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**The Growing Natural Foods Market:
Opportunities and Obstacles for Mass Market
Supermarkets**

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ABSTRACT

Seven serious obstacles hinder the success of mass market grocery stores that try to succeed in the natural foods market. Finding timely and complete market information, linking with natural foods suppliers, and pricing and marketing natural foods are the three most important. Uncertainty about future standards for natural foods is the only major obstacle for natural foods stores. The problems facing mass market stores trying to succeed in the natural foods market are related to the market structure for natural food, to compatibility between standard operating procedures in the mass market and natural foods market, and to inadequate data collection about prices and other market characteristics. The problem for natural food stores is due to policy, primarily the lack of strong standards for natural foods.

In the survey that forms the basis for these conclusions, almost half of mass market retailers had increased the scale of their natural foods operations and diversified their natural foods offerings. But few were satisfied with the degree of success of this approach. More successful strategies included developing labels (i.e. brands) for natural foods and hiring special staff for natural foods. These strategies are uncommon among mass market stores. Natural foods retailers tried them more often. Both mass market and natural foods retailers considered these strategies to be successful.

How can mass market retailers overcome the obstacles they face and take advantage of the opportunities that the natural foods market provides? One key requirement for a healthy market is consumer confidence. There are two steps that mass market retailers can take to bolster consumer confidence. First, they can work to ensure that the natural foods in their stores are consistent with the standards that natural foods consumers demand. Second, they can make the effort to incorporate the concepts behind the natural foods movement into their strategic planning (e.g. adding organic product promotions to advertising plans, and by taking account of the environmental implications of their own operations). In addition, by working in concert with other retailers, trade organizations and appropriate non-profit organizations and governmental agencies, mass market retailers can help create a healthy business environment for natural foods in the long term.

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Part I: The natural foods market and mass market grocery stores

The natural foods market grew by 59.7 percent in 1998, from \$5.49 billion in 1997 to \$8.77 billion in 1998 (Raterman, 1999).¹ The growth rate for the retail foods market as a whole was only 2.5 percent during that year (USDA ERS, 1998). The natural foods market is currently on the radar screens of virtually all food retailers: small health and gourmet food stores, mass market supermarkets, natural foods supermarkets (also called “supernaturals”) like Whole Foods and Wild Oats, and price-cutting superstores like WalMart and Costco.

Supernaturals and small health food stores are both finding success in today’s fast growing natural foods market. These retail formats are growing in number and improving their same store sales figures at a fast rate in comparison to the rest of the retail supermarket industry (Wells, 1999). Despite this fact, the majority of mass market retailers who try to bring natural foods into their product mix do not succeed. In fact, a survey done by the Wallace Institute for Alternative Agriculture in 1998 showed that, although nearly half (49%) of all mass market supermarkets surveyed had attempted to increase the scale of their natural foods offerings or diversify their natural foods operations, fewer than 20 percent of those that had tried claimed success.

Mass market stores are failing to make the most of the natural foods market for a number of reasons, according to Ann Woods, Director of the Organic Alliance. First and foremost, most mass market supermarkets do not give natural foods the support necessary for success. By making an insufficient investment in natural foods, mass market supermarkets take a step in the

¹There is no single, standardized, widely accepted definition of “natural foods. Natural foods are defined here as foods that are produced with organic or sustainable farming methods, are minimally processed, and are free of artificial ingredients, preservatives, and chemicals. Not all of the statistics that are mentioned in this paper fit this definition.

wrong direction. The most common mistake is bringing in only a small number of “bestseller” products (Woods, 1998). Poor placement, poor quality, and poor pricing decisions worsen this situation. Natural food products must have the support of the company behind them. This means a commitment from the whole store – starting with top-level executives and maintaining focus straight through to buyers, store managers, and floor employees.

Responsibility for lack of success does not rest solely with mass market stores. The policy environment in which the natural foods market operates, and the structure of the natural foods market channel itself create critical problems for mass market supermarkets trying to make natural foods profitable.

Two major policy issues are exceptionally important to retailers – and to the market as a whole. The first relates to standards. There are no set standards for the natural foods category as a whole. Organic foods have the most established standards, but there are still about 44 different certification mechanisms in the U.S., many of which are certifying organic foods to many slightly different standards. A national organic standard, now in the works at USDA, will help to make the organic market more desirable to both current and potential future organic food consumers (USDA, 1999).

Other than organic, natural foods may fall into one of three broad categories. There are third party certified natural foods (e.g. IPM-grown produce at Wegmans Market, which is certified through a Cornell University program [USDA, 1999]), there are self-certified natural foods, and there are uncertified foods which are making a natural claim without basis. In today’s legal environment, all of these foods may be labeled as natural without negative legal implications or risks.

The second policy issue is related to information collection. The USDA collects detailed market and price information for mass market food products from sugar to corn to tomatoes. This information is used on a daily basis to determine fair prices and good markets by producers, manufacturers and other businesses that buy and sell farm products (USDA, 1999). USDA does not provide for the specific informational needs of organic and other sustainable agricultural producers in this manner. The market for these products is as yet too small, in the words of Michael Dunn, Undersecretary for Marketing and Regulatory Programs for the U.S. Department of Agriculture, to merit market and price information collection by the government (Dunn, 1998).

Due to the structure of the natural foods market, mass market retailers frequently can not purchase natural foods from the suppliers that they regularly deal with. Building relationships with new suppliers takes time and effort. Many natural foods suppliers make this relationship building even harder by failing to provide the level and type of service that mass market supermarkets are used to receiving (Food Marketing Institute, 1999). Natural foods suppliers are less likely to use Efficient Consumer Response methods (e.g. category management, electronic data interchange, activity-based costing, and continuous replenishment). In fact, the survey found that only 10 percent of the natural foods distributors surveyed used ECR techniques, while 22 percent of mass market food distributors did. Clearly, almost 80 percent of mass market distributors in our survey do not use ECR, but the fact remains that they are still about twice as likely to be use ECR than their natural foods counterparts. In addition, natural foods suppliers have a far higher out-of-stock rate than mass market suppliers do, although this problem is being alleviated through the work of some of the larger natural foods distributors (May, 1999).

Mass market retailers that want to sell natural foods also face new and different consumer-level challenges. They have to educate their consumers about new issues, and provide a different level and type of consumer service than they are used to providing. Organic and other natural food products are being sold not just on their appearance and taste qualities, but on their environmental, nutritional and health attributes as well. Many consumer surveys (e.g., Food Marketing Institute *Shopping for Health*) indicate that they want healthful food that is produced using environmentally-sound production methods (56% -- Food Marketing Institute *Shopping for Health* report, 1997). This FMI report also found that consumers are particularly concerned about production level issues including pesticide and herbicide residues, antibiotics and hormones in meat and dairy. Few consumers are confident in their ability to select food with these attributes. They lack information about which supplements and foods satisfy their health and environmental concerns.

Finally, there is the problem of finding, training and retaining staff, a problem for virtually all mass market stores, whether or not they sell natural foods (Yaeger, 1999). Training staff to educate and market natural foods complicates an already difficult situation. Increased pressure on staff is another part of what makes success in the natural foods market hard. Allocating staff time and gaining new skills, training, financing equipment and/or processes were rated as barriers by between 18 and 21 percent of retail supermarket respondents (21% in the mass market segment and 18% and in the natural foods market segments for each barrier, respectively).

Topics Covered

This paper is designed to help mass market retail food stores to identify and overcome obstacles in the natural foods market. It is based on a comprehensive literature research and the results of a survey of 72 supermarkets, 39 of which were mass market retailers and 33 were natural foods retailers. The supermarkets were selected randomly (by state) from lists provided by Trade Dimensions and Venture Direct Worldwide list management services. The survey was performed by telephone by an independent survey research firm, Westat Inc., in Rockville, MD.

Part II below describes today's retail market for natural foods, and examines what industry and financial analysts predict it will look like in the future. The next section describes the major obstacles that mass market supermarkets face as they try to succeed in the natural foods market, based on our survey findings. The paper then moves to a discussion of possible actions that mass market supermarkets can take to overcome these obstacles make the most of the growing natural foods market. Finally, the paper briefly examines several natural foods-related topics of particular interest to mass market supermarkets. These include private label natural foods, contracting with natural foods suppliers, and mergers and acquisitions in the natural foods market.

Part II: Background Information on the Natural Foods Market

Unfortunately, there are no hard data available that fully and accurately describe the natural foods market. This situation has come about in large part because the market is unusually diverse compared to other food markets, and because it is still a very small proportion of total food sales. A substantial percentage of natural foods are sold through a variety of unconventional

retail outlets including small health food stores, direct markets (such as farmers' markets and mail order catalogs), health practitioners, and the Internet.

The *Natural Foods Merchandiser*, the primary trade publication of the natural foods industry, estimated natural product market retail sales at \$25.4 billion in 1998, still a very small proportion of total food sales. Just under half of these sales (\$12.3 billion) took place in natural foods supermarkets. Only 26 percent (\$6.6 billion) took place in mass market retail food stores. Internet suppliers, mail order organizations, and other non-retail outlets garnered the remainder (Raterman, 1999).

The two main categories of natural products are food and supplements. Of the total \$25.4 billion in 1998 sales, the *Natural Foods Merchandiser* estimates that at least \$8.8 billion were food sales. This paper focuses on food, but it is interesting to look at food sales in relation to supplement sales in both natural and mass market retail outlets in order to better understand the current retail market for natural products. In natural foods supermarkets, food outsold supplements by approximately six to five. In mass market retailer stores supplements outsold food by about two to one (Raterman, 1999).

As stated at the beginning of this section, the numbers for the natural foods market are open to question. We have used the best sources we know of to describe the market. A specific caveat must be placed on the figures cited since only part of the total sales were measured directly using scanner data by Spence Information Systems (SPINS) NaturalTrack and Information Resources, Inc. Figures for produce, meat, bulk, and food service, and for sports nutrition and meal supplements were augmented with estimates (Natural Foods Merchandiser, 1999).

In sum, the natural foods market is growing because consumers have made it clear that they want to buy more and more natural foods. Dairy products are a good example; the growth of organic milk and other organic dairy products has been steep, with a 92 percent growth rate in organic dairy from 1996 to 1997. Organic grain snacks and candy grew at a 90 percent rate over the same period. More established organic categories like baking mixes and sweeteners and vegetarian items grew at rates closer to 10 percent (Organic Trade Association, 1998).

The media have been reporting on issues related to natural foods by reporting on topics like the creation of a national organic standard, salmonella and other bacterial outbreaks, “mad cow” disease, and genetically engineered foods. The media have also reported regularly on scientifically valid studies showing that diets high in whole grains, unprocessed fruits and vegetables, and other natural foods are beneficial to health and well-being. All of this media coverage may have helped to increase consumer preferences for natural foods because, rightly or wrongly, consumers relate natural foods with greater food safety, health and nutrition.

Part III: Barriers to selling natural foods in mass market supermarkets

Despite strong growth in consumer interest in natural foods, most mass market stores have not yet determined how best to take advantage of this new consumer interest. They are struggling to understand exactly how best to integrate natural foods into their product mix as an important, high margin segment (Mackey, 1999). Part of this is just the difficulty inherent in dealing with a new market. Adjustments must be made whenever this is the case, and they are part of normal market development and functioning. However, our survey findings indicate that there are also some market level obstacles to the natural foods market reaching its full potential,

problems that can only be resolved through careful public policy actions and vital public-private partnerships. This section examines the obstacles in the natural foods market from the perspective of mass market retailers, and identifies which obstacles may require public policy attention.

Dedicated natural foods retailers have made natural foods central to their business strategy, tying the success of their businesses directly to the success of this market. Not only is this not the case for mass market retailers, but many of these retailers have not even incorporated natural foods into their business strategy, only into their product mix. They are committed to the category only as long as they have the desired sales volume (Wells, 1999). This attitude leads mass market retailers to introduce a few best selling natural foods items rather than build natural foods products into the product mix management plans (i.e. their category management plans). For example, a small selection of organic potatoes, tomatoes, lettuce and broccoli hidden in a dark corner of the produce section will be far less effective than an integrated end cap of organic products needed for a full Italian meal (e.g. pasta, sauce, vegetables, bread) with a large, colorful sign. In fact, mass market retailers normally only carry a small variety of natural foods, and 31 percent of their natural foods products make up 96 percent of their natural foods sales (Esterson, 1997). These attitudes and practices may also lead mass market stores to give up on natural foods before these foods have had a chance to “take off” with their consumers.

Because of these weaknesses, most natural foods retailers believe that they need not be concerned with competition from mass market retailers who are selling natural foods products, that mass market retailers do not have the knowledge or people resources to make natural foods work for them. They believe that when mass markets add natural foods to their product mix,

which they are simply making more customers for natural foods. They believe that these customers will eventually come to natural foods retail outlets for the increased selection and greater customer service and education they provide, according to public statements by Whole Foods and Wild Oats CEOs.

Natural product retailers are not having a problem, for the most part, with garnering benefits from the growth in the natural foods industry. Natural foods supermarkets, small health foods stores, and direct markets such as farmers' markets are all growing in number and total sales volume. Sales volume of small health food stores and large natural foods supermarkets (the aforementioned "supernaturals") has grown rapidly. Natural foods stores have been selling at least 40 percent more natural foods this year than last year (Raterman, 1999).

While smaller natural product outlets and direct market outlets like farmers' markets are growing in number and sales volume, it is generally the supernaturals that give mass market supermarkets the most cause for worry. When these stores move in next door, they can steal away customers. And not just any customers – they attract the highly educated, high-income customers that bring the mass market supermarkets the biggest profit margin per trip to the market.

Whole Foods and Wild Oats are the two major chains of natural foods supermarkets. According to annual reports and other public sales and profit information, they are both doing very well. Whole Foods has 87 stores that average 25,000 square feet. They also have eight distribution centers, 10 regional bake houses, a nutritional products manufacturer, a coffee roaster, and other assets. They operate in 19 states and the District of Columbia and had sales of \$1.39 billion (up 24 percent over 1997). Whole Foods employs 14,000 people and currently has

29 new stores in development (Whole Foods Supermarkets, 1998). Wild Oats' sales have grown 53 percent on average over the past five years. Their 1998 sales are up 28 percent over 1997 to reach \$398.9 million. They have 63 stores in 18 states and Canada, and they have 15 new stores in development for 1999. They also have more than 20 new stores in development for 2000. Wild Oats' new prototype store is 25,000 square feet, and includes a food court with operation juice bar, sushi bar and other prepared food items (Wild Oats Supermarkets, 1998). Chris Hitt, Whole Foods Markets' President, has stated that he believes that the national natural foods supermarkets' pace will likely slow after a few more years of rapid growth, following a well-known market growth pattern.

The 1998 survey done by the Henry A. Wallace Institute for Alternative Agriculture included questions about 20 potential barriers to success in the natural foods. The potential barriers that were given a rating of over 3 on a six point scale (where 1 = not a barrier at all and 6 = a major barrier) by at least 35 percent of the mass market or natural foods market retailer respondents are shown in bold print in Table I (page 20). Mass market supermarkets rated seven out of 20 as barriers. In contrast, natural foods supermarkets rated only one as a barrier. Four barriers showed statistically significant differences between the mass market and natural foods market retailers.

It is important to note here that there were a relatively small number of respondents indicating a rating of three or higher for any potential barrier. None of the potential barriers received a rating of three or higher from over half of the survey sample as a whole. This may be a reflection of the fact that the natural foods market is in a phase of robust growth, and that growth minimizes perceived barriers. Nonetheless, if approximately a third of the respondents

indicate a category as a moderate or major barrier, we judged that to be an indication of a potentially serious problem in fulfilling the full market potential of natural foods.

Percentages for the mass market supermarkets are equal or higher in all but three cases: “allocating staff time,” “lack of government standards for natural foods,” “and uncertainty about future standards for natural food products.” That more mass market supermarkets are having more problems succeeding in the natural foods market is not surprising. Mass market foods are the heart of their business and are, therefore, where they spend their time focusing. Natural foods supermarkets, on the other hand, are fully invested in the success of organic, eco-labeled, and other natural foods.

Natural foods supermarkets found the most difficulty lies in one main issue: uncertainty about future standards for natural foods. Natural foods supermarkets are committed to the category and they are involved in natural foods for the long haul. This may make them more aware of labeling and certification issues than mass market supermarkets. They are more aware of the fact that consumers depend on truthful labels and certification schemes in order to build and maintain their faith in the category than mass market supermarkets. Also, the survey came on the heels of an intense public debate about the proposed natural organic standards. Indeed, the Secretary of Agriculture said publicly that the proposed standards would be significantly revised in response of public comments, adding considerable uncertainty.

Mass market supermarkets cited finding timely, complete market and price information, pricing and marketing natural foods products, linking with natural foods suppliers, and difficulty finding agricultural producers relatively highly. These four issues are directly related to public policy in vital ways. The first two can be linked together, as can the last two, creating two major

policy issue areas to be addressed: finding market information and finding adequate supplies.

Consider the first potential policy barriers to finding market information. Forty-one percent of our sample rated finding timely, complete market and price information as a barrier, and 43 percent found pricing and marketing natural foods products to be a barrier. Mass market retailers find these products difficult to price because there is no good tracking of price or market information currently, while the U. S. Department of Agriculture tracks mass market foods (see www.ams.usda.gov/marketnews.htm for market news reports), it does not similarly track organic and other natural foods.

Without accurate tracking of pricing and marketing, accurate market information for organic and other natural foods remains a mystery. Although this information is used most regularly at the production and processing end of the chain, uncertainty about pricing and marketing for these foods travels from the producers up through the food system to the retailers.

In addition to governmental efforts to collect market and price information, communications channels must be opened up between private industry, government, trade organizations, and researchers in order to create a wide ranging exchange of ideas and information. The result of this exchange should be a platform on which to build a system for the gathering of good information (e.g. a public-private strategic planning commission leading to an Internet-based price and market reporting system). This system must be developed in a straightforward manner and made easily available to those involved in food production and distribution, so it can be used throughout the natural foods market as a benchmark for marketing and pricing natural foods products, just as the USDA market news reports are used.

The other pair of barriers relates to policy issues surrounding the establishment of industry contacts. Forty-one percent of mass market retailers found that linking with natural foods suppliers was a barrier. Forty-six percent said the same about difficulty finding agricultural producers. In some markets, problems like these are purely private. The market does not provide public benefits that deserve public policy attention. However, the natural foods market does have the potential to provide public benefits in the form of environmental goals. Natural foods retailers did not rate these potential barriers as actual obstacles to success in the natural foods market. There are several reasons why mass market retailers may have more difficulty building ties with natural foods suppliers.

Natural foods suppliers have traditionally been small, independently owned and operated businesses. Producers, manufacturers, and other food handlers have worked in a close-knit market where they knew the people who were buying their products personally and relied little on formal contracts and agreements. This business environment is substantially different from that in the mass market. However, the natural foods market is changing. It is becoming more mature and sophisticated managerially, operationally, and technologically. But many natural foods businesses are still operating with different standard operating procedures than the mass market. These differences can create substantial problems for businesses that want to span the gap between mass market and natural foods. Again, since products in the natural foods market have the potential to bring (when meeting consumer desired standards for health and environment) environmental benefits, this is an issue deserving of public policy attention.

Part IV: Opportunities for mass market supermarkets in the natural foods market

In addition to the many challenges facing supermarkets that sell natural foods, there are also many opportunities. Indeed, no potential barriers in our survey were rated as being a barrier by over half of the survey sample. The two opportunities that merit the most attention are developing labels for natural foods and hiring special staff for natural foods.

Thirty-three percent of natural food retailers in the survey have developed a natural foods label but only five percent of the mass market retailers have done so. Of the five percent of mass market retailers who tried this strategy, most felt that their effort to develop a natural foods label was successful. Mass market retailers indicated an average of 4 on a scale of 1 to 6 (1 = not successful, 6 = a total success). Natural foods retailers rated it at 5.4 on the same scale.

Two retailers that have had success with their own natural foods labels are Wegman's, a mass market New York-based supermarket chain, and Wild Oats, a major natural foods retailer. Working with Comstock Michigan Fruit and the Cornell/State of New York Integrated Pest Management (IPM), Wegman's developed a reduced pesticide line of fruits and vegetables. The program, administered by Cornell, is quite precise technically and includes canned corn, peas, frozen beans, carrots, and sauerkraut, and fresh berries, cucumbers, peppers and tomatoes (*The Label*, 1997). *Gempler's IPM* newsletter has heralded the program as a model for other food retailers.

Among the more than 100 Wild Oats brand products available on the retailer's web site (www.wildoats.com) are corn chips, pasta sauces, marmalades, salad dressings, candy bars, sodas and breads; organic beer, rice beverages, ketchup, cheeses, cereals, and coffee will soon be available. The private label items in this line contain only organic ingredients, and their prices

are competitive with those of the other organic products sold in their stores.

Hiring special staff for natural foods is also a key business strategy for supermarkets. While 13 percent of mass market retailers in our survey stated that they had tried this, a full 58 percent of natural foods retailers stated that they had done so. Both mass market (at 4.2 out of a possible 6.0) and natural (at 5.1 out of a possible scale of 6.0) retailers who had used this business strategy rated it highly on a scale of success.

Over 60 percent of supermarket companies surveyed by the Food Marketing Institute in 1997 stated that recruiting new employees had “become somewhat more difficult” or “much more difficult” in the past 12 months. Most difficult to recruit for were skilled positions (e.g. cake decorators) and department managers. Stores reported needing to conduct more interviews to fill positions than they did three years ago. Supermarket companies surveyed stated that improved economic conditions and low unemployment, and competition from other retail channels were the top two reasons for their recruiting difficulties (Food Marketing Institute, 1997). Supermarkets often pay \$6.50 to \$7.00 per hour (Yaeger, 1998). Given these low wages, it is not a surprise that labor is a critical issue.

Labor issues may be harder for natural foods supermarkets than for mass market supermarkets, for several reasons. First, natural foods stores are generally smaller than mass market food stores. They have a harder time providing benefits than the larger stores can provide (Bucco, 1996). This becomes even more critical when combined with the second fact: many natural foods store employees are there because of personal convictions and philosophies (not purely monetary concerns). They desire benefits that match with the “natural lifestyle” mission to which the store subscribes (Dinar, 1999), such as paid community service hours and

“alternative” medicine coverage. Third, many natural foods supermarkets are still grappling with employee performance evaluation techniques and pay-and-benefits levels that mass market supermarkets have already institutionalized (Cotter, 1999). Last, natural foods retailers require another layer of training and skills development on top of those that all supermarket retailers must grapple with: they need employees who understand natural foods products and promotions. Like gourmet foods retailers, natural foods retailers depend on their employees to sell products, both through educating consumers and treating consumers with respect (Granato, 1995).

The Wallace Institute survey asked respondents to rate the success of “increasing the scale of natural foods operations” and “diversifying natural foods offerings.” Although relatively large percentages of mass market retailers had tried these business strategies (49 percent for each of the two business strategies mentioned), few rated these strategies as “a success” or “a total success” (16 percent for each of the two business strategies mentioned). In contrast, 82 percent of natural foods retailers diversified and 64 percent increased scale. Seventy-six and 67 percent, respectively, rated these business strategies successes. Together, the survey results related to business strategies commonly used in the food market serve to reemphasize the point made earlier: adding natural products to the product mix does not sell natural products in and of itself.

Part V: Topics of Special Interest to Mass Market Retailers

Topics of special interest to mass market retailers interested in the natural foods market include contracting with natural foods suppliers, mergers and acquisitions, and private label natural foods. It is unfortunate that data about these topics is incomplete and non-quantitative, but descriptive information does provide some insights.

Contracting and the Natural Foods Market

Contracts are an integral part of the food system. There are basically two types of contracts: production and marketing. Marketing contracts are agreements between a contractor and a grower that set a price (or pricing mechanism) and an outlet for the product before it is ready to be marketed. Production contracts are agreements between a contractor and a grower that specify in detail the production inputs supplied by the contractor, the quality and quantity of a particular product, and the type of compensation for services tendered.

Contracts have been increasing in importance since the 1960s, and continue to become increasingly important as the food system becomes more vertically integrated and consumers demand more processed and uniform food products. By 1993, 32 percent (\$47 billion) of total U.S. agricultural production was produced under contract arrangements (USDA ERS). For some commodities, the vast majority of production takes place under contract, such as 89 percent of poultry production. For other commodities, such as corn, only 13 percent is under contract (USDA ERS).

Contracts offer many potential benefits for both the contractor and the grower. They provide a tool by which both seller and buyer can reduce risk. Sellers can reduce financial risk (and perhaps debt as well) and buyers can reduce production and price risk (USDA ERS).

Contracts can help farmers by providing income stability, improved efficiency (e.g. by lowering transactions costs), market security and access to capital. Contract can help contractors by controlling input supply, improving response to market demand, and expanding and diversifying operations.

Contracts, specifically production contracts, also have some potential disadvantages. Growers who sign contracts are usually given less latitude in selecting input and production practices (Welsh, 1997). They may lose control over critical aspects of the production process. Production contracts have the potential to be exploitative and restrict entry of growers into a market (Martinez and Reed, 1996). An increase in contracting relationships that are not satisfactory to the grower have resulted in a corresponding increase in the number of court cases filed over contract disputes (Hamilton, 1995).

There is potential for contracts for organic and other sustainable produced food products between mass market retailers and agricultural producers to help both parties. Marketing contracts with organic and sustainable growers may help those growers to reduce their financial and marketing risks while providing the products that consumers desire. Production contracts with growers for food grown to organic or sustainable specifications can help increase acreage in sustainable agricultural production, and thereby lower unit costs of production due to economies of scale. Producer-retailer contracting may also increase the value of the crop to consumers willing to pay more for food grown in this way by assuring specific performance. Contract agreements can also result in benefits accrued to society. These benefits may include the reduction of negative environmental impacts (e.g. better animal waste management or reduction of pesticide use) and preferred social arrangements such as slowing the declining number of

farms and concentration of production (i.e. by helping small farms grow a more consistent set of products otherwise available only from large farms).

Mergers and Acquisitions and the Natural Foods Market

Mergers and acquisitions are structural developments in the food marketing system. A merger is the combination of two or more firms into one. An acquisition is the purchase of a business unit or subsidiary by another firm. Two related terms are also important: divestitures and leveraged buyouts. The former refers to the selling of a business unit or subsidiary. The latter refers to the purchase of the common stock of a company through debt financing (where a pledge of the assets of the new company is used as collateral) (Gallo, 1998).

The number of mergers fell in the U.S. food industry in 1996. Leveraged buyouts and acquisitions also fell. However, the average value of these transactions remained the same as it was in 1995. Food retailing mergers fell from 42 to 37. Food retailers ranked second among all manufacturing industries in the value of mergers (Gallo, 1998). These statistics point to a situation in which a smaller number of very large transactions are taking place. In the industry, these transactions are sometimes called “megamergers.”

Recent megamergers in the retail supermarket industry include the merger of the Kroger Co. with Fred Meyer Inc., and the acquisition of Giant Food by Royal Ahold. Supermarkets see benefits coming from these activities in areas like private label purchasing and merchandising. They see challenges in integrating and blending regions and developing shared organizational cultures (Orgel, 1999) Theoretically, mergers and acquisitions may have both positive and negative effects. They have the potential to increase efficiency (e.g. through sharing

administrative functions, buying inputs in larger quantities), enhance the store base, and reduce costs for consumers. But they may also reduce competition and weaken solid local economic bases that independently owned regional supermarket retailers bring to the industry.

Mergers and acquisitions in the natural foods industry are actually accelerating at a very fast clip. There were 70 mergers and acquisitions in 1998, a 40 percent increase over 1997 (Chase, 1999). While activity in the supplement and the food and beverage industry sped up in 1998, the number of transactions in the retail and distribution segment actually dropped (from 15 in 1997 to 11 in 1998). This may be due to the diminishing number of companies that have not already undergone a merger or an acquisition. United Foods distributor and Wild Oats retailer led the way in merger and acquisition activity in 1998 (Chase, 1999). Industry experts predict that mergers and acquisitions will continue to occur at a fast clip in the near future (Patsky, 1998).

Although about 80 percent of transactions related to mergers and acquisitions in the natural foods market occurred between two natural foods market companies in recent years, companies outside the natural foods market have shown interest in merging with and acquiring natural foods companies. A recent example in the food manufacturing industry was General Mills' purchase of Small Planet Foods (owners of Fantastic Foods and Cascadian Farms). Private equity and venture capital firms are also active in this market (Chase, 1999).

Private Label Products and the Natural Foods Market

Private label products can help mass market supermarkets by lowering costs and increasing gross margins (The Food Institute, *The Food Industry Review*). They are very popular with both supermarket retailers and consumers, according to Information Resources, Inc. IRI found that sales of store brand products rose 8.3 percent in 1996 to reach \$40 billion (up from \$36.6 billion in 1995). These sales accounted for more than half of all dollar volume gains. Sales of private label products are increasing in almost all large supermarket chains. Between 12 and 23.5 percent of sales are now from private label in these retail outlets in 1998 (American Institute for Food Distribution, 1999). The top private label categories last year were milk, fresh bread and rolls, cheese, fresh eggs, and ice cream. Carbonated beverages, frozen plain vegetables, and sugar were also popular private label categories (American Institute for Food Distribution, 1999).

Supermarket CEOs of Big V, Safeway and other large supermarket chains see major growth potential in the private label segment of their sales. Many plan to expand their private label lines and increase their private label penetration (Orgel, 1999). Kroger, for example, states that private label penetration for that store is currently 25 percent of dollar sales and 30 percent of unit sales. They see private label sales growing faster than total sales, and expect to see this trend to continue (Orgel, 1999).

Natural foods retailers are also involved in developing private label food products. They believe that private label can help bring about increased profits and greater consumer loyalty via store brand recognition (Mergantime, 1997). However, only a few natural foods retailers are currently pursuing private label products. Some are concerned that developing private label products will create tension between themselves and branded natural foods manufacturers with

whom they want to maintain good relationships. Whole Foods, which introduced its first private label product in 1990 under the “365” brand, now has over 500 stock keeping units (SKUs) in 22 categories. Their private label sales are expected to generate \$25 million in sales between 1998 and 2000. Their long term goal is to have a full 20 percent of branded products be their own Whole Foods labels (May 1998).

Some natural foods industry analysts believe that natural foods retailers have an edge over mass market retailers in the private label area because consumers who shop in natural foods stores have a higher level of trust in the store itself (Mergantime, 1997). However, mass market retailers have more knowledge of the private labeling process and thus may have an edge in developing natural private label foods and thus cutting themselves a market niche with high margins.

Part VI: Conclusion

Mass market retailers feel that they face a variety of obstacles to successfully entering the natural foods market. In comparison to natural foods retailers, they are far more likely to perceive problems coordinating with suppliers, pricing products, and effectively reaching consumers.

However, our findings also imply that there are actions, both on a company by company basis and as a part of the natural foods market, that mass market retailers can take that may help ensure their success in that market. On the company level, these include attempting to create a natural foods label, hiring special staff for natural foods and integrating the concepts behind the

natural foods movement into their strategic planning and managerial operations. On the industry wide level, these include working for strong standards for natural foods that consumers demand.

TABLE I

Percent of Respondents who Identified Barriers to the Natural Foods Market
By Respondent Type and Barrier

	<i>Mass Market Supermarkets</i>	<i>Natural Foods Supermarkets</i>
Finding timely, complete market and price information	41	12
Integrating new natural food ventures into existing operations*	36	15
Linking with natural food suppliers*	41	12
Gaining new skills, training, financing, equipment and/or processes	34	33
Maintaining quality and safety standards	38	15
Allocating staff time	31	33
Linking with buyers' interest in environment, health, and safety*	34	12
Pricing and marketing natural food products*	43	6
Difficulty finding agricultural producers	46	27
Difficulty finding manufacturers*	33	9
Difficulty finding distributors*	31	9
Insufficient market demand*	33	15
Insufficient market supply	31	24
Unreliable market quality*	39	6
Lack of government standards for natural food products	20	21
Lack of industry standards for natural food products	18	18
Uncertainty about future standards for natural food products	20	36

Note 1: Potential barriers rated as barriers by over 35 percent of mass market and/or natural foods market respondents are in bold type.

Note 2: Potential barriers are starred where there is a statistically significant difference between mass market and natural foods supermarkets' ratings at a level of 5 percent or less.