demonstrates that as business margins are continuously squeezed, the willingness to differentiate products reduces.

Our evidence also highlights the risk of abusive market behaviours as a result of an increase in buying power by the new entity. In our members view, increased buying power could easily result in unreasonable demands on suppliers, in turn transferring excessive risk and unexpected costs onto primary producers.

Coupled with the squeeze of margins, this could contribute to businesses ability to innovate and invest.

This effect on competition will outweigh any consumer benefit derived through the proposed lower consumer prices.

The NFU wish to see a fair, innovative and sustainable retail environment that allows all areas of the supply chain to deliver for consumers and businesses alike