Big box retailers aren't always able to squeeze small suppliers

Has the rise and consolidation of 'big box' retailers, such as Walmart, Tesco and Carrefour, undermined the ability of suppliers, especially small ones, to earn sizeable profits? Are small suppliers that bargain with these giants doomed to earn a meagre share of the 'channel surplus' – the difference between retail revenues and variable production costs?

While the answer to these questions has been hotly debated among both commentators and academics, a clear answer based on hard evidence has been elusive. The paucity of research examining this question can be explained, primarily, by the lack of appropriate data.

Measuring the channel surplus requires a good estimate of production costs, which is usually unavailable to researchers since it is seen as sensitive information by manufacturers. Similarly, being able to determine the share of the pie obtained by retailers and suppliers requires observing the negotiated wholesale prices (those paid by retailers to suppliers), which are not publicly observed due to confidentiality.

Our study tackles this challenge by using a novel dataset that includes wholesale prices paid by major supermarket chains in Chile to packaged coffee suppliers over the period from 2005 to 2007. We focus on the Chilean packaged coffee industry for two main reasons:

- First, the industry is characterised by the interaction of two large retailers that bargain for their share of the channel surplus with suppliers of varying size, the dominant one being the large multinational Nestlé.
- Second, coffee production costs are easy to estimate, as the production technology is relatively simple and the largest share (at least 50 per cent) of costs is accounted for by green coffee beans, for which prices are publicly observable.

Combining data on prices at the retail and wholesale levels, quantities and estimated coffee production costs, we find that while the largest supplier, Nestlé, is able to secure a large fraction of the pie (around 65 per cent) the median fraction of the surplus obtained by other smaller suppliers is a sizeable 41 per cent. This indicates that it is not necessarily the case that small suppliers bargaining with large supermarket chains are doomed to earn negligible profits. Some are able to secure relatively large fractions of the surplus at stake in negotiations with retailers in spite of their small market sizes.

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What explains the ability of small suppliers to earn such a large share of the channel surplus? To answer this question, we decompose the fraction of the channel surplus earned by the two 'players' in the negotiation into two components.

One component is what is known as bargaining position and is the difference between agreement and disagreement payoffs. Disagreement payoffs are the payments for both players in a hypothetical scenario where the retailer does not carry any of the manufacturer's products. Since disagreements are not observed in the data, the researchers estimate a demand system and use these demand estimates to compute a measure of the profits that the supermarket would obtain if a given supplier's products were taken off its shelves. The less substitutable (more differentiated) the product is, the lower the profits a supermarket would obtain in the event of a disagreement in their negotiations with the supplier. In this case, the supplier is in a better bargaining position.

The second component of the fraction of the channel surplus earned by a player is what we call bargaining power or bargaining weight – a broad component encompassing deep factors such as relative bargaining skills, patience and risk aversion.

The study finds that the relatively large share of the surplus earned by small coffee manufacturers can be rationalised by retailers' low 'outside options' (disagreement profits are about 27 per cent of agreement profits). The results suggest that the most likely explanation for small manufacturers' ability to capture value is that they provide differentiated products to a small but highly loyal group of customers.

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Notes:

- *This blog post is based on the authors' paper Are Supermarkets Squeezing Small Suppliers? Evidence from Negotiated Wholesale Prices, The Economic Journal, May 2018.*
- *The post gives the views of its authors, not the position of LSE Business Review or the London School of Economics.*
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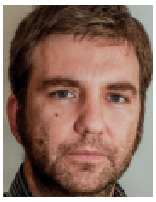

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