Productivity and profitability of food retail in Hungary

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Abstract

The food retail sector in Hungary has changed significantly owing to the privatisation that took place in the 1990s. In the millennium the so-called modern distribution channels have taken the lead role in the food retail sector, suppressing the traditional retail forms. The turnover of the retail sector in Hungary has been decreasing since 2007, and although the decline in food sales has been smaller, the unfavourable trend can be observed there, too. The number and floor area of the food shops have also decreased, although behind this trend there has been a major restructuring: the big food stores have expanded at the expense of the smaller food shops. The effects of the expansion of some food retail chains, especially discount chains, are clearly observable in the data of the Hungarian Central Statistical Office.

By international comparison the Hungarian shop density is very high, especially if the low purchasing power and traditions in the retail in Hungary is taken into account. The competition is also high in the sector. The concentration of the Hungarian food retail sector has been high since the millennium, although it does not exceed the average of the EU countries. According to the results of our analysis, the room for manoeuvre available to retail firms in Hungary is restricted by external factors and their profitability is, contrary to popular belief, very low. So the growing concentration is probably inevitable owing to the pressure for increasing their productivity and turnover.

The profit before tax of the food retail sector declined dramatically between 2005 and 2010. This can be explained by the fact that the competition is higher in the retail sector: the retailers sacrificed part of their profit in order to increase or preserve their market share. It is possible that this phenomenon will survive the economic crisis because the Hungarian consumers are increasingly price sensitive according to the market surveys of AC Nielsen, a fact that draws the consumers toward the hard discounters.

Of course the average numbers hide the data of individual actors and the Tax Office data which were analysed in our study only show what the companies concerned would like to disclose about themselves.

1. Introduction

The political and economical transition at the beginning of the nineties and the privatisation had significant effect on Hungarian food trading. It was attractive for investors, especially foreign investors. Several international supermarket chains started operating in Hungary, by reconstructing the old supermarkets or with green field investments. Some supermarket chains of Hungarian ownership were also created, some of them developed very quickly, expanding also abroad. In spite of this, most of the Hungarian trading businesses are small- and medium-size enterprises, and short of capital. Concerning the changes in the Hungarian food trade we have distinguished five periods:

1. Privatization 1989 – 1994;
2. Concentration begins 1995 – 2000;
3. Accelerated concentration 2001 – 2004;
4. “Hard times” 2005-2008;

5. Even harder: crisis years 2009-.

In the period of privatisation the number of independent small shops increased and the first FDI appeared in the supermarket and cash & carry segment. Between 1995 and 200 the concentration began, the period was determined by the increasing role of modern retail formats and development of retailers' power in the supply chain.

In the next period the dominance of hyper- and supermarkets form increased, independent shops joined the domestic „franchise" chains (CBA, Coop) in masses. The market arrived to a maturing phase, which also meant that good credence values (certified) became competitive advantage for suppliers. PL products started to gain market presence. Retailers' regional and country distribution centres were built.

In „hard times" years (2005-2008) the number of shops (small independent) started to decrease. Hard-discounters (Lidl, Aldi) appeared as new competitors in the Hungarian retail market. PL products developed and triumphed in consumer acceptance. Centralized distribution centres and on-line procurement entered into the supplier-retailer „game". Affordable consumer prices and horizontal price war became the centre of retail strategy.

In the still on-going crises period (2009-) all the „hard times" characteristics are valid for suppliers but the negative consequences of economic crises makes the supplier-retailer relationship even tenser. Private label (PL) products and hard-discounters gain even more ground and price war increases. Hard discounters (Aldi, Lidl) use PL products – dominantly imported from Germany - as the basis of their corporate strategy.

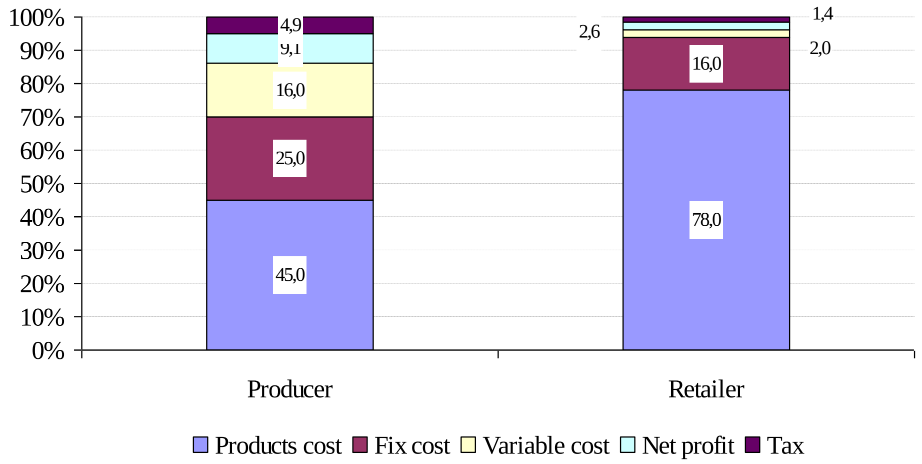
2. Methodology

This paper analyses the productivity and profitability of food retail in Hungary using classic financial methods. The main source of data was the database of the Hungarian National Tax Office on the tax returns of the joint ventures operating in the sector in the period 2005-2010. We investigated separately the sub-sectors of the retailers, the different size groups of the firms and also the different shop types. In addition to the analysis of financial data and indexes we studied the different factors that influence the productivity and profitability of the sector, such as consumption, demand, consumer habits, competition and concentration. We also compared the Hungarian data to international data where it was possible.

3. Literature review

Cortjens and Steele (2008) has analysed the average cost structure of food processors and retailers based on the released financial accounts of 50-50 European firms. According to their calculation the cost of products is a lot higher, the fix and variable costs lower in the cost structure of retailer firms. This cost structure explains the usual expanding strategy of retailers. The retailers can increase their profit twice as much if their sales grows, while the gained profit of the food processors is more moderate because of their increasing variable costs. This fact causes the continuous concentration in the retail sector according to the authors (figure 1.).

Figure 1.: **Comparison of costs and revenue of producers and retailers in Europe, 2006**

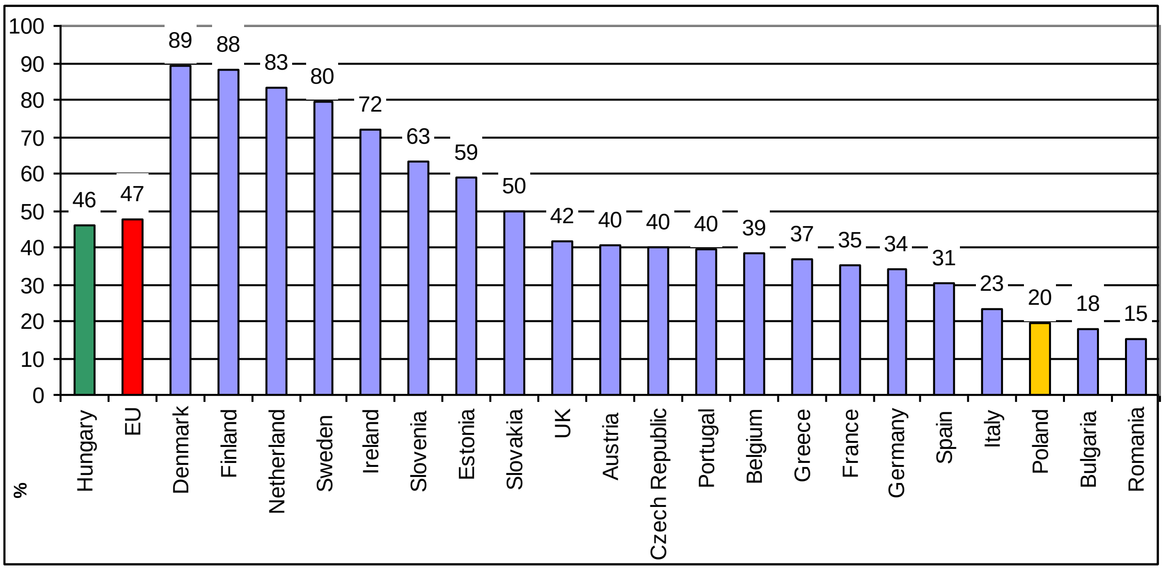


Source: Cortjens and Steele, Journal of Retailing and Consumer Services 15 (2008)

The EU Commission (2009) has stated that though there is strong concentration in retail sector in the EU countries, the sector is competitive. According to empirical researches the buyer power experienced in the sector did not result higher profit for retailer but the more favourable purchasing prices created lower consumer prices. This was proved by the fact that the food prices has increased below the general inflation rate in the last 25 years. This means that due to the strong competition higher concentration in the sector does not create higher profit, but on the contrary, concentration is a must because in retail the net profit rate is so low that it is profitably only in higher volume.

The concentration in the retail sector in Hungary is high if we compare to the concentration of the food industry or agriculture, but it is under the average of the EU. Within the EU the dispersion of the CR3 equivalent is high: while it is 80-90 percent in the Scandinavian countries and Netherlands, there are countries with CR3 below 20 percent, such as Bulgaria, Romania and Poland (figure 2.).

Figure 2.: **CR-3 in the EU countries**

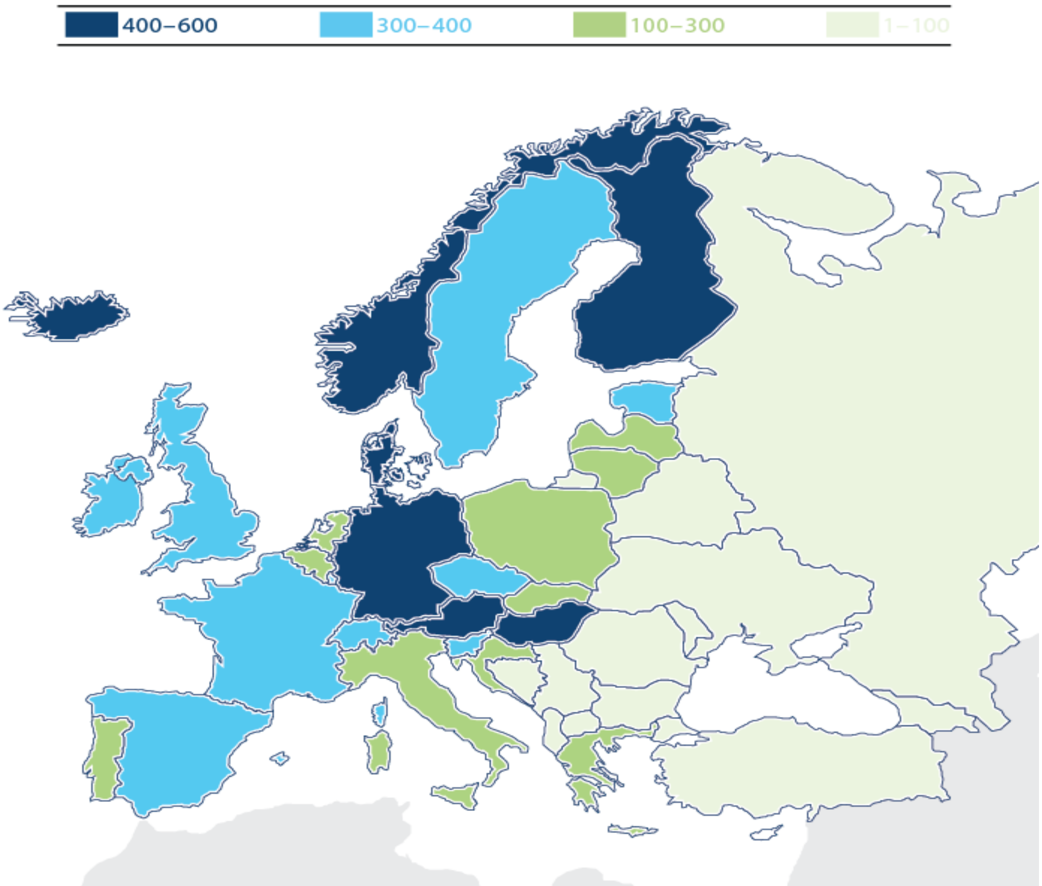


Source: Europanel, 2011

The medium concentration means that the competition is high in the Hungarian food retail market. Until the last years 10-12 strong actors were present in the Hungarian market, but their number reduced after the acquisitions due to the crisis. The high competition results lower consumer prices but it causes hard conditions for the suppliers.

By international comparison the Hungarian shop density is very high, especially if the low purchasing power and traditions in the retail sector in Hungary is taken into account. The highest shop density is typical in the Scandinavian and German speaking countries, while in the Southern countries due to the more traditional shopping habits, in the Eastern countries because of the lower purchasing power the lower shop density is characteristic (Figure 3.) But this fact only means higher competition in the sector as there are several retail firms in the country.

Figure 3.: **Shop density in Europe, m^2/thousand consumers**



Source: Metro Retail Compendium 2011/2012

In the last years the two hard discounts Aldi and Lidl entered to the Hungarian market which caused some restructuring in the food retail sector. As it can be seen (table 1.) the number of shops belonging to the different chains changed significantly between 2000 and 2011, some chains − first of all supermarkets − did not change or reduced the number of their shops, some retail firms, especially the discounts were expanding in the last years. The hypermarket chains were more careful, only the Tesco increased dynamically the number of its shops, the Spar group has expanded earlier − in 2009 − taking over the shops of Plus. The two Hungarian retailers Coop and CBA are a franchise chains, they has increased their shop numbers by absorbing the independent small shops into their system. This is a very different strategy from the policy of expanding chains as this did not mean investment for these firms.

Table 1.: **Number of shops of the largest food retail firms in Hungary, 2000-2011**

	2000	2005	2006	2007	2008	2009	2010	2011
Aldi					45	70	73	78
Auchan	2	10	10	10	11	12	12	12
CBA	800	na	3182	2924	2780	2904	3072	3077
Coop	1991	4963	5286	5283	3066	3116	5250	5225
Cora	5	7	7	7	7	7	7	7
Csemege-Match	169	132	125	124	124	122	123	121
Metro	9	13	13	13	13	13	13	13
Lidl		51	68	90	105	125	135	148
Penny Market	127	148	155	163	169	173	186	189
Plus	108	165	165	165	172			
Reál Hungária		2290	2310	2310	2311	2311	2320	2140

Source: AC Nielsen, 2012

Examining the number of shops according to their size it is remarkable that the number of the largest shops (over 2500 square meter which means size of hypermarket and 401-2500 square meter) increased dynamically even after the starting of the crisis. If we calculate with an average shop size of 2500 m^2 in the largest category and with 500 m^2 in the second group, the increasing of the sales area was 600 000 m^2 between 2000 and 2012. If we examine the years after the starting of the crisis, it is remarkable that the sales area increased by 206 000 m^2 in the largest size categories. The expanding means that the food retail firms continued their competition even after the starting of the crisis thought it was a risky strategy (table 2.).

Table 2.: **The number of shops according to their sales area in Hungary, 2000-2002**

	2000	2008	2009	2010	2011	2012
over 2500 m^2	24	123	137	152	166	170
401-2500 m^2	657	943	1 007	1 071	1 103	1 121
201-400 m^2	919	853	805	801	834	848
51-200 m^2	5 777	6 888	6 593	6 426	6 355	6 294
below 50 m^2	17 859	12533	11 393	11 451	11 111	11 111

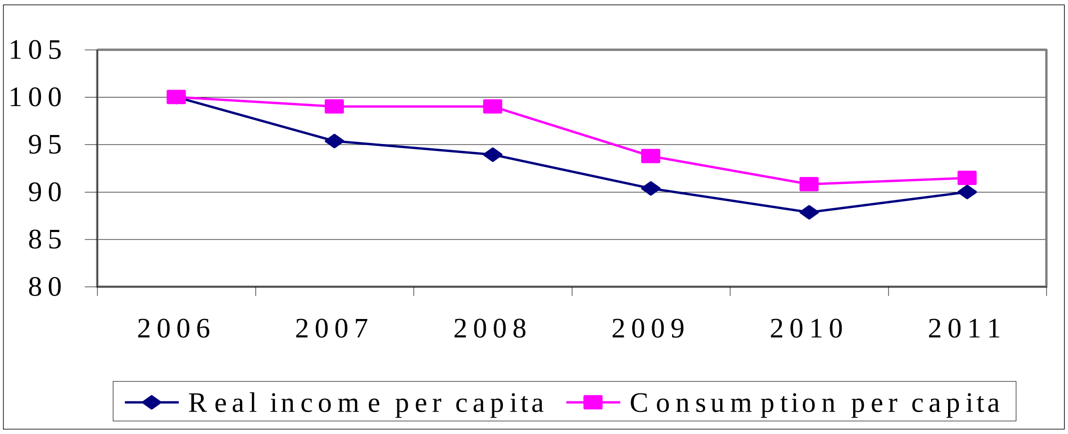
Source: AC Nielsen, 2012

4. Discussion

4.1. Demand: consumer income, food sales

The real income of the Hungarian consumers started to reduce since 2006 due to the economical severity. The real income per capita fell back first in 2007 and this tendency continued until 2011 when temporarily it increased because of the tax allowances for families with children. But the next year reducing was measured again in the different income groups, though the previous national calculation was suspended because of the difficulties due to the new tax system. The tendency continued in the next years, too, because of the economic crisis which had serious and long-lasting effects on the Hungarian economy. The falling income of course resulted lower consumption (figure 4.). It is remarkable that the rate of overall consumption did not fall back significantly until 2008. This is probably due to the fact that the middle and upper classes could balance the reducing consumption of households with low income. Unfortunately the economic crisis caused serious reduction in the disposable income even among the households with higher income due to the dramatically increased loan repayments of foreign currency credits which were widespread in Hungary. This is why the consumption seriously dropped back only in 2009.

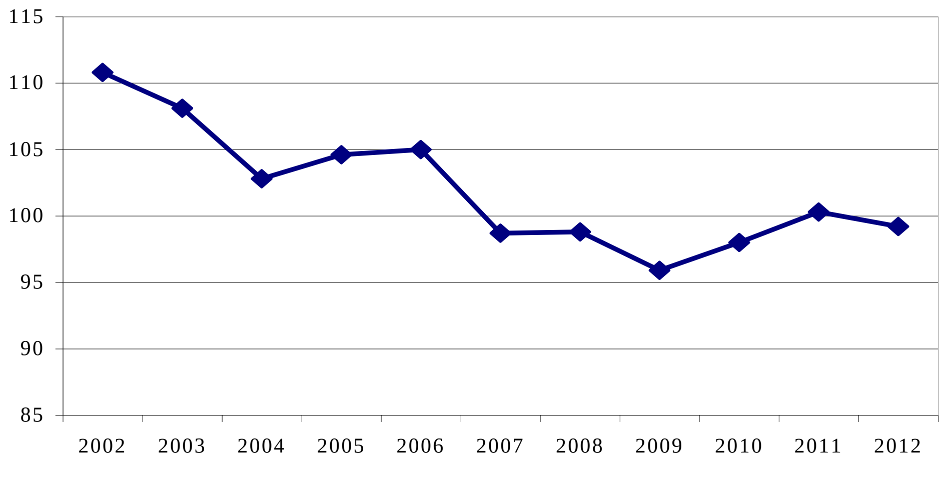
Figure 4.: **Volume index of income and consumption per capita in Hungary, previous year: 100%**



Source: Central Statistical Office, Hungary

Thought the purchasing of foods did not reduce as much as the general consumption the negative tendency could be detected in the sales volume of the food retail sector, too (figure 5.). The volume index of the food sales shows a declining-stagnating trend line in the last ten years, especially after 2008.

Figure 5.: **Volume index of food retail sales, previous year: 100%**



Source: Central Statistical Office, Hungary

4.2. Consumer preferences

According to the research of AC Nielsen (2009) the financial crisis has modified the consumer habits in Hungary. The amount of disposable income decreased for nine out of ten Hungarians because of the increasing cost of housing. Half of the population feels that the amount spent on food and household chemical products was higher in 2009, whilst the other half feels it has fallen: i.e. the discrepancy within society has increased. Nearly half of Hungarians have to make significant economies even on food products but the other half of the population is trying hard to save wherever they can but do not economise on food products.

More than half of Hungarian households go on a weekly shopping trip less often than they did previously. In addition, the average shopper's "basket" has become smaller since the start of the crisis, i.e. for more than half the population it can be said that they buy fewer products.

On the other hand still a significant share of the consumers thinks important saving time, this is why the hypermarkets, where they can buy everything at the same time are still very popular.

The search for favourable prices is also indicated by the fact that last year a majority of households visited several shops whilst doing their shopping – in order to find the best buys – so that the number of customers increased in almost all the retail channel types. At the same time, the basket size did not grow in size but became smaller as shopping became a hunt for favourable offers.

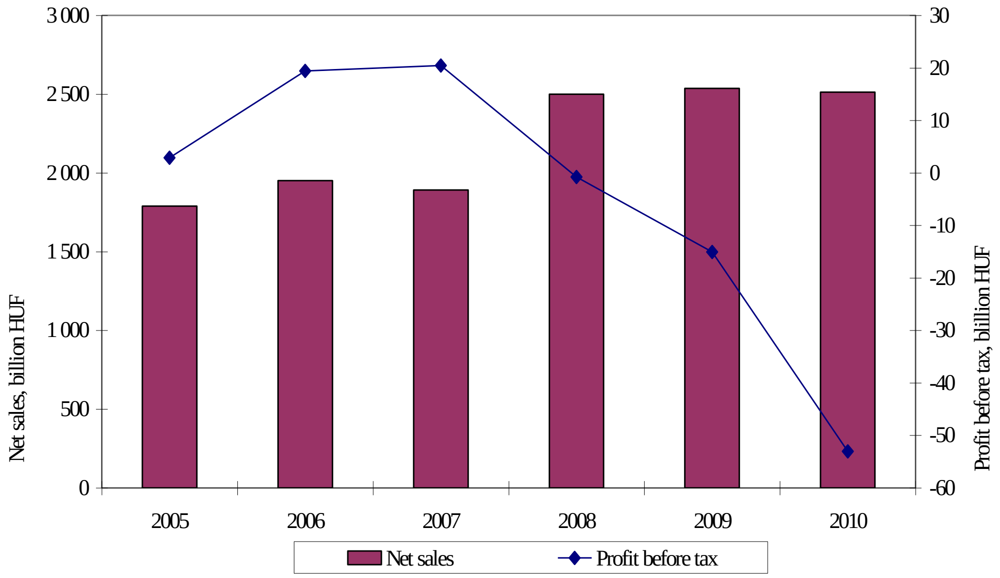
Because of the strong price sensitivity the importance of price/value ratio increased and this resulted that the PL products became more and more popular among the Hungarian consumers.

According to the press release of GFK (2012) in the last two years (2011-2012) even the amount of the purchased foods decreased and this caused more severe economic condition for the retail sector.

4.3. Economic results of the retail sector

The expanding of the retailer firms and the reducing-stagnating consumption reduced strongly decreasing profitability in the sector. Thought the volume of sales increased between 2005 and 2008, after that year it stagnated and the profit before tax started to fall back heavily going under zero from 2008 (figure 6.).

Figure 6.: **Sales and profit of food retail sector in Hungary**



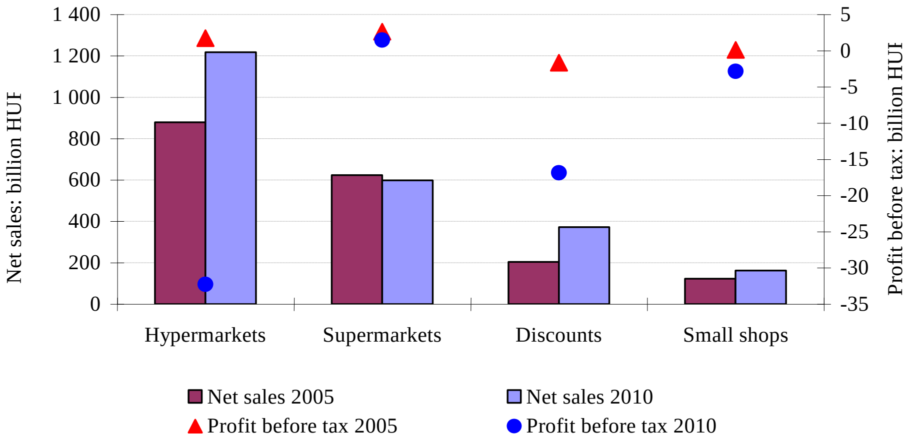
Source: Own calculation based on data of National Tax Office

The profitability and volume of sales was not the same in the different shop types[1]. The discounts and hypermarkets could increase their sales significantly between 2005 and 2010 due to

[1] We organised the retail firms into four shop types. Aldi, Lidl, Penny Market and Profi was put into the discounts' group. Tesco, Auchan, Cora and Spar into the hypermarkets' group. The remaining firms were divided into two groups

their strong expanding policy but their profitability has fallen back the most within the sector. While the small shops and supermarkets did not increase or even reduce their sales but their profit remained stable in the hard times (figure 7.).

Figure 7.: **Sales and profit of food retail sector according to shop type**



Source: Own calculation based on data of National Tax Office

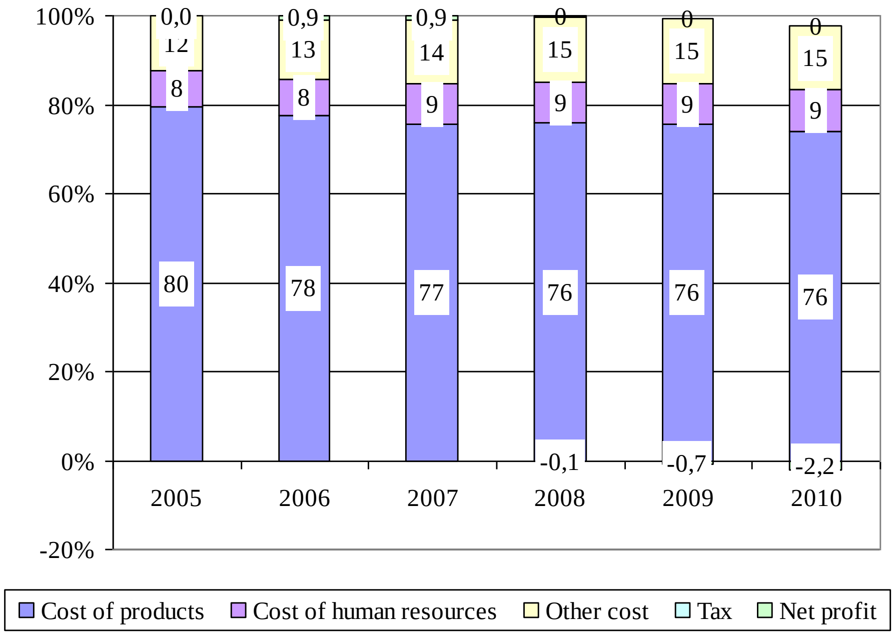
During deeper analysis of the financial data according to the shop types we identified different factors as the reasons of low income in the different groups. In the case of the small food shops and supermarkets the stagnating gross margin was responsible for the low income. In most shop types we could detect an excessive number of employees compared to the net sales except in the small food shops. What is more − again with the exception of small food shops − the rate of the increase in the labour costs was higher than the growth rate of the net sales per employee, which means that the labour costs were one of the reasons for low profitability in these shop types. In the case of hypermarkets and discounters the increasing rate of invested assets worsened the income, while the current assets management was poor in the case of hypermarkets, especially in 2010.

We have prepared a cost structure analysis for the Hungarian retail sector. According to our results the cost of products is similar to the European's rate in Hungary, but the share of this cost decreased between 2005 and 2010 and other type of costs increased which means that the efficiency and profitability of the Hungarian retail sector decreased (figure 8.).

Analysis according to the shop types have shown that the efficiency of the discounts and hypermarkets is higher than the supermarkets' and small shops' thought their profitability was lower. This means that the low profitability of discounts and hypermarkets is probably only a temporary problem due to the strong expanding in a period when the consumption side was in a bad condition. In long term the investments will show a return for these firms. Durieu (2008) has found similar results in German shop types, so the Hungarian tendencies are similar to the international ones.

according to the number of their employees. The firms with 10 or more employees were put into the group „supermarkets", while the others into the type of „small shops".

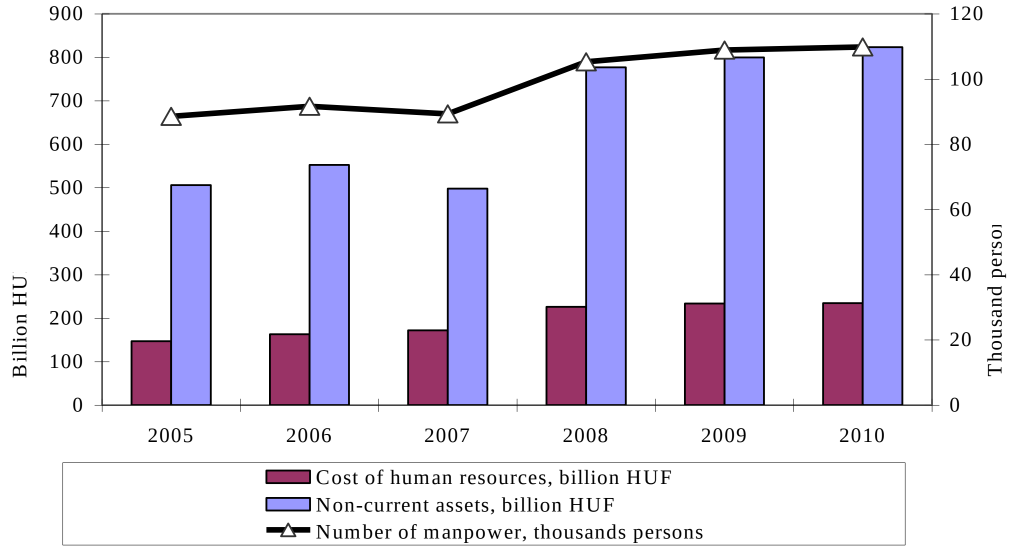
Figure 8.: **Cost structure of the retailers in Hungary**



Source: Own calculation based on data of National Tax Office

In order to find the economic reasons of decreasing profit of the retail sector we have carried out further analysis on the financial data of the retail sector. We have detected two important factors which decreased the profit of the sector, especially in the case of the expanding discounters and hypermarkets: increasing cost of human resources (due to the higher number of employees) and the elevated amount of non-current assets which also increased the long term credit and interest cost of the sector. Both factors were more significant in the case of discounters and hypermarkets because these shop types have expanded the most in the last years.

Figure 9.: **Financial data of retail sector in Hungary**



Source: Own calculation based on data of National Tax Office

5. Conclusions

According to the results of our analysis, the room for manoeuvre available to retail firms in Hungary is restricted by external factors and their profitability is, contrary to popular belief, very low. So the growing concentration is probably inevitable owing to the pressure for increasing their productivity and turnover. Of course the average numbers hide the data of individual actors and the Tax Office data which were analysed in our study only show what the companies concerned would like to disclose about themselves.

Our conclusion is that the firms operating in the food retail sector are able to expand only at the expense of each other; the shrinking market does not offer any opportunities for newcomers. At present the level of return on investments is in doubt, this is why we do not expect new investments in the sector to occur. The firms operating in the food sales sector can improve their profitability by postponing their further developments or by increasing their rate of profit. This profit can be improved by reducing the costs or increasing the gross margin which means lower supplier prices, lower wages, fewer employees, or higher consumer prices. As all the three components are at load limit (suppliers complain because of the low supplier prices, the wages are very low in the retail sector, increasing consumer prices can easily backfire as the purchasing power is small in Hungary) the room for manoeuvre is very limited for retail companies.

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