Year: 2014

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Originally published at:
Lottanti von Mandach, Stefania (2014). More Competition, More Direct Sourcing? In: 50th Congress of the Business History Society of Japan, September 11-13, Tokyo, J, Tokyo, 11 September 2014 - 13 September 2014, 1-13.

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More Competition, More Direct Sourcing?

Exploring Direct-Trading Relationships between Large Retailers and Manufacturers in Japan, 1990-2005

1. Introduction

Japanese distribution channels have been described as networks of institutionalized relationships that emphasize cooperation rather than competition, evidenced by the fact that even large retailers[1] source through wholesalers (Saeed & Mayo 1990; Johansson & Hirano 1996; Min 1996; Lackman et al. 1997; Drew et al. 1998; Maguire 2001; Martin & Herbig 2002) despite the efficiency gains that direct sourcing from manufacturers could provide (WTO 1997; Maruyama 2004).

However, severe economic distress after the collapse of the asset bubble in Japan at the beginning of the 1990s posed a serious challenge to the institutional stability of the Japanese distribution system. Competition between channel members intensified and forced them to exploit previously unrealized efficiency gains in their supply chains (Schaede 2008). Manufacturers and retailers alike reduced the number of wholesalers with whom they contracted, a measure that wholesalers compensated for by expanding their coverage with mergers and acquisitions (Johansson & Hirano 1996). In addition, Japanese retailers increasingly sought direct-trading relationships with manufacturers, not least in order to exploit the advantages of information technology (Johansson & Hirano 1996; Cabinet Office 1998).[2] One of the retailers reported to have switched at least partly to a direct-purchasing model was Aeon (Dodd 2003; Aoyama 2007).

While government statistics suggest that wholesale circuity[3] improved between 1990 and 2005, analyzing whether the Aeon case reported is an exception or, rather, reflects a general trend among major retailers is difficult due to a lack of pertinent statistics on direct-trading relationships between retailers and manufacturers (Lottanti von Mandach 2010). To examine this topic, three alternative approaches are possible: first, a case study approach; second, large-scale data gathering; or third, an

[1] According to the Japanese Statistics Bureau, large-scale retailers refer to department stores and supermarkets, each with 50 employees or more. See http://www.stat.go.jp/english/data/nenkan/1431-13e.htm.

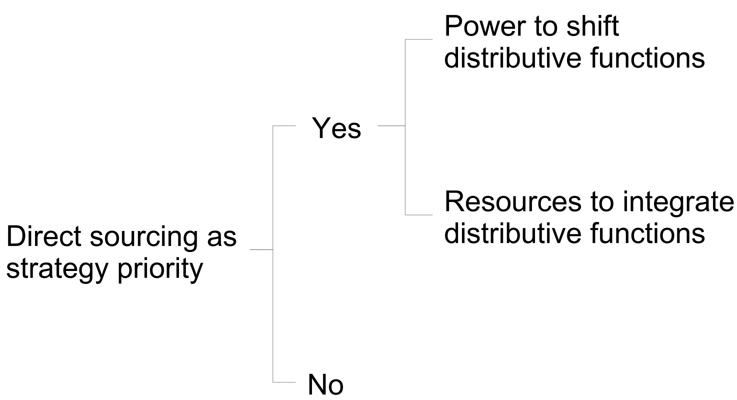
[2] Large-scale retailers generally tend to source a larger share of their goods directly from manufacturers because of the increased efficiency that direct sourcing can provide.

[3] Wholesale circuity refers to the number of separate title-holding intermediaries between a manufacturer and a retailer.

indirect analysis approach.

The difficulty of the case study approach lies in choosing a representative case that shows a strong bivariate causal relationship from a large population of potential cases. In the social sciences, however, few such relationships are found. Usually more than one causal factor must be evaluated (Gerring 2007). Next, large-scale data gathering is difficult, if not impossible, for a number of reasons, such as a lack of access to companies as well as resource constraints. We therefore choose the third option and explore this question indirectly by relying on existing data and research. The framework as shown in Graph 1 will guide our exploratory efforts.

Graph 1: Framework



Source: Author.

We start by exploring the question of whether direct sourcing was a strategic priority for large retailers during the time frame studied. If so, to implement such a strategy, retailers must have the resources to either integrate the distributive functions performed by wholesalers and/or have the power[4] to shift these functions to manufacturers (and make them bear the costs). Furthermore, retailers must have the power to circumvent the wholesale sector.

This paper is structured as follows. Section 2 addresses the strategy and resources of large retailers in the time frame studied. Section 3 explores the question and sources of retailer power over manufacturers and wholesalers. Section 4 then summarizes the main findings.

[4] Retailer power is the ability of retail firms to obtain from suppliers more favorable terms than those available to other buyers or than would otherwise be expected under normal competitive conditions (Dobson 2005).

2. Strategy and resources of major retailers

Throughout the 1990s, the financial situation of large retailers was dire. Sales stagnated or decreased, consumer confidence was weak and retail spending per household fell (JETRO 2004). To make matters worse, retailers were forced to generate cash flow to service their high levels of interest-bearing debt, a relic of the bubble economy in the second half of the 1980s (Dawson & Larke 2004).

To increase sales, they chose to maximize sales space, open new stores, expand product selection and increase the frequency of new product introduction (Dawson & Larke 2004; JETRO 2004; JETRO 2007).[5] Among reported measures to increase efficiency, they streamlined their supply chain and reduced the number of wholesalers that they contracted with. The question is whether an increase in direct sourcing was part of their strategy to lower their supply chain costs (Maruyama 2004; The Economist 2004). Given their strategy of increasing sales by maximizing sales space, expanding product selection and increasing the frequency of introducing new products, reducing the number of wholesalers is plausible for a number of efficiency-related reasons; increasing direct sourcing, however, is not:

1. According to Maruyama (2004), delivery frequency from wholesalers to retailers increased during the time frame studied. This suggests that retailers increasingly relied upon wholesalers for storing the goods and the timely supply of merchandise in accurate, small quantities, because maximizing sales space and expanding the number of product items requires storage space in stores to be minimized.

2. Dawson & Larke (2004) report that the use of consignment purchase agreements and supplier-employed sales staff in department stores increased after 1990.[6] This observation fits well with the strategy of competing on product selection under financial constraints. Consignment purchase agreements with wholesalers lower the retailers' risk associated with

[5] According to data provided by the Statistics Bureau of Japan, the sales space of department stores, for example, increased by 10%, while that of supermarkets increased by 112% (Statistics Bureau of Japan, Historical Statistics, Chapter 13 Domestic Trade, Table 13.11). The number of department stores decreased from 378 in 1990 to 345 in 2005 (-9%), while that of supermarkets increased from 1,980 in 1990 to 3,940 in 2005 (+99%).
Competition in product selection rather than on price would explain why only some of the largest retailers took advantage of the new regulatory environment by opening large numbers of new stores. According to (Davies & Itoh 2001), there was an increase in the average store size among large retailers, but there was less of an increase in the total number of large stores. Retailers sought to benefit from an increase in scope (that is, obtaining a wider range of products at the same location by increasing store size) rather than scale (i.e., generating greater purchasing power from greater sales of the same goods by increasing store numbers).

[6] Kikkawa & Takaoka (1998) describe how these trade practices took root the in the post-war economic rehabilitation period .

the frequent introduction of new products and simultaneously lower the personnel costs associated with directly paid employees.[7]

3. Competing on product selection requires that retailers have the resources to access a wide range of products. Sourcing through wholesalers allows retailers to access a large number of manufacturers while keeping the related costs comparatively low.

Thus, from the point of view of strategy and resources, it is plausible that direct sourcing did not increase substantially during the time frame studied.

3. Power

To increase direct sourcing, retailers must have the power to a) make manufacturers adopt direct-trading arrangements and bear the related costs, and b) circumvent the wholesale sector.

3.1 Power over manufacturers

In this section, we analyze two potential sources of retailer power over manufacturers. To this end, we consider two main indicators of retailer power: market concentrations and the value share of private labels[8] in total retail sales. For the sake of international comparisons, we analyze the numbers on a national level.

3.1.1 Market concentration

Market concentration relates to the number of firms that account for the total production within a given industry. Market concentration is often indicated by how much of the total market the top firms control, i.e., what their market share is. The most commonly used concentration ratios (CR) are the four-firm and five-firm concentration ratios (CR4 and CR5).

Studies have found a negative relationship between retail concentration (the market share of the largest retailers in a retail market) and manufacturers' profit margins (Inderst & Mazzarotto 2008). Thus, market share is a necessary condition and proxy for retailer power. According to the UK Competition Commission, a CR1 as low as 8% can already give a retailer significant power (Dobson 2005). Market concentration is, however, only a starting point for the analysis, because other factors such as a favorable image among consumers influence retailer power as well (Amato

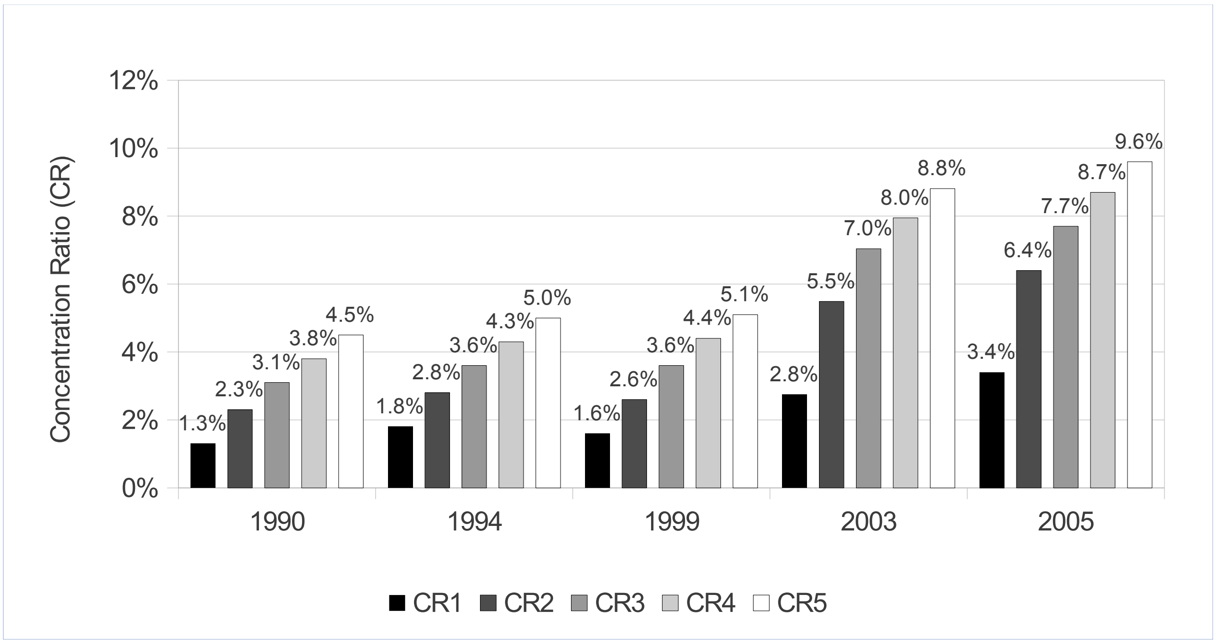
7 Under such an arrangement, the risk of new product introductions is borne by manufacturers. Manufacturers reduce this risk by dispatching their own sales personnel and acquiring expertise by closely following and anticipating consumer trends. The extensive use of consignment purchase agreements eventually results in manufacturers controlling sales floor operations and retailers depending on manufacturers' market expertise and dispatched employees for both know-how and cost-related reasons. See Kikkawa & Takaoka (1998).

8 Private labels are products owned and exclusively distributed by one or more retailers.

and Amato, 2009). Furthermore, because a market has a demand and a supply side, not much can be deduced about retail power from retail concentration ratios, unless the ratios are interpreted, at a minimum, through comparison with concentration levels prevailing in manufacturing markets (Amato & Amato 2009). We therefore compare the market concentrations (CR) of the retail industry with the product market concentrations in 40 processed food and 37 non-food product markets. We choose products that are available in supermarkets and/or department stores, and for which the Japan Fair Trade Commission provides data for the time frame studied.

As can be seen in Figure 2, the total retail market concentration in Japan more than doubled between 1990 and 2005. On the CR3 level, it increased from 3.1% in 1990 to 7.7% in 2005, and on the CR4 level, it increased from 3.8% in 1990 to 8.7% in 2005. In 2005, the biggest retailer (Aeon) had a share of 3.4% of the total retail market in Japan (CR1=3.4%).

Figure 2: CR1-5 of the total retail market in Japan, 1990 – 2005

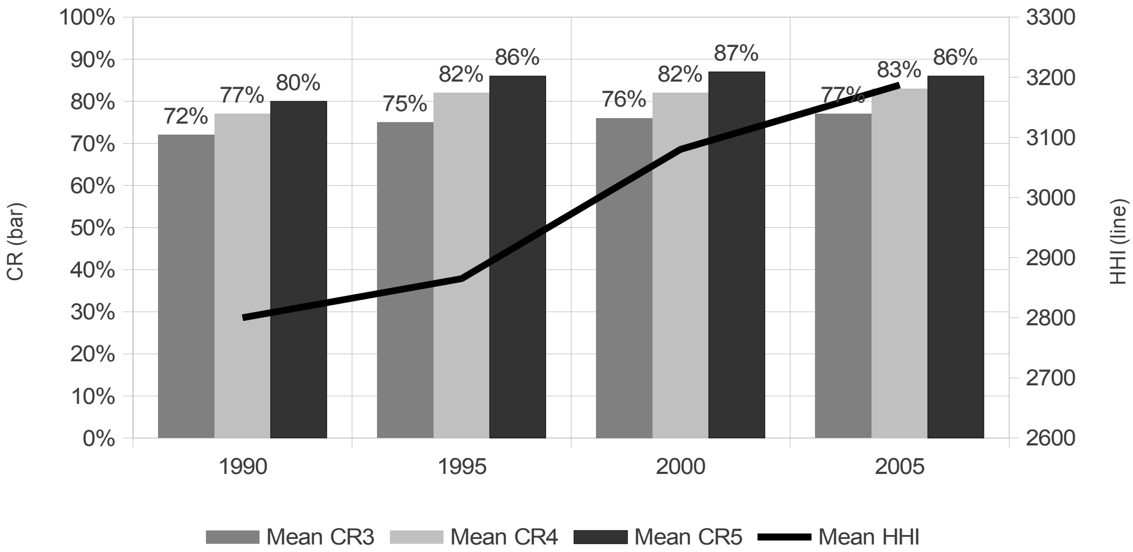


Sources: JETRO (2007), Nikkei Marketing Journal (1992, 1996, 2005); Dawson and Larke (2004).

Despite this doubling in the retail market concentration between 1990 and 2005, market concentration in Japan is still very low when compared internationally. In 2002, CR1 was 23% in Great Britain, 14% in France, Germany and Spain, 10% in Italy, and 19% in the U.S., while CR5 was 67% in Great Britain, 56% in France, 36% in Germany, 26% in Italy, 52% in Spain, and 32% in the U.S. (Dobson 2005).

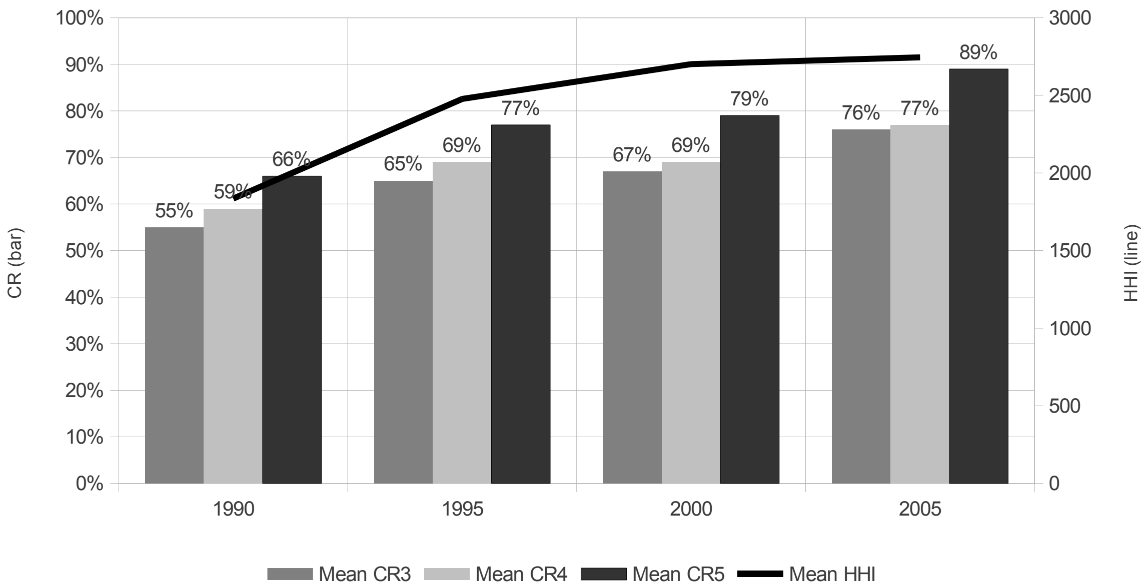
We now compare retail market concentrations with market concentrations prevailing in the selected non-food and food product markets. Figures 3 and 4 show their mean CR3-5 and the Herfindahl Hirschman Index (HHI). The HHI indicates how market shares are distributed within an industry, and is calculated as the sum of the squares of the market shares of all firms in the market. As can be seen, both the mean concentration ratios as well as the HHI increased in the time frame under consideration. The mean CR4 of the selected non-food product markets increased by 6pp from 77% in 1990 to 83% in 2005, while that of the selected food product markets increased by 18pp from 59% to 77%. The increase in the HHI also indicates that these product markets became less competitive. The finding that market concentration across product markets increased is consistent with Cortes (2006).

Figure 3: CR3-5 and HHI of selected non-food product markets



Source: Based on data from the Japan Fair Trade Commission.

Figure 4: CR3-5 and HHI of selected food product markets



Source: Based on data from the Japan Fair Trade Commission.

We can summarize the results as follows: First, product market concentration levels are considerably higher than total retail market concentration. Second, the concentration ratios of both the demand and supply side increased during the time frame studied, indicating that neither side could unilaterally and substantially increase power. Third, the retail concentration in Japan is very low from an international perspective. As noted above, even the biggest retailer in 2005, Aeon, had a market share of only 3.4%. This would explain why even Aeon had difficulty convincing manufacturers to enter into direct trading relationships (Aoyama 2007). The low figure in total retail concentration is reflected in the fact that only a few nationwide retailers were operating at the time (JETRO 2004). In the drug store market, for example, even the industry-leading chains were only regional, and there were no national players. Similarly, in the home improvement industry, there were no nationwide chains. The industry leaders were all regional chains. Japan still had a large number of department store chains, whereas in many Western nations, the number of department stores had been reduced to only a few. As of July 2003, there were 99 department store operators in Japan. Only 10 out of these 99 operated nationwide, and the same 10 accounted for 57% of the total department store sales. The remaining 43% were regional department stores that focused on their respective prefectural capital (JETRO 2004).

3.1.2 Value share of private labels

We now turn to the second proxy for retailer power, the value share of private labels in total retail sales. With the introduction of private labels, retailers become direct competitors to brand producers (Dobson 1998). Private labels lead to more competitive manufacturing markets and enhance retailer power because retailers can credibly threaten to market their own private label products at the expense of the manufacturer's branded products (Dobson 2005).

In 2000, the worldwide average value share of private labels in packaged consumer goods was 14%. The share in Western Europe and in the United States was 20%, and in Australasia, it was 15%. In Japan, in contrast, the value share of private labels was only 2%, which is significantly below the worldwide average. Only Central and Eastern Europe as well as China showed lower figures (Kumar & Steenkamp 2007).

In 2005, the value share of private label products across 38 countries and 80 categories was 17% over the 12 months ending the first quarter of 2005, compared to 15% in 2003 (A.C. Nielsen 2005). The value share varies widely across the countries included in the study. Switzerland records the highest share of private label products, at 45%, and the Philippines registers the lowest, at less than 1%. The emerging markets in the Asia-Pacific region and Latin America had fewer developed private label markets than did Europe or North America. Japan’s share of private label products was 4%, a low figure when compared internationally, with no change from the figures in the (A.C. Nielsen 2003) report.

Thus, in the Japanese retail sector, market concentration ratios and the value share of private labels are both very low when compared internationally. Assuming that market concentration ratios and the value share of private labels are a proxy for retailer power in general, we can therefore hypothesize that the power of Japanese retailers is rather weak. Furthermore, the retailers' increasing dependence on consignment sales and dispatched sales personnel (see section 2) must have contributed to their weak bargaining position.

Why then are both retail concentration and private label value shares so low from an international perspective? According to A.C. Nielsen (2005), four factors foster high retail concentration: 1), the presence of aggressive discounters that 2) sell a limited selection of products (mainly shelf-stable food) at 3) a very low price and 4) with high purchase frequency. In Japan, purchase frequency is high, but Japanese retailers competed on product selection rather than price and increased the number of products offered to consumers rather than limiting their selection. Furthermore, Japanese consumers expect to find a variety of fresh products (Aoyama 2007). With regards to the low private label value share, the value share of private labels is connected with retail concentration: the higher retail concentration is, the higher the value share of private labels (Dobson 2005). From this perspective, the small value share of private labels in Japan simply reflects the low retail market concentration. Based on the insights of section 2, one might also argue that the low value share reflects the retailers' lack of market knowledge and resources to develop private label products, as well as their dependence on manufacturers of branded products. Kojima (2010) argues similarly, commenting that developing private labels was too risky a strategy even for major retailers during the time frame studied.

3.2 Power over wholesalers

In this section, we investigate whether retailers had the power to circumvent the wholesale level when establishing direct-trading relationships with manufacturers.

Japanese wholesaling has widely been regarded as moribund (Larke & Davies 2007), particularly because the use of the Internet for business transactions has rendered wholesalers redundant as order-processing intermediaries between retailers and manufacturers (The Financial Times 2000). This view, however, ignores the fact that General Trading Companies (GTC), which are large and highly integrated wholesale organizations, have actually strengthened their positions in the retail and wholesale markets. According to Larke & Davies (2007), GTC have, on the one hand, enhanced their position in the domestic wholesale sector by investing in or merging with other wholesale firms. On the other hand, they have assumed control of major retailers, which represents a new direction in GTC strategy (Meyer-Ohle 2004).[9] By capitalizing on both their existing embeddedness in the domestic market and their international supply network, the GTC can efficiently supply Japanese retailers with both domestic and imported products. By assuming a significant stake in major retailers, the GTC can diminish the retailers' ability to establish direct trading-relationships with manufacturers because the GTC may insist on using their own (wholesale) facilities (Meyer-Ohle 2004). Given these dependencies, it is questionable whether large retailers had the power to circumvent the wholesale level.

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9 For example, in 1998, Itochu acquired a 30% stake in FamilyMart, a convenience store company; in 2000, Mitsubishi acquired 20% of Lawson, and in 2002, the company acquired a 10% share of am/pm, both convenience store companies; in 2000, Marubeni acquired a 10% equity stake in the leading supermarket company, Maruetsu, from Daiei and increased its share to 30% in 2001; later, the company became a shareholder of Daiei itself by acquiring 5% of the company; in 2003, Maruetsu and Marubeni together acquired a 17.5% share of Tobu store, a mid-sized operator of food supermarkets; in 2000, Sumitomo purchased an equity stake of 12.5% in Seiyu, a major operator of food supermarkets and general merchandising stores (Meyer-Ohle, 2004).

4. Conclusion

This study explores the question of whether increased competition in the Japanese distribution system led to more retailer-initiated direct-trading relationships between large retailers and manufacturers in Japan in the years from 1990 to 2005. Due to a lack of pertinent data to verify this claim, we chose to explore the question indirectly. Our synthesis of existing data, research and available information indicates that direct sourcing did not substantially increase during the time frame studied. First, direct sourcing was not a strategic priority for large retailers. Second, major retailers did not have the power to shift the distributive functions from wholesalers to manufacturers, nor, third, did they have the resources to assume them themselves. Thus, although competition within the Japanese distribution system increased, the basic sourcing strategy of large retailers through wholesalers remained largely intact.

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