

Wal-Mart: The Nation's Largest Grocer Rolls-out Organic Products

Market Expansion or Market Delusion?

A White Paper from The Cornucopia Institute



CORNUCOPIA
INSTITUTE

**Prepared by
Mark Alan Kastel, Senior Farm Policy Analyst
The Cornucopia Institute**

September 27, 2006

Acknowledgements

The following staff members, advisors and individuals helped write, research, edit and support this paper:

Mark A. Kastel, Senior Farm Policy Analyst
Will Fantle, Research Director
Margaret Hannah, Board President, Scientific Editor
Steve Sprinkel, Policy Advisor

About The Cornucopia Institute

The Cornucopia Institute is a Wisconsin-based farm policy group working nationally on organic and sustainable agriculture issues. Its mission is dedicated to *the fight for economic justice for the family-scale farming community*. The Institute acts as a government and corporate watchdog. Through research, organizing, networking, and coalition building, Cornucopia seeks to empower farmers and consumers, both politically and through marketplace initiatives—protecting the environment, human health and economic justice.

Founded in April 2004, Cornucopia's core membership comes from the farm community and their urban/organic consumer allies. A nine-member board of farmers and farm business professionals, environmentalists, scientists, and consumers sets organizational policy. A seven-member policy advisory panel of leading organic thinkers and practitioners offers guidance and counsel.

Individuals interested in more information can contact The Cornucopia Institute at PO Box 126, Cornucopia, WI 54827, by email at cultivate@cornucopia.org, or may visit the organization's Web page at www.cornucopia.org.

Contents

- Abstract 4**
- Wal-Mart's Strategic Approach to Organics 5**
- Organic Product Sourcing: Factory Farms 5**
 - Organic Dairy 5**
 - Organic Produce 7**
- Organic Product Sourcing: Chinese Imports 7**
 - USDA Organic Accreditation/Certification 8**
- Wal-Mart Invents a "New" Organic 9**
- Pricing 9**
- Organic Certification Oversight/Ethics 11**
- Conclusion: Likely Impacts on Organic Marketplace 11**
 - Natural Food Retailing 11**
 - Manufacturing and Distribution 12**
 - Organic Farmers 12**

Wal-Mart Rolls-out Organic Products Market Expansion or Market Delusion?

I. Abstract

This spring's announcement by Wal-Mart Stores, Inc., that it would dramatically expand its product offerings of organic food has left many organic industry officials and consumers questioning the corporation's likely impact.

If Wal-Mart applies its economy of scale and logistical prowess to the organic sector it will likely create a more competitive pricing environment, benefiting consumers, and greatly increasing the accessibility of organic products. Consumers would be big winners while retail competitors and distributors would need to carefully analyze and improve their practices and lower their costs. And the increased demand for organic food would likely bode well for agricultural producers, at least in terms of sales volume.

However, if the giant corporation instead decided to apply its traditional business model to organic food, *Wal-Marting* the marketplace, all existing entities, which have been part of building this market niche into a vibrant \$16 billion industry, would likely lose. And much of the basis behind consumers' loyalty to the organic label, illustrated not only by growth but by extremely limited resistance to historic super-premium pricing, might be lost in the transition.

This report is an initial analysis of Wal-Mart's early organic marketing practices. It already appears that the corporation has chosen the latter strategy—partnering with the nation's largest agribusiness concerns to invent an alternative to the existing organic *movement*—"corporate organics." This competitive challenge has the potential to destroy healthy markets for other retailers, distributors, manufacturers/processors, and family-scale domestic farmers.

It seems clear that in addition to Wal-Mart's logistical strength, their low-price goal for organic food (10% over conventional) is based to a great degree on sourcing products from major agribusiness (with little or no history of manufacturing organic food), foreign sources, and domestic industrial-scale farms.

The worst-case scenario for the organic industry is for Wal-Mart to first destroy competition, as it has a history of doing in so many other market segments, and then create an abbreviated product line that ignores the ethical expectations of consumers. Will organic sales continue to flourish at the historic premium prices (even Wal-Mart prices are high compared to conventional food) if consumers no longer feel that their premium dollars are supporting superior food quality and environmental practices, humane animal husbandry, and economic-justice for family farmers?

Data was gathered for this report by visiting Wal-Mart's "laboratory" store in Plano, Texas, and other Wal-Mart Supercenters in Wisconsin and Colorado. Industry officials, including Wal-Mart suppliers, were also interviewed. In addition, price comparisons were made between a natural foods specialty retailer, a traditional grocer, a warehouse grocer, and Target and Wal-Mart stores in a modest-sized Midwest city.

II. Wal-Mart's Strategic Approach to Organics

Wal-Mart's expansion in organic food is integrated into two larger-scale strategic initiatives endeavoring to turn around the corporation's anemic same-store sales growth and its commensurate impact on corporate share value.

Wal-Mart has been unable to match the growth of other, more *upscale*, mid-market retailers such as Minneapolis-based Target Brands, Inc. Wal-Mart has been endeavoring to change their advertising approach and product mix in an effort to woo more affluent customers. Not only have they missed sales potential by not competing head-to-head with Target, but it is thought that their traditional customer base has been disproportionately impacted by current macroeconomic conditions—including the extensive rise in gasoline prices over the past year—and this has directly impacted the disposable income of their core constituency.

As best evidenced by their upscale, prototype store in Plano, Texas, the company has aggressively worked to change their product mix by greatly expanding selections of wine, plasma TVs, and more fashionable clothing offerings, and the addition of a greatly increased number of gourmet and organic food products. They have also remodeled some of their stores to facilitate a more sophisticated presentation of some of these product lines.

Although Wall Street has expressed support for the strategic shift, it is too early to tell what direct effect this far-ranging initiative will have on sales and bottom-line profits.

Organic retailing dovetails nicely with a second major campaign by the world's largest retailer: the *greening* of Wal-Mart. Smarting from a continuous string of investigations and negative publicity relating to the corporation's anti-union labor practices, charges of unpaid employee overtime, alleged exploitation of public assistance programs, sprawl and urban blight resulting from store placement, and huge fines paid for stormwater and polluted run-off, the company has looked toward improving its environmental practices as a way to garner both savings and a more positive public image.

While the corporation invests in energy savings at its stores and through improvements in efficiencies with its truck fleet, conservation land purchases through Acres for America, and pledges to reduce product packaging, its launching of an advertising campaign showcasing their newly found dedication to organic retailing is a logical adjunct to their public makeover.

III. Organic Product Sourcing: Factory Farms

Dairy

What has become obvious from our initial investigation is that Wal-Mart has followed their standard procurement practices in regards to sourcing organic food. It was already the nation's largest retailer of organic milk prior to its push to expand its organic product line. They have had an existing relationship with Dean Foods, the nation's largest dairy processor, selling Dean's Horizon brand of organic milk. Touted as the nation's largest organic brand, Horizon has a very impressive presence at the Wal-Mart prototype store in Plano. And unlike most other Wal-Mart outlets, and other groceries stores for that matter, in Plano they did not have just one presentation of organic milk (situated in the dairy cooler), they have a separate organic milk display in

conjunction with a "specialty" dairy cooler where they were merchandising yogurt, organic cheese, and refrigerated soy products.

The Plano store also has a large display of shelf-stable, aseptic milk packages (similar to juice boxes) in one of the grocery aisles, but it also had the same product on one of the most prominent endcaps (display at the end of the aisle) in the store.

End of aisle shelf space and refrigerated dairy coolers are two of the most valuable pieces of real estate in a grocery store. Endcap displays are usually the by-product of manufacturers paying promotional fees or some other monetary consideration. Dairy coolers contribute some of the highest profit per linear foot of shelf space, and stores demand a high turnover of products. The partnership between Dean Foods and Wal-Mart is a potent one in organic food.

It should be noted that while this relationship had increased Wal-Mart's market share in organic milk sales, Dean/Horizon has been under intense scrutiny for sourcing as much as half of its milk from large industrial-scale dairies that milk as many as 10,000 cows in feedlot-like conditions. Organic consumers find this objectionable for both philosophical and nutrition reasons. And the USDA is currently reviewing legal complaints alleging that two Dean-owned factory dairies have skirted federal organic regulations in terms of their livestock management practices.

This summer The Cornucopia Institute learned that Wal-Mart had entered into a contract with Aurora Organic Dairy, based in Boulder, Colorado, to supply the chain with private-label organic milk under the "Great Value" label. Aurora has a sordid history in terms of their reputation in the organic industry. Like Dean Foods, their corporate-owned factory farms are currently being investigated for confining their cattle in feedlots with little if any access to pasture as required by the National Organic Standards. They are also being investigated for buying replacement cattle and feed from nonorganic sources.

Unlike Dean/Horizon, which procures a significant percentage of its milk from family-scale farmers, in addition to their corporate-owned factory farms, Aurora, which was the nation's largest conventional factory-farm operator in the mid-1990s, produces or buys 100% of their milk from giant industrial-scale dairies, something highly objectionable to a large and growing percentage of organic consumers.

The fight over these factory farms said to be masquerading as organic dairies has been contentious and highly overt during the period that Wal-Mart would have been negotiating with Dean Foods and Aurora. Prominent articles in the *New York Times*, *Wall Street Journal*, *The Christian Science Monitor*, and many other national media outlets, including National Public Radio, assure us that Wal-Mart, and its undoubtedly savvy management, could not have entered into this agreement without knowledge of the serious accusations against both of these firms. Coverage of the legal complaints and consumer boycotts by the Organic Consumers Association against Horizon and Aurora products also has appeared in a number of trade publications serving both mainline grocery operators and the natural foods industry.

Wal-Mart's dependence on factory farms for supplying *cheaper* organic dairy products in the marketplace is an overt example of their historic management philosophy of sourcing products from least expensive supplier regardless of its impact on product quality, the environment, or our nation's workers.

Produce

It should be noted that for many of their primary produce items Wal-Mart is depending on the nation's largest organic produce growers, farming tens of thousands of acres in California, and importing fruit and vegetables from Mexico, Chile, and New Zealand. Their largest vendor appears to be Natural Selection Foods', Earthbound Farms label. Just like when Wal-Mart eliminated butchers from their stores, after a successful organizing effort, and turned to "case ready" meat products packaged by the nation's largest slaughterhouses, their technique in terms of organic produce is to buy products sealed in plastic from their suppliers not requiring any skilled labor at the store level. Will this hands-off approach to service be well received in the organic sector?

The USDA's organic regulations are "scale neutral." There is nothing that legally prevents farmers from operating dairies with thousands of cows or growing produce on tens of thousands of acres. The jury is still out on the mega-vegetable farms, but there is no doubt that you cannot congregate thousands of dairy cows on one operation and provide those cows legitimate access to pasture, as required by law, while caring for them in a humane manner that promotes, as required by law, their natural instinctive behaviors.

The one thing we do know about Wal-Mart's centralized purchasing is that it will cut out small and medium-size organic producers around the country who cannot compete on price with these industrial behemoths. And in the case of food security and food safety the downside of consolidating a large percentage of our nation's production, of any given commodity, in the hands of one corporate entity, or centralizing production in any given locale, has clearly been illustrated by this year's spinach debacle.

IV. Organic Product Sourcing: Chinese Imports

Organic consumers have supported the marketplace, at least in part, because they have felt that their patronage underwrote a more sustainable environmental ethic in terms of food production. Large industrial dairies that import their feed (corn and soybeans) from as far away as China and Brazil are not environmentally sustainable—or organic in the eyes of the consumer.

When it comes to organic groceries, there has been an exponential increase in imports from developing countries, especially China. Other retailers like Trader Joe's, and even established organic name brands like Cascadian Farms (owned by General Mills), depend heavily on imported frozen vegetables from China, New Zealand, Mexico, and Central America, as an example.

Our research has indicated that a number of product lines introduced at Wal-Mart obtain some or all of their purchased commodities, or even the entire finished processed product, from China.

Most of the brands introduced at Wal-Mart have little if any of the background information on their labels that traditional organic products have offered. This is certainly a change in marketing tactics, since historically organic consumers have wanted to know the background of their food—where it is from and how it is produced.

As an example, in canned beans (pinto, garbanzo, black, etc.) as offered by Wal-Mart, Chinese imports have become a standard. The brand offered by Wal-Mart is labeled Libby's®. But there

really isn't any such thing as Libby's® organic beans. The package says it is distributed by Seneca Foods Corp. under trademark license.

These canned beans are as much as 50% less in cost than name-brand organic beans (available at natural foods stores we surveyed). It is unlikely that dried beans produced in North America, and processed by established organic firms, will be able to compete on this pricing level.

USDA Organic Accreditation/Certification

Don't Panic—Go Organic was a familiar bumper sticker responding to a series of food scares a number of years prior to the USDA taking over regulatory oversight for the organic industry. Now it might be a more apt refrain from the corporate players who are making deep inroads into the organic marketplace.

That has, in essence, been the response from a number of large retailers, including Wal-Mart, and manufacturers when queried about the pedigree of their organic products. They tell anyone concerned that all their products are all "USDA certified," period.

However, the USDA has been widely criticized for its lax oversight of the organic program. Not only have they allowed apparent and overt violations of the organic standards on livestock operations, milking as many as 10,000 cows or confining as many as 100,000 laying hens, they have allowed dozens of new foreign-based certification agencies to oversee offshore organic production without determining whether the certifiers are qualified under the law. In fact, in the case of China, to our knowledge, they have yet to make a legally mandated site-visit to audit and review the qualifications of the state-control certification system. This in a country where there are virtually no independent foreign certifiers operating and no US-based organizations to inspect organic farms or processing plants. These functions have been mostly relegated to state-controlled agencies.

Two independent audits, published last year, substantiate concerns about the USDA's oversight of organic production. In a legally required independent audit, the American National Standards Institute (ANSI), an internationally recognized trade review body, found that the USDA's National Organic Program (NOP) was failing to properly perform their accreditation responsibilities. A second audit conducted by the inspector general's office at the USDA was also highly critical of the NOP.

In addition to concerns regarding certification oversight, the growing of organic food in China is troubling to many industry observers. China has a history of institutional and governmental corruption and fraud. A recent survey conducted by the Beijing Consumers Association looked at labeled organic products and found that approximately 10% were "counterfeit." This is not the first report of improprieties of this nature in China. Furthermore, China's industrial revolution has created one of the most serious pollution and toxic waste risks on the globe. According to a September 2006 *New York Times* story, toxic sludge is commonly dumped directly into the Yellow River and other tributaries and canals that are used for irrigation. There is also a history of using human waste for fertilizer in some regions of China, a practice explicitly prohibited by the USDA's organic regulations.

When responding to the fact that the USDA has never done a site visit to verify certification in China, a former governmental official and high-ranking international certification officer commented by saying, "Who would they visit? The USDA has not accredited any certifier doing

inspections in China!" Millions of dollars of organic trade is taking place in China via handshake deals and reciprocity with other international certifiers.

V. Wal-Mart Invents a "New" Organic

Just as it has done in other consumer product sectors in this country, and more recently worldwide, Wal-Mart has reinvented the nation's retail and distribution system for organic food. One of the outstanding questions is: Are they grossly miscalculating their move into organics and underestimating the knowledge and commitment of the organic consumer?

Besides eliminating the margin usually enjoyed by distributors, and buying directly from manufacturers, Wal-Mart has opted in many cases, such as with the example of Libby's-brand canned beans mentioned earlier, to invent their own product line. Although they sell private-label organic milk and soymilk, we are not talking private label here. Rather we are talking about partnering with existing major agribusiness concerns, most of whom have no prior experience in the organic marketplace. Another example is Del Monte tomato products. Available, as far as we know, only at Wal-Mart, these products sell for as much as 40% less than similar but more recognizable brands of organic products at natural food retailers.

In August the *Wall Street Journal* addressed this issue and profiled one of Del Monte's California contract growers, with 26,000 acres of tomato production. Like Wal-Mart and Del Monte, this grower had no prior experience in organics and was finding large-scale production, not surprisingly, challenging.

Another unique product line at Wal-Mart is Kellogg's cereals. Just like conventional Rice Crispies®, Raisin Bran®, and Frosted Mini Wheats®, these products are loaded with sugar. Only in this case the manufacturer is using "certified organic" sugar. Again, to our knowledge, these products have very limited initial distribution outside of Wal-Mart and some Safeway stores.

Other organic products that appear to be rather unique to Wal-Mart include Pace organic salsa (Campbell Soup Co.), Pam organic canola and olive oil sprays (ConAgra), Ragu spaghetti sauce (Unilever), and Swanson organic chicken broth (Campbell Soup Co.).

It appears that Wal-Mart is successfully creating an alternative to accepted organic brands and practices. Will this enhance their image as an aggressive price cutter, or will this undermine their efforts to improve their societal image and to paint the company "green?"

VI. Pricing

In an effort to understand more about Wal-Mart pricing philosophy, and to see how they were accomplishing their stated goal of selling organic food at just 10% over the cost of conventional products, we collected price data on organic milk in various markets around the country. We also did a more comprehensive analysis using a market basket of 30 popular organic products in a medium-sized urban community in the Midwest. Surveyed products included refrigerated, frozen, grocery, and produce items.

Wal-Mart did not quite make their 10% goal. (Were they using a benchmark of *their* price on conventional food or the average market price?) However, they were decidedly less expensive than their competition, both nationally on milk and in the Midwest market we more comprehensively studied. (In one of the markets studied, Target actually had the lowest organic milk prices Horizon).

There is no doubt that because of the limited number of organic SKUs (stock keeping units) Wal-Mart is presently stocking that they are "cherry picking" the market, concentrating on higher-volume products. In our representative Midwestern city we compared organic pricing at:

1. A successful specialty/natural foods retailer with \$10 million in annual sales
2. A regional supermarket chain with a dedicated organic section
3. A prominent Midwest grocery warehouse with an expanded organic section
4. The local Wal-Mart Supercenter

Only a very limited number of produce items could be compared because, with the exception of the natural foods retailer, all stores had an incredibly limited variety available, and in some cases the products were in such poor condition they were only marginally salable. This has been a problem dating back to the Alar scare when grocery stores, many *a flash in the pan*, jumped on organics. They did not maintain the fruits and vegetables well (an imperative because many organic produce items are not treated with synthetic, petroleum-based waxes to lengthen their shelf lives prior to sale), and because they have a higher cost, stores were reluctant to aggressively cull for quality defects. This has led some consumers to erroneously believe that organic produce is high priced and substandard. A good juxtaposition to this problem is illustrated by the recent report published in *Consumer Reports* where their surveyed readers gave Whole Foods Market one of the highest scores for produce quality in the grocery industry (with an extensive organic product line).

When comparing Wal-Mart prices to those of the natural food retailer, our representative market basket was 26.7% less expensive at Wal-Mart. Because they were using "their own" brands of organic products, not to be confused with private-label brands, a true (organic) apples to (organic) apples comparison was challenging. We did not compare name brands to private-label brands. We made an attempt to compare genuinely comparable brands and products (although the sources for these products might very well be factory farms and imports from developing countries).

Wal-Mart was 22% less expensive than the product sample at the warehouse grocer and 19.1% less than the traditional grocery retailer. Again, we need to emphasize that, because of the limited offerings at all three of these stores; far fewer direct product comparisons were possible. For all the hoopla, Wal-Mart is truly stocking only a very small number of organic SKUs. But they are some of the highest-volume products in the industry, so they will likely have quite an impact.

VII. Organic Certification Oversight/Ethics

Our observations concerning one of the "organic" dairy products offered at Wal-Mart—Stonyfield yogurt—is perhaps representative of the company's commitment to organics, their pricing power, and the dearth of experienced store personnel.

Posted on Cornucopia's Web page is a photograph of Stonyfield nonfat yogurt in the dairy cooler at a Wal-Mart store. In the aforementioned Midwest market, this store was selling quarts of the product for \$2.50 each. This is slightly less than the acquisition cost at the natural foods retailer we also surveyed. Besides the obvious tremendous price advantage enjoyed by Wal-Mart, there was one other slant to this picture—the signage flagged the product as one of Wal-Mart's organic offerings, but the product is not organic!

We doubt whether this was a malicious attempt to deceive customers, but unfortunately it might be, again, emblematic of the company's lack of investment in knowledgeable staff, its inexperience, and its questionable commitment to organics. This might very well be viewed as just another widget in the materials management environment by Wal-Mart, but most ethical retailers understand that organics requires a different kind of knowledge base and management oversight for successful marketplace participation.

We have informed Wal-Mart management of this mislabeling problem and assume that they will promptly attend to it.

Wal-Mart is even marketing two brands of organic infant formula that contain synthetic additives that have not been reviewed by the National Organic Standards Board, as required by law, and that have been processed with hexane, a powerful neurotoxin. These products and materials are now being closely scrutinized by the Institute. This also might very well be representative of Wal-Mart's lack of qualifications or commitment to oversee what promises to be one of the nation's largest organic manufacturing, distribution, and retail infrastructures.

VIII. Conclusion: Likely Impacts on Organic Marketplace

Because of the size of their grocery sections it is unlikely that Wal-Mart's penetration into the organic food market will amount to more than just "cherry picking" the fastest-moving product lines. Even their conventional offerings are quite limited in comparison to larger main-line grocers. Still, the impact of their presence in the market could be far-reaching.

Natural Food Retailing

Within the past year organic food retailing experienced a major shift. Now, reportedly, 50% of organic food is being sold through traditional grocers, rather than specialty, natural foods retailers. This has greatly enhanced accessibility to organic food by consumers and increased competitive pricing pressure.

Grocery chains recognized the potential sales contribution that organic food can make at a time when Wal-Mart was putting tremendous pressure on their margins. Retailers have enhanced other aspects of their store, attempting to excel in niche areas that Wal-Mart was neglecting—so much for organic food offering a unique marketing advantage for the stores. As they attempt to battle Wal-Mart's low-wage structure and economy of scale with a more mature, experienced, and expensive workforce, will they be forced to offer *cheaper* organic "off brands," of questionable integrity? Or will they attempt to differentiate themselves by offering a more credible product line and superior service?

How much will the natural food marketers, like Wild Oats, Whole Foods, or the hundreds of cooperatively owned retailers around the country have their bottom lines impacted? Will these specialty retailers run into the same fiscal problems that large grocery chains have experienced in trying to contend with Wal-Mart's impact?

Manufacturing and Distribution

Will manufacturers of organic food be forced to shift their commodity purchases to China or other Third World countries? Without the direct cost advantage that Wal-Mart enjoys, limiting distribution warehousing and transportation and lowering production costs might not be enough to make them competitive. Some manufacturers will look to Wal-Mart to make up for falling sales at traditional outlets, while others might be "blackballed" by natural food and grocery retailers for teaming up with Wal-Mart. Some shakeout in organic food manufacturing is possible.

Organic Farmers

Family-scale dairy farms, typically milking 50 to 70 cows, cannot compete with the high-production/low-cost model of industrial dairy production. If Dean/Horizon and Aurora are successful in their partnership selling factory-farm milk through Wal-Mart, at deep discounts, will some family-scale farmers be forced out of the business? Already, other investors are following the lead of these two giant dairy firms and investing millions in additional "organic" mega-farms that might eventually glut the market with milk. There might be a short-term advantage for consumers, in terms of lower pricing, but as was the case in the United Kingdom, when a similar surplus resulted in a pricing crash causing many farmers to exit the industry, the resultant lack of competition eventually firmed pricing back up to previous levels.

Farmers producing other commodities might see their marketing opportunities dwindle as they fail to meet competitive pricing offered by import brokers. Already, Midwestern organic farmers cannot compete with Chinese soybeans landing on the west coast.

Ultimately, the real risk is to the value of the organic label. Will consumers continue to hold organic products in high esteem and be willing to pay premium prices for them? If corporations recklessly concentrate just on the bottom line, at the expense of organic integrity, all players in the industry, regardless of scale, will likely lose.

Note: By visiting www.cornucopia.org, and clicking on photo galleries, readers can view images of an assortment of the organic products being marketed by Wal-Mart and referenced in this report. For more background on the industrial-scale dairies mentioned please refer to both the photo galleries on the web site and the link for Cornucopia's organic dairy report, "Maintaining the Integrity of Organic Milk," and the accompanying scorecard rating the nation's approximately 70 organic dairy brands.