



A Guide for New Manufacturers

Food Distribution Channel Overview

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Food Distribution Channel Overview

The food distribution system in the U.S. is complex. Many players—including middlemen—produce, manufacture, transport, distribute, market, and sell every type of food product imaginable. By the time a product is placed on a grocery store shelf, it has traveled countless miles and has been handled by many people. Each person has evaluated and scrutinized the product to assess its risk and opportunity. Each has considered quality, price, packaging, labeling, and marketing plans. By the time the product is purchased, the manufacturer, broker, distributor, and retailer have all determined it to be viable and profitable, and the end consumer has deemed it to be of significant value.

Not every new product reaches the final consumer. Many great products never leave the manufacturer's warehouse. Creating the product is only half the battle; the next step is to distribute and market it. While some manufacturers can market their products directly to consumers (e.g., through farmers' markets, online sales, or DSD¹), most food manufacturers need to use middlemen (Henehan).

This publication explains the main issues that challenge new food businesses as they distribute their products to retail customers.



Food distribution channel players

The food system encompasses many activities, from harvest to processing, retailing, and consuming. This system is called by many names: marketing channel, distribution channel/chain, or supply chain. In this publication, we use the term *distribution channel*. The main middlemen in the distribution channel are as follows.

Food distributors purchase products from a manufacturer or from another distributor and sell and distribute the products to retailers, food-service companies, and other distributors.

¹Direct Store Delivery: Manufacturers deliver products directly to the retailer.

Food brokers act as food manufacturers' representatives and facilitate sales between manufacturers and retailers. They do not take ownership or physical possession of products.

Food wholesale distributors are very similar to distributors, but they do not perform as many services, such as stocking and managing retail shelves.

Foodservice distributors and brokers are similar to retail brokers and distributors, except that they focus on servicing foodservice customers.

Self-distributing retailers are large retailers, such as Albertsons, Fred Meyer, Safeway, and Wal-Mart, who have their own distribution centers. Manufacturers deliver directly to these centers. The retailer then distributes the product to individual retail stores. This system accounts for roughly 34 percent of distribution centers in the U.S. (Harris, et al.).

The product distribution pathway

A new food product can take one of several paths to reach the consumer. Distribution options depend on the product, the market, the type of retail establishment, and the manufacturer's sales skills. Some manufacturers reach the consumer directly by selling products at farmers' markets. Others use elaborate distribution methods involving several brokers and distributors. Many manufacturers do not have the skills or the time to promote and sell their new product. For them, the use of food distributors and brokers is the only way to obtain distribution.

Most foods go through a distribution channel to reach the end consumer, whether that consumer is a shopper in a retail grocery store or a diner at a fine restaurant. The conventional distribution path for a packaged food product is from manufacturer to broker to distributor to retailer. This path can vary greatly depending on the product, the target markets, and the

manufacturer. In general, more perishable foods, such as fresh seafood, have fewer handling exchanges from the producer to the consumer, than, say, a packaged product such as jams and jellies.

Many requirements, such as UPC codes, nutritional labeling, and product packaging, must be satisfied before distributing a product. One of the first activities is to determine your product's target market. This includes identifying the geographic area, retail markets, and consumers that will make up your core market.



Typical distribution process for a retail food product

Step 1. Test the waters

Many new food manufacturers introduce their product at small, local retail markets. This is a great way to test the waters. Many small retailers like to help new local businesses. These retailers are also a valuable resource for advice on pricing, packaging, and promotions. Starting locally gives you an opportunity to tweak your product, packaging, and promotions.

Step 2. Hire a broker

While some new food manufacturers have the skills to sell successfully, most do not. A broker can help you with this job.

Securing a broker takes time, money, and effort. Aside from initial sales to small retailers, brokers are the first “sale” a manufacturer must make. You must convince the broker that your product is viable and profitable. For a broker, the costs and energy required to launch a new product are great. On average, brokers will take a 3 to 5 percent commission. For more information on brokers, see *Using Food Brokers in the Northwest: A Guide for New Manufacturers* (EM 8922).

Step 3. Find a distributor

Distributors purchase, inventory, transport, and sell products to retail accounts that the manufacturer has set up. They also assist in gaining new retail accounts. Distributors act as logistics experts for food distribution. Markups can range from 10 to 35 percent of the wholesale price, depending on the product, category, distributor, and retail customer.

Finding the right distributor is key. Many distributors sell to specific types of retailers. If you are targeting a specific type of retailer, it is wise to choose a primary distributor for that retailer. If you’re using a broker, the broker often will help gain the attention of appropriate distributors.

Selling to a distributor can be a huge accomplishment. Having a detailed and well-thought-out plan for your product will help you secure a distributor. Many requirements must be met before a distributor will consider your product. Make sure you understand them and do your homework ahead of time. For more information on distributors, see *Using Food Distributors in the Northwest: A Guide for New Manufacturers*.





Step 4. Secure retail accounts

Even with a broker and/or a distributor secured, your selling role isn't over. You must now work alongside your broker to make the crucial sales to retailers. Remember, if the retailer doesn't buy your product, the distributor won't either!

Choosing the right retail accounts is crucial. All retailers are different and have different requirements. It is important to know the retailers. Do research and know who's competing in your product category.

New food businesses usually find it best to start small for financial and logistical reasons. Oregon is a great place to start a food business. Many retailers, mainly small independent stores and chains, support local food manufacturers. For more information on retailers, see *Grocery Retailers in the Northwest: A Guide for New Manufacturers* (EM 8924).

Overarching imperative: Remember the customer

Throughout this process, you have been convincing many people that your product is viable, marketable, and profitable. In the end, the consumer will have the final say. If the end consumer doesn't buy your product, no one along the distribution channel will buy it. Remember consumers, and target your promotions and other marketing efforts to win them.

Pricing and the distribution channel

Pricing your product correctly is crucial to its success. The price should reflect the product's perceived value to the consumer. Consumers won't purchase a more expensive product unless its perceived value is greater. Consider the competition's price on the retail shelf. Visit stores and view the competition; note prices and how package size relates to price.

Many new manufacturers are unsure of how to calculate margins and markups, or they might not understand the difference between the two (Taylor). Manufacturers must understand how the retail food dollar is broken up. Every handler, from the manufacturer to the retailer, takes a percentage. Appendix A gives examples of the retail food dollar and

explains how margin and markup are calculated. Use Appendix B to help you estimate your selling price with a given markup or margin.

When calculating profits, consider all your costs, not just the costs to produce the product. Additional costs include promotions, transportation, and slotting fees. A slotting fee is a fee that retailers charge manufacturers to cover the costs of putting a product in their warehouse and on their shelf. These fees also cover the risk assumed by the retailer when taking on new products (Hall).

Slotting fees vary depending on the product, region, and amount of required shelf space (Marion). Slotting fees usually consist of payments to the retailer, but they also can include discounts and free merchandise. These fees range from \$100 to several thousands of dollars. They can be a flat rate across a chain or vary by store. Since larger manufacturers have larger promotion budgets, they are more able to afford slotting fees; smaller manufacturers often have a hard time paying these fees. Slotting fees can be negotiable if there is a demand for the product and it has local recognition (Brooks).

Getting distribution

Whether approaching a broker, distributor, or retailer, be prepared. When marketing a product, you'll need to address the following: product viability, knowledge of the market, marketing budget and plan, and finding a broker or distributor that fits your objectives (Thilmany and Grannis). Jim Brooks, business and marketing specialist at Oklahoma State University's Food and Agricultural Products Research and Technology Center, encourages manufacturers to use direct store delivery initially in order to build relationships with individual stores, their employees, and their customers (Brooks).

Distributors, retailers, and brokers are running a business. They are looking for profitable products—ones that will sell easily, in sufficient volumes, and will provide the margins needed to cover fixed costs and generate a profit. Retailers carry thousands of items that compete for limited shelf space. Distributors, who deal with inventory and space issues, generally look for products that will sell better than the ones they are currently carrying and have the potential to bring in more money. Brokers invest a lot of money and manpower to promote new products, so





they want products that can cover these costs. In the end, you must sell each player on the benefits of your product. You'll also need to show brokers and distributors that you are serious about their business and are interested in building long-term relationships.

To prove a product is viable, you first must establish consumer demand for your product—actual sales data or market research that shows consumer acceptance. The product must be attractive to the end consumer before a broker, distributor, or retailer will accept it.

“In short, there are three ways to be attractive to the consumer: be cheaper, be better, or be unique” (Thilmany and Grannis). It is always easier to attract consumers to lower priced products. When a product is higher in quality or unique, the manufacturer might need to rely on consumer education and promotions to attract consumers.

Other distribution issues

Technology²

New technologies and management systems are adopted every year in the food retailing and distribution industries. The goal is to create a more efficient, cost-effective, and responsive distribution channel. Management systems play a huge role in maintaining product integrity and distribution efficiency. Manufacturers need to be aware of these new technologies and management strategies. If your product or business isn't ready for the technology (e.g., correct packaging, labeling, software compatibility), it could be left behind.

The following are a few technologies that have been adopted or are being developed for use in the food distribution industry.

Electronic data interchange (EDI) is a substitute for paper invoicing, instead using electronic resources such as e-mail and the Internet.

Continuous replenishment uses shared computer networks between retailers and suppliers to view inventory at any time. Sometimes called “just-in-time” inventory or supply management.

Electronic consumer response (ECR) is a demand-driven replenishment system designed to link all parties in the distribution channel to create a massive flow-through distribution network. Replenishment is based

²Dimitri, C. and N. Richman. *Organic Food Markets in Transition*. Policy Studies Report No.14. Henry A. Wallace Center for Agricultural and Environmental Policy, Greenbelt, MD (2000).

on consumer demand and point-of-sale information. Overall, ECR translates to lower transaction costs for retailers.

Radio frequency identification (RFID), an automated radio signal identification, is used by food distributors and retailers for inventory purposes. RFID allows identification of merchandise while materials are being handled and in transit. Using RFID technology, along with ECR, helps retailers and distributors reduce costs and increase efficiency.

Product movement

Most food is distributed via trucks, owned either by the manufacturer, distributor, or a third-party transport company. Large retailers, such as Albertsons and Fred Meyer, have centrally located distribution centers. It usually is up to the manufacturer to have products delivered to the distribution center. From there, the retailer transports products to individual stores.

Efficiency is key in moving products through the food distribution channel, not only for cost reasons, but also for perishability and damage control reasons. Produce and other perishable food products must be moved to the end consumer as quickly as possible, and preferably with minimal handling. The more times a product is handled, the greater the chance that it will be damaged. Maintaining the product's quality throughout the distribution channel is a goal and challenge for producers (Fong, et al.).

Traceability

Due to recent food scares, such as mad cow disease, avian flu virus, *E. coli* outbreaks, and salmonella infections, consumers, as well as government agencies, are being more careful in regard to food handling. Traceability systems are used not only for food safety, but also to address issues such as bioterrorism and consumers' rights to know. Policy makers are studying the possibility of making traceability systems mandatory (Golan, et al.). Stay informed about current food safety concerns, especially those that might impact your production or sales.

Packaging

Packaging is a major consideration. Because many retailers use uniform shelving and layouts in all their stores, they can accept only products with conforming package shapes. Visit retailers and look at the competition's packaging. Whether it be a box, bottle, or jar, the size and shape needs to fit the retailer's shelf. A bottle that is too tall may not fit on the shelf, while





one that is too short or narrow will create undesirable “empty space” (Koppen).

Jim Brooks, at Oklahoma State University’s Food and Agricultural Products Research and Technology Center, warns manufacturers not to cut corners on packaging and presentation. While it is important to not spend too much on packaging, a good package is very important in making sales.

The U.S. Food and Drug Administration (FDA) requires most food products to include a nutritional label. There are exceptions for small businesses. The FDA exemption states, “Businesses with fewer than 100 full-time equivalent employees may claim an exemption for food products that have U.S. sales of fewer

than 100,000 units annually. Companies claiming this exemption must notify FDA that they meet the criteria before they begin marketing their products” (FDA website). Even if you qualify for the exemption, however, consider the appearance of your product. Today’s label-savvy consumers might see the lack of nutrition labeling as an indication that a product isn’t as good as others. At the very least, it is advisable to have a nutritional label on hand to respond to customer requests.

Summary

It is not easy to distribute and sell food products. A food product can take many paths to reach the retail customer, and these paths often include many hurdles. It takes a great deal of work, money, help, and luck to successfully market food products to end consumers.

Understanding the work of brokers, distributors, and retailers will greatly improve your chances of successfully distributing your product. Also, knowing early on whether to do your own marketing and distribution or to use brokers and distributors will save you time and possibly money. Doing your research and understanding pricing is critical. And, never forget that, in the end, consumers determine which products will succeed.

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Appendix A. Pricing, markups, and margins

Understanding markups and margins

Manufacturers are often confused about how to calculate markups and margins (profit). Markup and margin are different. *Markup* is the amount you add to your cost of goods sold (COGS) to arrive at a selling price. *Margin* is the percentage you make on the sale expressed as a percentage of the selling price. It states how much profit you've made based on a given selling price. For example, a 25 percent markup will yield a 20 percent margin.

Markup calculations

To find a product's selling price with a desired markup, use the following formula:

$$\text{COGS} \times (1 + \text{markup } \%) = \text{selling price}$$

Example 1: A product with a COGS of \$10.00 and a markup of 25%:

$$\text{COGS} \times (1 + \text{markup } \%) = \text{selling price}$$

$$\$10.00 \times (1 + 0.25) = \$10.00 \times 1.25 = \$12.50$$

Conversely, the formula for calculating markup with a given selling price and COGS is:

$$(\text{selling price} \div \text{COGS}) - 1 = \text{markup}$$

$$(\$12.50 \div \$10.00) - 1 = 1.25 - 1 = 0.25 \text{ or } 25\%$$

Margin calculations

To set a selling price with a given COGS and a desired profit margin, use the following formula:

$$\text{COGS} \div (100\% - \text{margin } \%) = \text{selling price}$$

Example 2: If an item costs \$10.00 and you want to add a 20% margin:

$$\text{COGS} \div (100\% - \text{margin } \%) = \text{selling price}$$

$$\$10.00 \div (100\% - 20\%) = \$10 \div 80\% = \$12.50$$

Conversely, the formula for calculating margin with a given selling price and COGS is:

$$(\text{selling price} - \text{cost}) \div \text{selling price} = \text{margin}$$

$$(\$12.50 - \$10.00) \div \$12.50 = \$2.50 \div \$12.50 = 0.2 \text{ or } 20\%$$

Note that the selling price in Example 2 is the same as that in Example 1, but the markup is 25 percent, while the margin is 20 percent. The reason is that the markup is calculated based on the COGS, while the margin is calculated based on the selling price.

Pricing—Work backwards!

Because your product must be priced competitively, work backwards to calculate your profit. If you or your distribution channel partners aren't making an adequate profit, the product will not succeed.

Although every product is different, a product's price increases with every exchange of hands. As the manufacturer, you must account for every markup and how this will affect the final retail price of your product. Thus, you need to know what commission the broker will take and how much the distributor and retailer will mark up your product.

For example, let's assume a manufacturer sells a product to a distributor, using a broker. The distributor sells to a retailer, with a final retail price of \$0.99 to the consumer.

The manufacturer produces the product for \$0.49 (COGS). With a 30 percent markup, the manufacturer sells the product to the distributor for \$0.64. Taking into account the 5 percent (\$0.03) commission to the broker, the manufacturer's revenue is \$0.61 per unit sold. The distributor purchases the product for \$0.64 and marks it up 15 percent to \$0.74. Retailers then purchase the product for \$0.74, mark it up 35 percent, and sell it to the consumer for \$0.99.

This retail dollar is broken down as follows. (These numbers are based on average markups; this example does not apply to every product.)

COGS	\$0.49
Manufacturer's 30% markup	0.15
Broker's 5% commission = \$0.03 (not added to price)	
Distributor's 15% markup	0.10
Retailer's 35% markup	<u>0.25</u>
Retail price	\$ 0.99



Appendix B. Pricing worksheet

A. Markups: Finding the selling price

$$\begin{array}{l} \text{COGS} \quad \times \quad (1 + \text{markup } \%) = \quad \text{selling price} \\ 1. \quad \underline{15.00} \quad \times \quad \underline{(1 + 0.30)} = \quad \underline{\$19.50} \\ 2. \quad \underline{\hspace{2cm}} \quad \times \quad \underline{\hspace{2cm}} = \quad \underline{\hspace{2cm}} \\ 3. \quad \underline{\hspace{2cm}} \quad \times \quad \underline{\hspace{2cm}} = \quad \underline{\hspace{2cm}} \end{array}$$

B. Markups: Working backwards from the selling price

$$\begin{array}{l} (\text{selling price} \div \text{COGS}) - 1 = \quad \text{markup} \\ 4. \quad (\underline{\$19.95} \div \underline{\$13.50}) - 1 = \quad \underline{0.478 \text{ or } 47.8\%} \\ 5. \quad (\underline{\hspace{2cm}} \div \underline{\hspace{2cm}}) - 1 = \quad \underline{\hspace{2cm}} \\ 6. \quad (\underline{\hspace{2cm}} \div \underline{\hspace{2cm}}) - 1 = \quad \underline{\hspace{2cm}} \end{array}$$

C. Margins: Finding the selling price

$$\begin{array}{l} \text{COGS} \quad \div \quad (100\% - \text{margin } \%) = \quad \text{selling price} \\ 7. \quad \underline{\$20.00} \quad \div \quad (100\% - \underline{20} \%) = \quad \underline{\$25.00} \\ 8. \quad \underline{\hspace{2cm}} \quad \div \quad (100\% - \underline{\hspace{1cm}} \%) = \quad \underline{\hspace{2cm}} \\ 9. \quad \underline{\hspace{2cm}} \quad \div \quad (100\% - \underline{\hspace{1cm}} \%) = \quad \underline{\hspace{2cm}} \end{array}$$

D. Margins: Working backwards to find the margin

$$\begin{array}{l} (\text{selling price} - \text{cost}) \div \text{selling price} = \quad \text{margin} \\ 10. \quad (\underline{\$25.00} - \underline{\$20.00}) \div \underline{\$25.00} = \quad \underline{0.2 \text{ or } 20\%} \\ 11. \quad (\underline{\hspace{2cm}} - \underline{\hspace{2cm}}) \div \underline{\hspace{2cm}} = \quad \underline{\hspace{2cm}} \\ 12. \quad (\underline{\hspace{2cm}} - \underline{\hspace{2cm}}) \div \underline{\hspace{2cm}} = \quad \underline{\hspace{2cm}} \end{array}$$

For more information

Grocery Retailers in the Northwest, EM 8924

Using Food Brokers in the Northwest, EM 8922

Using Food Distributors in the Northwest, EM 8923

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