

Direct marketing from producers to consumers: Economic aspects and key success factors

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Social Sciences Unit

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Agriculture and Fisheries Policy Area

Background

Background

ILVO

- ILVO conducts multi-disciplinary, innovative and independent research with a view to enhance the sustainability and competitiveness of agriculture and rural areas
- Based on research, ILVO develops knowledge and tools, for improving products and production technologies, for safeguarding quality and safety of food products, for informing policy and sector and for enhancing rural development processes

Background

Social Sciences Unit

- Mission: To present and clarify, on a scientific basis, the social choices concerning a sustainable and competitive Flemish agriculture, fisheries and countryside
- Agricultural and farm development group: socio-economic research on the sustainability, profitability, effectiveness, productivity and resilience of farming systems
- Rural development group: socio-economic research on spatial transformations, multifunctionality, regional development, governance processes and multistakeholders processes

Background



Introduction

Introduction

Direct marketing from economic, social and ecological point of view

- When direct marketing started to become a topic among people concerned with all things agricultural and rural, the focus was on its potential to provide income to – mostly – small-scale farmers
 - Alternative to conventional market
 - Increase margin over costs
 - Circumvent market power of retailers and traders
- Since late 90s, attention shifted on what direct marketing could accomplish in terms of socio-ecological sustainability

Introduction

Direct marketing from economic, social and ecological point of view

- Since crisis of 2008-2009 direct marketing is, again, proposed as one of the answers to decreasing margins, market power of big traders and retailers

Introduction

Observations

- A lot of statements are made about short supply chains:
 - “Less food miles so environmentally more sustainable”
 - “Short supply chains increase farmers’ income because of the higher price”
 - “Short supply chains are the solution for low incomes in agriculture”
 - “Food bought in short supply chain is healthier”
- These are treated as axioms (things that don’t need proof)
- While in fact they are statements (things that can be proven true or untrue – or rather (un)true in certain circumstances)

Introduction

Content of contributions

- Insights into the economics of direct marketing
 - Based on theoretical considerations
 - Based on general farm economics
 - Based on the limited empirical evidence
- Some key success factors for economically successful direct marketing strategies

The basic model : theory

The basic model : theory

Economic analysis

- Every business analysis should be based on
 - Economic analysis: tells you whether something is worth doing or which alternative is most worth doing
 - Cash-flow analysis: tells you how much cash is involved, when and whether cash obligations are likely to be met
 - Risk analysis: tells you how vulnerable the business becomes (after the decision) to unexpected values for key parameters such as prices and production
- The empirical comparison of income on farms with and without direct marketing might not tell you a lot
 - Attribution problem
 - Farms in your sample with direct marketing are success stories, failures exist as well

The basic model : theory

Income: The choice between marketing channels

- A very simple theoretical model reflecting the choice between a direct (d) and a conventional (c) marketing channel

$$\begin{aligned} \max_{Q_d, Q_c} NR &= P_d Q_d + P_c Q_c - C_d Q_d - C_c Q_c - C Q \\ &\text{subject to } Q_c + Q_d = Q \end{aligned}$$

- With

- P_d and P_c price received at direct and conventional marketing channel
- Q_d and Q_c quantity sold through the direct and conventional channel
- C_d and C_c marketing costs associated with the direct and conventional channel
- C costs independent of marketing (e.g., production costs)
- Q total production

The basic model : theory

Income: The choice between marketing channels

- Solving the first order conditions says that NR is maximized when Q_d and Q_c are chosen such that

$$\left(P_d - \frac{\partial C_d}{\partial Q_d}\right) = \left(P_c - \frac{\partial C_c}{\partial Q_c}\right)$$

- With

- $\frac{\partial C_d}{\partial Q_d}$ and $\frac{\partial C_c}{\partial Q_c}$ marginal marketing costs of direct and conventional market
- i.e., costs for one additional unit sold in the specific marketing channel

- Hence, decision to sell through a direct marketing channel or not, and how much, depends on
 - Price difference
 - Difference in specific marketing costs per unit supplied

The basic model: theory

Income: The choice between marketing channels

- This is just basic economics: your decisions are based on what you gain and what you must give up
- You compare benefits and costs
- Yet, most sources (internet, leaflets, etc.) talk about higher prices, but do not talk about costs
 - Income does NOT solely depend on prices
 - Strategies resulting in higher prices only lead to higher income if the associated costs do not increase as much as the price

Prices and costs in direct marketing

Benefits and costs in direct marketing

Specific marketing costs

- Costs associated with a particular marketing channel
- Think not only of pure marketing costs
- Rather, think of all costs that you would not have hadn't you chosen that particular marketing channel
- Costs differ across direct marketing channels

Benefits and costs in direct marketing

Labour

- Labour requirements associated with certain types of direct marketing might be very substantial, e.g., farm shop, farmers' market, roadside stand require significant amounts of labour
- Whereas labour costs do not appear in a cash flow analysis, it is an economic cost
- Differs across channels
- Moreover, even when not a cash cost, labour requirements might have indirect effects on cash income
 - Time spent in the farm shop cannot be spent on the field
 - Labour flexibility is reduced

Benefits and costs in direct marketing

Labour

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Benefits and costs in direct marketing

Fixed nature of many specific marketing costs

- Price should be compared with specific marketing costs *per additional unit of output* sold on that marketing channel
- However, quite a lot of specific marketing costs related to direct marketing have a fixed nature, which means they don't get smaller as sales decrease
- These costs are incurred, whether you sell a lot or little, hence, when sales are low, specific marketing costs *per unit sold* might be that high that they offset the higher price received

Benefits and costs in direct marketing

Fixed nature of many specific marketing costs

➤ Examples

- Promotion
- Market entry fees
- Farm shop
- Market stand
- Transport
- Sanitary requirements
- Packaging equipment
- Farm shop personnel
- Storage
- Processing equipment



Benefits and costs in direct marketing

Fixed nature of many specific marketing costs

- Fixed nature counters one of the advantages of direct marketing, the ability to enter the market at a small scale
 - A certain minimum scale is still needed in order for certain direct marketing channels to be profitable
 - Certain direct marketing channels require significant investments, such that certain volumes might just be too small

“With all these regulations and things you must install before you are even allowed (and then I’m not talking yet about the equipment itself) to sell your own dairy products, you cannot start small” (Farmer x from Y)

Benefits and costs in direct marketing

Unsold product

- In direct marketing channels
 - Higher prices are received for sold products only
 - While specific marketing costs are incurred for all products supplied to the market
- Implies a cost to the farmer
- Consequence of the perishable nature of most products supplied to short supply chains (vegetables, fresh fruit, dairy products, meat products)

Benefits and costs in direct marketing

Transaction costs

- Are costs incurred when changing from one channel to another (Verhaegen and Van Huylenbroeck)
- Distinguish between
 - TC related to the selling activity
 - TC related to the acquisition of the necessary skills

Benefits and costs in direct marketing

Transaction costs

- TC related to the selling activity
 - Number of transactions in direct marketing typically increases a lot, with respect to conventional markets
 - Farmers that do not use the conventional market for a while, may incur additional transaction costs related to being well informed about market conditions and prices
- TC related to the acquisition of the necessary skills
 - Farmers in the direct market may be less informed about new production methods
 - Farmers have to acquire marketing skills

Benefits and costs in direct marketing

Transaction costs

➤ TC related to the selling activity

- Number of transactions with retailers
- Farm income less the costs incurred about

➤ TC related to the buying activity

- Farm production
- Farm



“Get off my land!”

is a lot,
may
ned

Benefits and costs in direct marketing

Risk

- General idea is that direct marketing implies a less risky farm business
 - Prices are more certain
- However, market risk (the risk of selling less than expected) may be higher
 - Conventional markets generally buy all produce that is supplied
 - In direct markets, this is less certain
 - Success of farmers' markets, farm shops, roadside stands depends on number of customers, which is highly uncertain
 - CSA and similar forms of direct marketing spread the risk more equally between producer and consumer
 - Lower price risk, but more market risk can have equal impact on income (higher prices are only received for produce that is sold, marketing costs are incurred for everything that is supplied)

Benefits and costs in direct marketing

Risk and trust

- The nature of risk is changed through the mechanism of trust
- In conventional markets, due to increased distance between producer and consumer
 - Alternative mechanisms such as labels, brands, certification need to be devised to create trust
- In direct markets, the farmer materializes trust 'in persona'
 - The short distance is seen as the cornerstone of direct selling
- However, the absence of any "objective" measure of trust makes the performance of direct marketing channels (the sales) susceptible to changes in the level of trust
 - Importance of direct marketing certification schemes etc.

Benefits and costs in direct marketing

Risk and trust

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- How mak sale
 - Importance of direct marketing certification schemes etc.



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Benefits and costs in direct marketing

In sum

- Theoretical impact of direct marketing is unclear
 - Higher prices AND changes in marketing costs must be taken into account
 - The nature of the risk involved changes as well
- Hence, economic impact is an empirical issue
 - It is thus surprising that little empirical research has been conducted
 - Large amount of statements bears no relationship with small amount of empirical work

Benefits and costs in direct marketing

Some facts

- Labour
 - De Regt et al. (2010): when a value on own unpaid labour was set, net profit of direct marketing in dairy farms was negative
 - Several authors from the US found that costs related to time and labour were the most significant obstacles to expansion of local food sales
- Some work on comparison of specific costs across different forms of direct marketing.
- Verhaegen and Van Huylenbroeck: all specific marketing costs are compensated for by a higher price
- Duffy: net returns to land on CSA farm is much higher than on conventional farms BUT more than 50% of the farmers found net return to labour insufficient

Benefits and costs in direct marketing

Conclusion: success factors

- Diversification of marketing channels
- Scale of sales
- Managerial ability
- Farm characteristics
- Passion, attitude and effort

Thank you!



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