

# Foundational Economy Research

**What can Welsh Government  
do to increase the number of  
grounded SME firms in food  
processing and distribution?**

Report by Foundational Economy Research

June 2021

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# What can Welsh Government do to increase the number of grounded SME firms in food processing and distribution?

## Executive summary

- This report presents an original analysis and makes recommendations through a foundational economy lens. It focuses on the Welsh food system from field to fork and on the business models of SME processors and distributors. It builds an evidence base about food system stocks and flows within and beyond Wales and about the firm level difficulties of cost recovery. It then recommends a suite of coordinated policies which could increase the Welsh stock of grounded firms.
- The Welsh food system is heavily dependent on food imports and exports because Welsh farmers are narrowly specialised on meat and dairy for climate and topographical reasons. But Welsh consumers want a diversified diet and the demand of just over 3 million Welsh consumers can absorb only a small proportion of the main Welsh farm outputs. Just 5% of Welsh red meat output is consumed in Wales.
- SME food and drink processing is a challenging business because it sits in the middle of a chain between farmers and intermediaries (supermarkets and food service distributors). These intermediaries are the only gateway to volume demand: for example, Welsh households spend more than £3,000 million per annum on food in local supermarkets whereas Welsh public sector food and catering expenditure is just over £90 million.
- The Welsh stock of SMEs in food and drink processing has not increased substantially in the past decade because the business model has slim operating margins, limited cash generation and precarity, driven by intense price competition within both the supermarkets and food service distribution sectors. When capable processors gain new supermarket contracts or expand their distribution systems, they find it difficult to fund the investment requirements of step change expansion from retained earnings or bank borrowing.
- In food service distribution, the problem is different. Here Wales has the strategic asset of two family owned, expanding and successful Welsh SME independent food distributors. But they have not yet been directly incentivised to support Welsh producers. Their regional base and strong operating position means that both firms are also at risk of being bought out by national chains and reduced to distribution hubs.
- The first principle of the foundational approach is to develop system specific policies which are adapted to the specific and various characteristics of different reliance

systems. Given the high import and export characteristics of the Welsh food system, the long-standing Welsh public policy fixation on post code localism and switching public sector demand to firms with local headquarters is largely irrelevant. Public procurement can be important to the food system but only if it can be used in a more relevant and strategic way.

- Public policy on food is necessarily complex and includes important socio-cultural objectives like reform of the quality of the public plate and diet reform for public health. But, insofar as the focus is on volume economic effects, value adding and employment, the primary aim has to be to increase the stock of capable SMEs feeding into the intermediary systems within and beyond Wales. SMEs grounded in Wales by assets or ownership are more valuable because they typically combine productive, market and financial capabilities which are lacking in the Welsh production or distribution branches of larger corporate parents.
- Public policy could do more and better to grow the stock of grounded SMEs if Welsh Government divisions and local authorities build policy on a shared understanding of the food system's characteristics and co-ordinate a series of actions which ease the business model constraints. Growing a stock of larger SMEs in food processing and distribution is an intricate and challenging problem but it is amenable to an evidence-based suite of actions.
- With a series of connected foundational interventions across the food system, policy makers could get a better return from the focused effort already going into SME food business support and development. Detailed policy must be the responsibility of policy makers but the analysis in this report highlights three priority areas for action where innovative policies are required and could altogether make a substantial difference.
- **Priority (1) Engage the supermarket chains in conversation about greater effort to recruit Welsh SME suppliers and a move towards outcome measures.**

This is a volume opportunity because retailers are recognising that Welsh provenance is a market differentiator which customers increasingly want to see on the shelves (without paying a price premium). To varying extents, most UK supermarkets run supplier development programmes for domestic agricultural producers and/or SMEs. However, in both regards they have generally not committed large enough resources for a permanent step change in Wales. They also lack coherent and consistent approaches which can be externally assessed and coordinated toward long-term, systematic impact. Here Welsh Government can initiate high level conversations to encourage the more engaged chains to do more. The strategic aim should be to move towards agreed outcome measures and annual reporting of key indicators for all major supermarket chains.

- **Priority (2) Use public procurement indirectly and strategically on volume demand to get Welsh food service distributors to stock more Welsh product lines.**

- Local authority and health board behaviours are here the key to unlocking the second big demand side opportunity. Their procurement is an under-resourced function which has been rightly criticised for its default onto least cost rather than social value. But, a generic policy of localising supply is often or usually not an effective way of leveraging change. Instead, PSB members need to work together to analyse key reliance systems (like food, care and construction) and find specific ways to use public procurement differently and strategically to lever change in each system. In food, their big opportunity is to aggregate some demand through public contracts with food service distributors so as to put less weight on price and more on Welsh SME provenance as part of ‘social value’. This is not to let public procurement “off the hook” but to begin to ask how we can use it in more effective, system relevant, discriminating ways.
- **Priority (3) Maintain and consolidate hard and soft infrastructure support arrangements for Welsh food SMEs.**  
This action requires coordination between Welsh Government and local authorities to pool resources. The priorities are clear. Put in grant support to expand the three Welsh food innovation centres which make it easier for micro business to transition to SME scale. Recognise the limits of the existing Development Bank of Wales and of high street bank lending in this sector; and mobilise state finance to build more serviced sites and food parks. Here SMEs can focus on their operating business with rented buildings and leased equipment and thus get round the limit on finance required for expansion that is set by secured bank lending. These parks could also play an important indirect role in helping to access skilled employees and services and making it easier for micro firms with ambition to grow into capable SMEs.
- These priority actions would together add up to a change in practice which will only happen if public and private stakeholders come together to build an alliance for evidence-based change, which should include existing food processors and distributors, local authorities, health boards and Welsh Government all focused on the actions necessary in the various Welsh regions. It also, then needs more evidence and political action to boost local provenance in food service distribution and the supermarkets. Without action of this kind, the likely outcome is more of the same: no sustained growth in the stock of SMEs, along with an increase in the number of micro firms, many of which cannot offer decent wages and conditions and never grow into SMEs. Wales deserves better.

## Action research on the food system through the foundational economy lens

Foundational economy analysis has highlighted the Welsh national problem of the missing middle and a weak SME sector caused by the retreat of larger private employers and the proliferation of micro firms over the past 20 years in Wales. Hence the desirability (and realistic objective) of more SME firms in all activities. Food processing is a sensible place to start because food processing is by many measures the largest sector of manufacturing across the UK as a whole, directly employing more than 400,000. Food distribution employment is much larger and dependent on a network of local branches typically controlled by national chains of supermarkets and food service distributors.

Our specific focus in this report is on grounded Welsh SME firms in food processing and distribution which we define in this report as independently owned and with a high proportion of assets in Wales. These are a subset of the larger group of mid-sized firms in Wales which also include subsidiaries of public listed companies (PLCs) and investment funds. Grounded firms are particularly valuable because they have a full set of productive, market and financial capabilities, and often owners/ managers have a strong attachment to their location. In contrast, branches are typically production sites or distribution hubs, which can become pawns in broader processes of corporate restructuring.

There is a small group of Welsh owned SME food processors and distributors, like Puffin Foods, South Caernarfon Creameries, Harlech Food Services and Castell Howell Foods, that have successfully expanded to £30-£150 million of turnover and each employ more than 100 workers. However, there is a general agreement that this group of firms is too small and that increasing the number will depend upon growing grounded Welsh SMEs rather than inward investment, which can be directed to buying out Welsh firms as much as to setting up new branch plants.

Hence a three-month action research project in which Foundational Economy Research Ltd has aimed, first, to understand SME food processing firms through a foundational lens and, second, identify what more Welsh government and other public bodies could do to secure and increase the number of SME firms in food processing and distribution. The foundational economy approach is distinctive and different in two respects from previous analyses, in that it focuses analysis and prescription on the overall size and shape of the Welsh food system and the business models of Welsh food processing and distribution firms.

The foundational economy is the zone of the economy which produces daily essential goods and services. As well as food and housing it includes providential services like health, education and care plus the material pipe and cable utilities. These reliance systems are differently organised into systems of networks and branches under different kinds of ownership and dealing with diverse activity characteristics. This means that there cannot be a “one size fits all” generic foundational economy policy and policy interventions have to be related to the various characteristics of different systems.

What do we need to know about the characteristics of the Welsh food system? First of all, we have to understand the system from field to fork as an interconnected set of physical and financial flows which lead from producers through processors and distributors to final consumers. In food, as we will see, climate and topography dictate Welsh producer specialisation in meat and dairy. Like much else in the 2020s, the Welsh food system is therefore a long chain food system, which is heavily dependent on volume imports and exports so that Offa's Dyke does not mark its boundaries.

The second relevant consideration is the firm level business model or, more precisely in this case, the interaction between firm level business models along the chain in a food system of transactional relations. As we shall see, SME processor margins are constrained by an adverse power relation with intermediaries in the supermarket and food service distribution chains. The system is driven by intense price competition in the final product markets which serve households and then structured by the power of the large corporate intermediaries.

This food system and business model context is basic background knowledge for SME players in food processing and distribution; but it has not made its way into formation of public policy towards the food system. This is partly because Welsh Government is not organised to use official statistics or big data in a systematic way. For example, there is no central registry of which departments or teams subscribe to what database; nor a way to ensure that updates from these databases are easily available across departments. Going forward, better access to and use of data is a critical element in developing capacity to take action.

The aim of this report is to piece together and lay out the evidence systematically and propose a suite of action priorities which are relevant to food system flows, ease business model constraints and thereby create more favourable conditions for SME growth.

## Sources and methods

- We interviewed SME owners and managers, NGOs, local authority and Welsh Government officials. Our aim was to set their understandings and opinions in the context of a groundbreaking analysis of the Welsh food system and SME company financials which could define the possibilities and limits of public policies.
- Our desk research included (a) commissioning a special run of time series data from Office for National Statistics (ONS) for SME and micro establishments in the Welsh food and beverage processing sector covering the period 2010 to 2020; (b) accessing the Atamis supplier database to obtain information on Welsh Government public procurement food spend by company local to Wales and outside Wales by postcode; and (c) making our own analysis of the financials of a sample of 29 mid-sized companies involved in food processing and distribution.

# Analysis

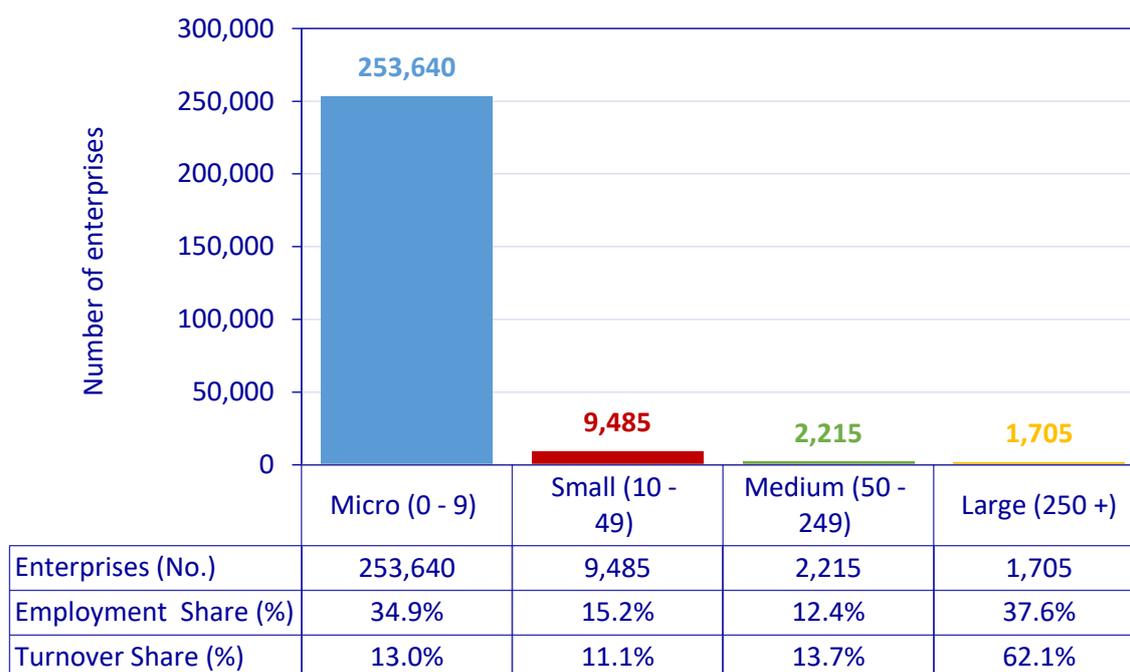
1. The Welsh SME context
2. Disappointments of business support policy
3. The Welsh food system
4. Food processing is a difficult business

## 1. The Welsh SME context

The arguments of this report about how to increase the number of food and drink SMEs rest on the premise that the future of decently paid, private sector employment in Wales depends on increasing the number of capable, grounded SME firms. SMEs matter because, as in other deindustrialised UK regions, large private firm employers are mostly in continued retreat and the majority of the employment growth has been in micro firms, which have a limited capacity to generate well paid employment.

The ongoing historic trends are clear, summarised in Exhibit 1 and presented in Appendix 1. The main changes in the distribution of Welsh private employment from 2003 to 2019 were a decline in the share of large firm employment, which fell from 42% to 36% from 2003-19, while there was a roughly corresponding rise in the share of micro firms from 31% to 35% of employment. SME firms employing 10 to 250 did no more than hold their share of employment.

**Exhibit 1: Welsh private business structure: number of enterprises and share of employment and turnover by size band in 2019<sup>2</sup>**



<sup>2</sup> Source: 'Business structure in Wales by size-band and measure', StatsWales. <https://statswales.gov.wales/Catalogue/Business-Economy-and-Labour-Market/Businesses/Business-Structure/Headline-Data/latestbusinessstructureinwales-by-sizeband-measure>

Note: The classification of firms by numbers employed is straightforward for micro, small and medium firms which most probably have a single establishment or a few establishments within the region. But it is more complicated in the case of multi-site large firms. In this series, 'large' means firms employing more than 250 workers on all sites inside and outside Wales. These firms may employ less than 250 in their Welsh branch establishments.

The result is a dumb bell distribution of Welsh private sector employment by firm size. In 2019, 250,000 micro firms and the 1,700 large firms each account for more than one third of Welsh employment. Small and medium firms accounted for a further quarter of employment: 9,500 small firms in the 10-49 employee category accounting for 15% of employment and 2,200 firms in the 50 -249 employee category accounting for some 12% of employment.

Welsh private employment is being decanted into the micro sector where the average enterprise employs just 1.6 people and is not so much a firm as a small businessperson-with-helpers operation. The typical micro firm is a limited capability and ambition operation where low sales turnover limits its ability to generate a decent living for principal and helpers. Micro firms account for 35% of all private Welsh employment but just 14% of sales turnover.

The solid performance of the small and medium sized firm sector, accounting for 27.6% of private employment and 24.7% of private turnover, provides a base on which we can build. The question then is how to use policy to create new demand and supply side conditions to enable some micros to transition into SMEs and more grounded SMEs to grow.

Increasing the number of very small Welsh micro firms has limited benefit overall for firm capability, resilience and performance unless a significant number of these grow into capable and financially sustainable SMEs. And, as argued in our 2015 report for FSB Wales, creating and sustaining grounded firms is the priority because growing capable SMEs only to see them sold on to funds or international corporate buyers limits the benefit, as functions are stripped out and the firm becomes a branch often with the loss of capabilities and local connections.

### **Policy implications:**

- Growing the missing middle is a policy conundrum: an intricate, difficult to solve problem but one which is amenable to analysis and resolution if definition and solutions can be agreed within and beyond Welsh Government.
- The starting point for our analysis is the evidence in the next section on how existing Welsh Government business support policies have not substantially increased the stock of food and beverage SMEs.
- The analysis then focuses on (a) the volumes in the food system and (b) the business model issues facing SMEs in food processing and distribution because these together define the possibilities and limits for the existing stock of firms. The argument is that policies for micro firm transition and SME growth can only be identified after we have analysed these specifics.

## **2. Disappointing results: a focused Welsh policy effort in business support does not increase the stock of SMEs**

The starting point is that the Welsh Government's food and drink division has active, focused and intelligent business support policies. However, Wales does not have a growing stock of grounded SME enterprises, though there has been a significant increase in the number of micro firms which mostly do not grow and transition to SMEs. These key points about the stock of firms emerge strongly from the new ONS evidence summarised below and presented in Appendix 2.

### ***Welsh business and market development offers a world class advice and soft support system for food processors***

Welsh Government food and drink business advice is comprehensive and draws on a wide range of expertise to provide firm level mentoring, mutual support in specialist clusters, access to commercial market data, trade fair participation and courses like a boot camp for those wanting to sell in London. The relevance and quality of this business support was universally praised by all the SMEs we interviewed (who often noted that this kind of support was not available in England).

Wales also benefits from three food innovation centres<sup>3</sup> which provide technical, operating and commercial support for producers upscaling from kitchen table and/ or growing and requiring SALSA and BRC certification to supply supermarkets or food service distributors. Grant funding for the innovation centre at Horeb has supported a model offer which includes access to food technologists, trial runs and flexible manufacturing facilities rentable by the day.

### ***But our time series evidence shows that the return in terms of an increasing stock of larger SMEs is limited***

We commissioned an ONS run from VAT and PAYE data on individual reporting enterprises based in Wales, with the results summarised in Appendix 2. These give a time series view, over the cycle from trough in 2010 to peak in 2020, in terms of the population of enterprises in food and beverage processing with the enterprises grouped in bands using employment and turnover criteria<sup>4</sup>.

The number of micro firms is increasing but, overall, few are transitioning in a sustainable way so that there is a net growth of SMEs (Exhibit 2). Between 2010 and 2020, micro firms accounted for 190 of the 200 additional enterprises; more than two thirds of these new micro firms over this decade were in beverages, probably reflecting the boom in microbreweries. Few micro firms transition upwards, and some of those that do will replace other firms that

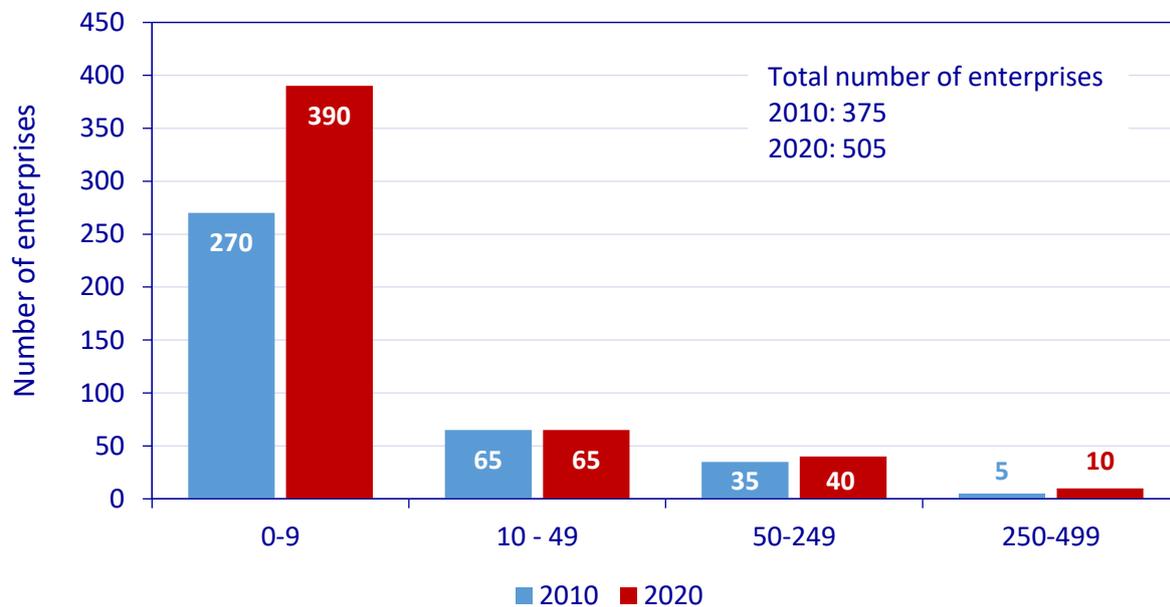
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<sup>3</sup> Food Centre Wales at Horeb, Llandysul; ZERO2FIVE at Cardiff Metropolitan University; Food Technology Centre, Llangefni.

<sup>4</sup> See Appendix 2 for detailed data with narrative description.

are shrinking or exiting: for example, the number of small SME enterprises employing 10-49 is the same in 2020 as in 2010.

**Exhibit 2: Number of Wales based food and beverage manufacturing enterprises by employment bands<sup>5</sup>**

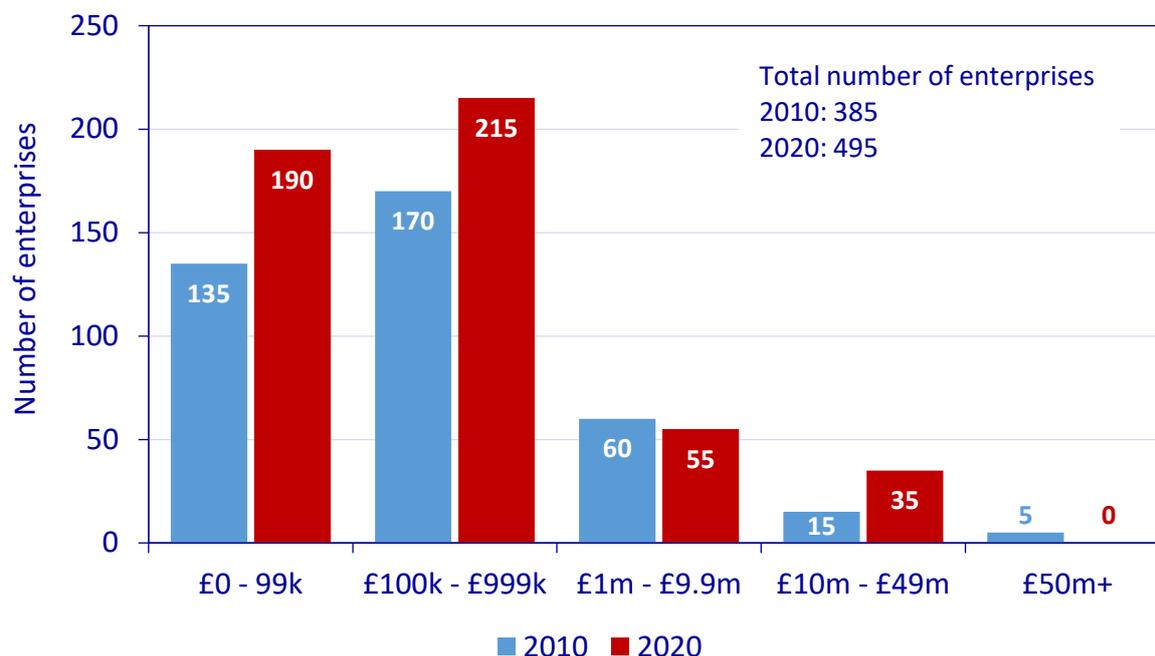


The number of mid-sized SMEs does increase but very weakly. Using the employment criteria, the number of enterprises employing 50-249 increases from 35 to 40, with all of the increase in beverages. Beverages also drives an increase in the number of enterprises with turnover of between £100,000 and £1 million, but the number of enterprises with turnover of £1-10 million actually falls (Exhibit 3).

The large enterprise sector is chronically weak. The number of larger enterprises employing 250-499 is stuck at five for a decade (2010-2019) before an increase in 2020 doubles the number. This looks to be a nudge effect as growth takes firms just over the 250-employee threshold: significantly, the number of enterprises with turnover of more than £50 million falls from five to zero.

<sup>5</sup> Source: NOMIS. <https://www.nomisweb.co.uk/query/select/getdatasetbytheme.asp?theme=49>

**Exhibit 3: Number of Wales based food and beverage manufacturing enterprises by turnover bands<sup>6</sup>**



Part of the explanation is that, while some SME firms are growing, others are contracting. This point emerges clearly from an analysis of annual accounts for a sample of 29 mid-sized companies in food and drink<sup>7</sup>. Over the decade 2010 to 2020, five firms in this sample increased turnover by 100% or more, with seven showing declines. Across all 29 companies, the pattern of turnover growth suggests firms are just nudging into the next size bracket, not bounding upwards.

These findings are consistent with those of earlier academic literature on SMEs which has generally found that growth comes in steps and is not sustained across different time periods so that there is no group of consistently fast-growing SME ‘gazelles’.

**Policy implications:**

- Despite the efforts of WG food and drink support activities and initiatives over the last long upswing through the 2010s, the modest stock of mid-sized firms in food is not growing strongly. Of course, some of these initiatives are relatively recent and the full effects are no doubt not yet evident. The number of small micro firms is increasing steadily - probably reflecting the ambitions of food micro-entrepreneurs and consumer tastes, as much as policies in this case - and there is an acute problem about the small number of micros transitioning to SMEs to create net growth in this category.
- The implication is not to reduce or redirect this business support but to integrate these activities into a wider set of enabling actions that address the demand as well as the supply

<sup>6</sup> Source: NOMIS. <https://www.nomisweb.co.uk/query/select/getdatasetbytheme.asp?theme=49>

<sup>7</sup> See Appendix 4 for detailed data with narrative description.

side. To make this transition we need to clarify the problem through analysis of (a) the Welsh food system and (b) the SME business model issues in food processing. This will allow identification of an evidence-based suite of policies to improve the return to business support effort. Specifically, these actions need to address demand side limits on market access and supply side financial constraints on expansion. This would justify the maintenance and targeted expansion of support, for example, through innovation centres which will need new sources of grant funding in the next few years.

### **3. The Welsh food system: the hard frame around processing firms and policy makers**

If we want evidence-based policy from a foundational economy perspective, we can start by analysing the specifics of the food system because individual reliance systems (like food, care or housing) are all differently organised. This system specific framing allows analysis of the flows between major actors, which define the possibilities of policy intervention and determine the leverage from specific interventions. The evidence summarised below and presented in Appendix 3 shows the Welsh food system is heavily import and export dependent, and that the modest value of Welsh public food procurement gives limited direct leverage.

#### ***Narrow specialisation of Welsh agriculture means a food system which is export and import dependent***

Welsh farm producers specialise in a narrow range of products. Red meat (beef and lamb) and dairy account for 80% of Welsh farm revenues. This specialisation is mirrored in the composition of the food processing sector, where – as shown in Appendix 4 – the key grounded firms are in meat and dairy related activities. This pattern of local agricultural production gives Welsh food processors a very narrow input base which is also environmentally problematic because ruminant based farming is emissions-intensive even when grass based. In the long run there is a risk of ‘stranded assets’ for farming communities and processors, without a significant shift into new products.

The first corollary of narrow specialisation is export dependence, which is absolutely necessary to sustain the incomes of Welsh farm producers given the current pattern of output. The Welsh population of just over 3 million consume only 5% of the red meat produced in Wales so that 95% is exported (Exhibit 4)<sup>8</sup>. Only half of the milk produced in Wales is domestically processed, though 90% of Welsh processed milk goes into making nearly 100,000 tonnes of cheese each year, with 80% or more exported.<sup>9</sup>

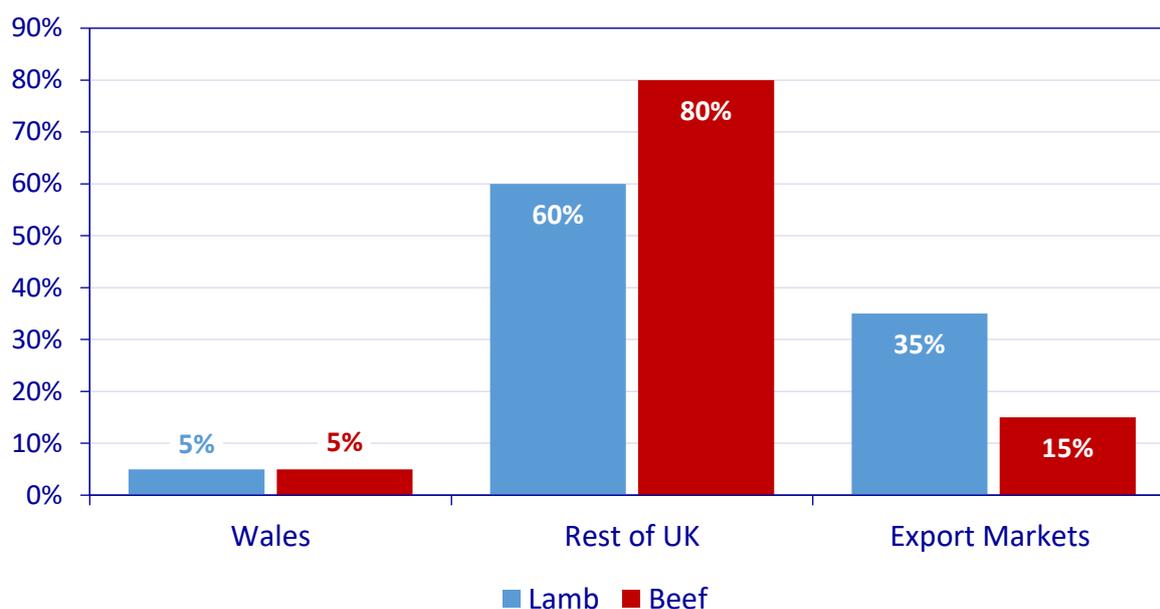
The second corollary of narrow specialisation is that the Welsh food system is heavily import dependent. Climate and topography limit the scope for the highly desirable large-scale diversification of Welsh farmers into arable and horticulture. Welsh consumers demand a diversified diet which is not restricted by land suitability and seasonality; hence the reliance on imported produce from the East of England, Southern Europe and the rest of the world.

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<sup>8</sup> <https://meatpromotion.wales/en/industry-statistics#:~:text=Exports%20of%20red%20meat%20from,the%20Welsh%20economy%20in%202019.>

<sup>9</sup> [https://meatpromotion.wales/images/resources/HorizonWelshReport\\_%28Eng%29.pdf](https://meatpromotion.wales/images/resources/HorizonWelshReport_%28Eng%29.pdf)

**Exhibit 4: Share of Welsh red meat sales split by domestic and export markets<sup>10</sup>**



Another effect of narrow specialisation is that an important part of the Welsh food processing sector turns imported raw and semi processed inputs into processed foods which are often consumed outside Wales (including Hilltop Honey, Deeside Cereals, Halo and Brighter bars and Village Bakery).

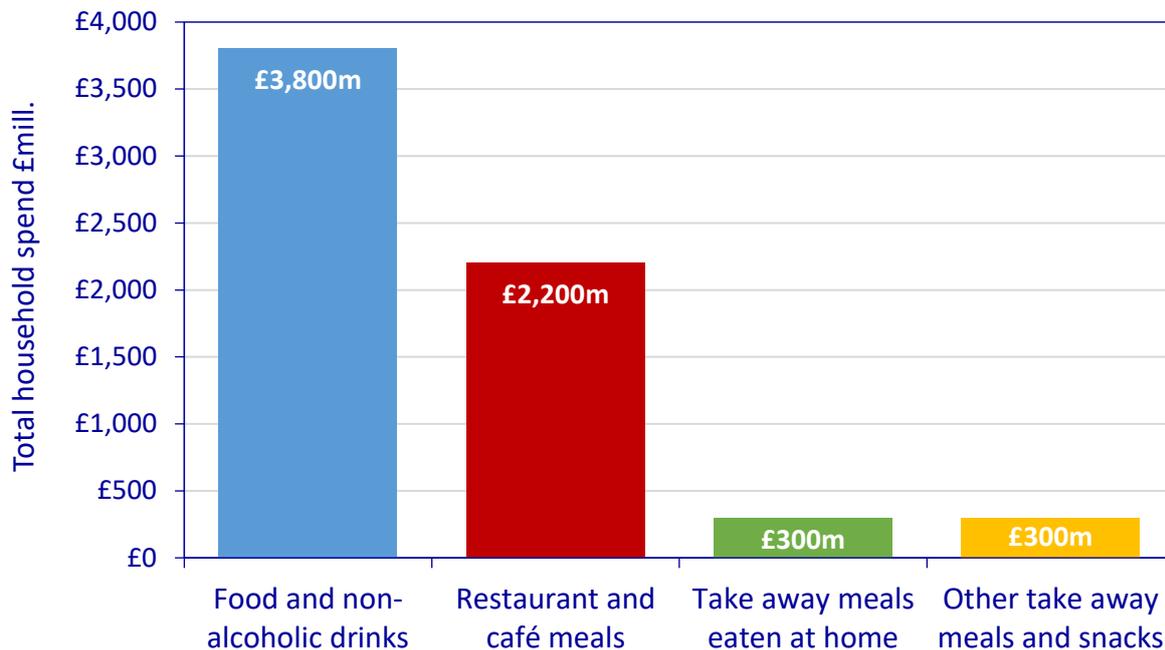
The diversification of the Welsh agricultural system, including through new kinds of farming systems, and the expansion of the Welsh food processing and distribution sector need to be viewed as interlinked challenges, though discussions about the two appear to have been largely carried out separately. The complementarities and inter-dependencies between agriculture and food processing, make the structural challenges of the former a key brake on the latter.

***Volume demand can only be accessed via the intermediaries, supermarkets and food service distributors***

Basic magnitudes are important here. Household expenditure data is available from the ONS on a regional basis, so we can directly see that, despite lower incomes, on average Welsh households spend £53.70 per week on food (including non-alcoholic drinks) as well as £31.60 on restaurant and takeaway spend. Thus, Welsh household spend on food (excluding restaurants and takeaways) is £3,800 million per annum; Welsh household restaurant and takeaway spend adds a further £2,800 million (Exhibit 5).

<sup>10</sup> Hybu Cig Cymru – Meat Promotion Wales (HCC), [https://meatpromotion.wales/images/resources/HorizonWelshReport\\_%28Eng%29.pdf](https://meatpromotion.wales/images/resources/HorizonWelshReport_%28Eng%29.pdf)

**Exhibit 5: Total annual household spend of Welsh households on food and beverages, in restaurants and takeaways, (£m)<sup>11</sup>**



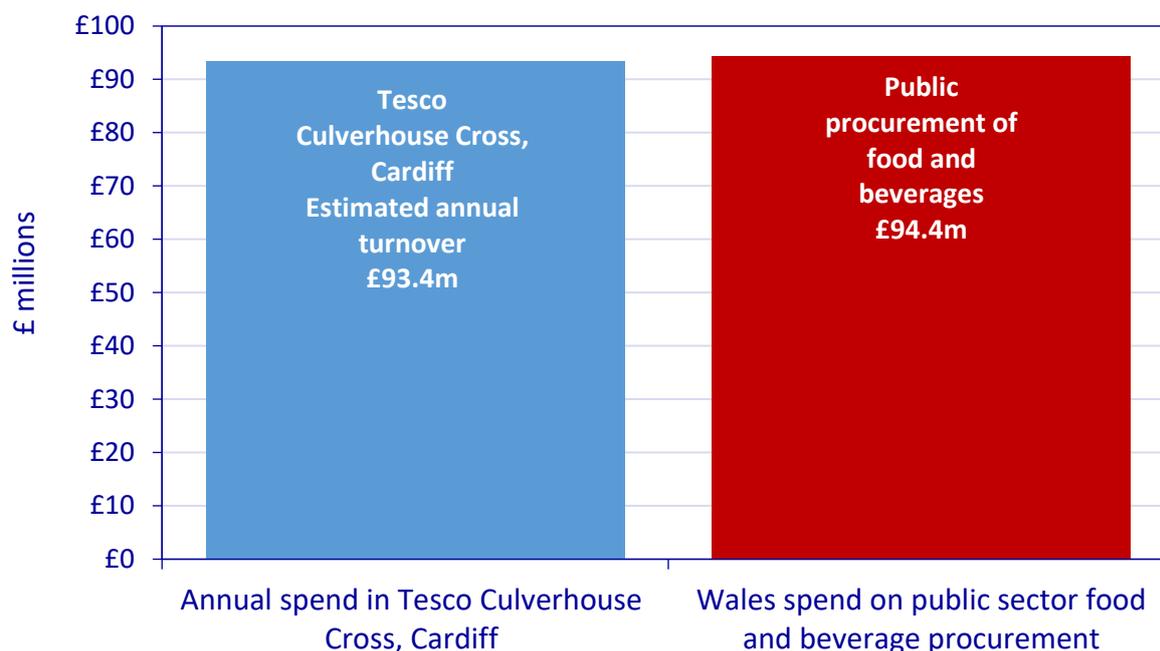
By way of contrast, a commissioned run on the Atamis database of public sector purchase invoices shows a total pre-Covid Welsh public sector spend on food and outside catering of £94.4 million in 2019. This is roughly equal to the (non-fuel) turnover of one Tesco hypermarket<sup>12</sup> like the store at Culverhouse Cross, Cardiff (Exhibit 6). Assuming sales per square foot at the Culverhouse Cross store are at the Tesco corporate average, then in 2019 the one store's turnover was £93.4 million, mainly comprising food and drink.

Welsh public food and catering procurement of £94.4 million is divided between many categories so that the larger categories like meat and dairy individually account for no more than £10-15 million. This implies that, even if all public sector organisations across Wales aggregated their demand in one broad category like dairy, their purchases would not be large enough to directly provide more than the equivalent of 15% of the turnover of one successful grounded Welsh SME, like South Caernarfon Creameries with more than £60 million of turnover.

<sup>11</sup> Source: Office for National Statistics (ONS), 'Detailed household expenditure by countries and regions: Table A35', <https://www.ons.gov.uk/peoplepopulationandcommunity/personalandhouseholdfinances/expenditure/datasets/detailedhouseholdexpenditurebycountriesandregionsuktablea35>  
StatsWales, 'Household numbers in Wales', <https://gov.wales/sites/default/files/statistics-and-research/2019-12/household-estimates-mid-2018-937.pdf>

<sup>12</sup> Tesco has 252 hypermarkets across the UK.

**Exhibit 6: Comparison of turnover of one Tesco store in Cardiff against Wales public sector procurement spend on food and beverages, 2018-19<sup>13</sup>**



The corporate intermediaries (supermarkets and food service distributors) are the gateway to accessing volume demand because independent food retailers and direct restaurant and takeaway supply account for a much smaller amount. At least 85% of the household grocery spend is with UK-wide supermarket chains which meet the demands of a relatively low income, time poor and car dependent Welsh population. As discussed in Section 4, participation in these channels places major financial and technical demands on food manufacturers, which are a key obstacle to overcome for most SMEs. Food service distributors are equally dominant in serving restaurants and commercial catering, although the position here is interestingly different because Wales has two family owned, grounded Welsh regional players (Castell Howell and Harlech) with £170 million combined annual turnover.

***Welsh foundational policy has failed to engage system wide structural constraints and trends in the Welsh food system***

As part of its foundational economy agenda, the Economy Ministry has been interested in local supply, approaching public procurement reform at public service board (PSB) level with the generic objective of shifting public sector contracts to firms with headquarters in Wales. It has not so far focused on what public procurement could do differently, system by system,

<sup>13</sup> Sources: Tesco annual report 2020, [https://www.tescopl.com/media/755761/tes006\\_ar2020\\_web\\_updated\\_200505.pdf](https://www.tescopl.com/media/755761/tes006_ar2020_web_updated_200505.pdf) and Wales Online, <https://www.walesonline.co.uk/news/wales-news/triple-sized-store-set-create-300-2182492>

Notes: Fuel turnover is excluded. The largest Tesco Extra outlet is at Culverhouse Cross in Cardiff which extends to 105,000 sq. ft. There are also two 100,000 sq. ft stores at Western Avenue in Cardiff and at Talbot Green.

when the public spend is, for example, large and market dominant in the care system and relatively small in food and drink.

The Foundational Economy Challenge Fund has also supported experiments in alternative food production and distribution. While this can contribute modest social innovations, it does not engage with the changing group of chain retailers which will continue to dominate the volume grocery market in Wales because they have a value offering which is being capably and continuously developed.

Most recently, we have the rise of Aldi and Lidl as new kinds of hard discounters with a 20% cheaper basket<sup>14</sup> and a smaller store format well suited to Wales. Coming on behind the hard discounters, there may well be new entrants like Amazon, expanding the market for home delivery of both the weekly shop and convenience items.

The scale and pace of the latest changes in retail distribution have not yet been fully taken on board by policy makers. The Aldi chain currently has 50 stores in Wales and plans 36 more, all to its standard 20,000 sq ft format. Aldi's UK stores each have an average annual turnover of around £15 million and, on that basis, the existing Aldi operation in Wales is capturing a Welsh household spend of around £ 750 million and plans to increase that substantially<sup>15</sup>.

### **Policy implications:**

- Local sourcing (with short chains from field to fork) has limited overall relevance to the Welsh food system which in value and volume terms is dominated by long chain imports and exports, with the balance of the two cross border flows more important than autarchy through import minimisation. The question of what 'local' means is also relevant and needs to be examined, not least in relation to sustainability where local does not necessarily imply better.<sup>16</sup>
- Local provenance is important in various ways in terms of both economic and socio-cultural objectives. It is relevant for some SMEs because it is a point-of-sale differentiator on the lines they supply to supermarkets, other retailers and food service distributors. Locally produced food is also relevant to the offer in some segments of the hospitality sector and availability of a range of products from accredited firms is important in supporting growth of distinctive tourism and hospitality offers. Equally, firms processing imported materials should not be treated as second class because the processing sector can grow through producing new lines which retailers are keen to stock.

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<sup>14</sup> The Grocer in June 2019 compared a 33 item Aldi basket against the same basket from Tesco, Morrisons and Sainsburys.

<sup>15</sup> The Aldi chain in 2019 had £12.3 billion of UK turnover and was operating around 800 stores. <https://retailanalysis.igd.com/news/news-article/t/aldi-uk-fy19-8-sales-growth/i/26792>

<sup>16</sup> For an exploration of these important issues, see Goodwin-Hawkins, B. (2020) 'How local is local', available at: <https://rural-urban.eu/publications/how-local-local-rethinking-local-food-and-public-plate-monmouthshire-wales>

- Local value added is crucial because, if the aim is to support food processing SMEs, Welsh firms need to capture a larger share of the processing value added in specific volume products. And that will involve variable mixes of import substitution and export marketing according to product line. For example, three quarters of potatoes produced in Wales are bagged fresh and only 20% are processed (7% as chips) compared to 40% (12% as chips) in Great Britain<sup>17</sup>. The value-added question here is why should Welsh frozen chips come from Belgium and, if we make them in Wales, how do we also sell them in England? More generally, there may also be significant value added in fresh fruit and vegetables with more limited amounts of processing, mainly sorting and packaging.
- In food service distribution, Castell Howell and Harlech are competing for Welsh public sector orders, though their growth also depends on expanding the reach of their Wales centred distribution networks to sell more product into English markets. Their adjacent English market has a much larger potential when the Welsh population is not much over 3 million and 4.9 million of the English live within 25 miles of the border. There is a market for Welsh product in Northwest England and the West Midlands, though there is also a high level of competition with UK-wide food service firms like Bidfood and Brakes.<sup>18</sup>
- On public procurement, it is important to have a realistic and strategic view. Public procurement expenditure is too small to directly support many SMEs at scale by switching to firms with Welsh HQs or local postcodes on their invoices. The opportunity is to use procurement in a more innovative and indirect way as one element in a larger suite of policies for growing value, volume and product diversity, in addition to meeting important socio-cultural objectives like the quality of food on the public plate.

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<sup>17</sup> [https://meatpromotion.wales/images/resources/HorizonWelshReport\\_%28Eng%29.pdf](https://meatpromotion.wales/images/resources/HorizonWelshReport_%28Eng%29.pdf)

<sup>18</sup> G. Ifan and G. E. Poole (2018) *The Welsh Tax Base*, Welsh Governance Centre at Cardiff University.

## 4. Food processing is a difficult business: requiring many capabilities and generating little cash

A venture capitalist recently searched for SMEs to buy and used financial criteria to draw up a list of 200 Welsh target companies which on past and current performance would offer a return on his investment: it is striking that just one food processing SME made this list. Our business model analysis explains how and why this is a business where it is difficult to make money in a sustained way. The analysis is based on a sample of 29 companies, with the results presented in Appendix 4 and summarised below.

### ***Squeezed between input costs and output prices: cash margins of 6% are good***

The analysis of financials is based on a sample of 29 mid-sized companies operating in Wales, comprising two in distribution and the rest in food and drink processing. They have achieved some success because all 29 firms have turnover of more than £10 million, and two thirds have turnover of more than £20 million. More than one third (11) are Welsh grounded in that they have all their assets in Wales and another four are semi-grounded family-owned firms with assets split between Wales and England; eight are subsidiaries of PLCs or private equity investments and the remaining six are subsidiaries of family controlled MNCs.

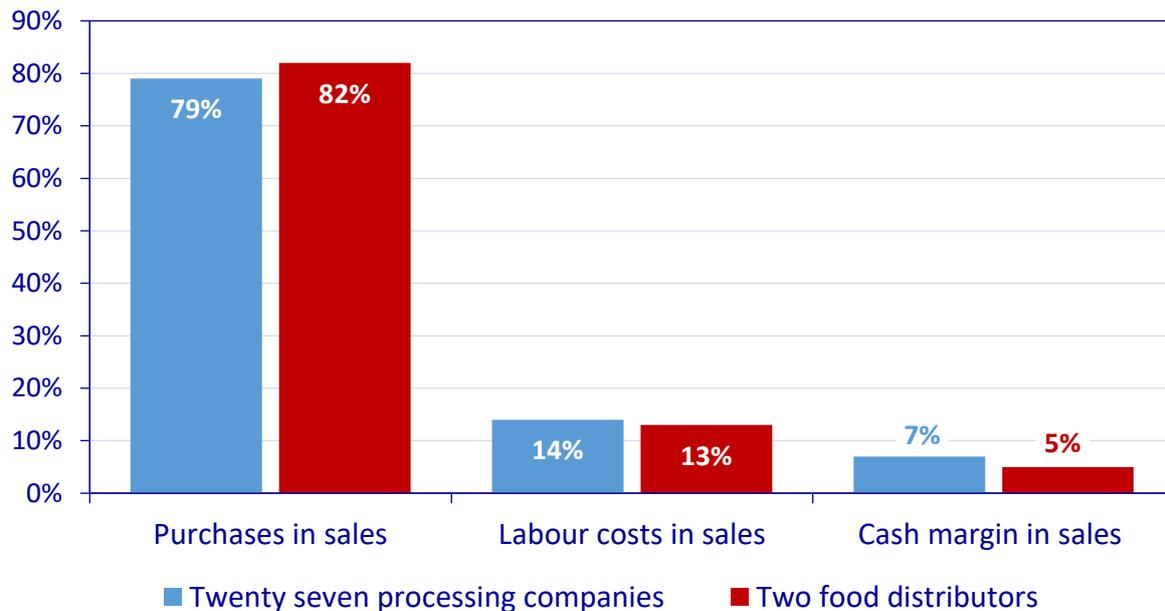
On the input side, there is an activity-based limit on cash generation in the form of high purchase/ sales ratios, with significant operating labour costs taking most of the rest of the revenue. For the 27 processing companies in the sample, purchases of raw and semi-processed materials are equal to 79% of sales revenues. Labour costs account for a further 14% leaving a modest cash residual of 7% (Exhibit 7). These are the kind of ratios we would expect and do find in the two food distribution companies and, remarkably, the ratios are more or less the same in food processing.

On the output side there is another significant activity-based limit on cash generation in the form of adverse power relations with much larger supermarkets and food service distributors. These buyers compete in price sensitive markets and require volume supplies of consistent quality with suitable SALSA and BRC certification which will be sold on at low margins. The problem that processor SMEs face is that they sell to supermarkets or food service distributors who have very similar operating ratios but much more power, with delisting a constant threat.

While the establishment of the Grocery Code Adjudicator has provided a remedy for the worst abuses of buyer power by supermarkets, there are still structural features of supermarket supply chains and business models which are inadvertently disadvantageous to SME processors, making it difficult for them to enter and remain in this channel. This includes the centralised distribution hub model with just-in-time delivery processes, providing major logistical efficiencies that translate into low process for customers, but which can create insurmountable volume and logistics challenges for small firms. The typical credit terms, rebates and returns policies can place major strains on working capital that smaller firms struggle with.

The driver of supermarket and distributor behaviour is price competition in the final market. This takes a particular form for the Welsh food service companies who compete as regional players against UK wide chains like Bidfood. It is easy to lose customers if distributors cannot make the price point; if the public sector wants them to stock more Welsh lines, then there has to be less weight on price in public contracts and more emphasis on Welsh sourcing as part of social value.

**Exhibit 7: Structure of purchases, labour cost and cash margin in sales for 27 food processors and two food distributors in Wales<sup>19</sup>**



With supermarkets the problems are compounded because most chains have not consistently put resources into developing Welsh suppliers which can meet their price, volume and quality criteria. In the past a changing sub-set of the major retailers have made commitments on Welsh local sourcing which were often not sustained. The supermarkets are currently aware that customers in Wales want local provenance as a differentiator. Tesco has re-located one of its buyers from head office into a Welsh store, while Morrisons and the Co-op are also both engaged in working with Welsh suppliers. For example, the Coop is extending to Wales the locally sourced ranges and promotions used in Scotland.

***The conditions of firm success and failure: productive, market and financial capability***

From our interviews, successful SME firms are exceptional in that they have a combination of internal productive, market and financial (PMF) capability. All-round PMF capability in a food processing SME means: (a) production can reliably deliver volume with consistent quality; plus (b) marketing nous to manage a “something for something “relation with supermarket

<sup>19</sup> Source: Companies House for annual financial reports, various years.

buyers, usually for a niche presence in a changing market; and (c) tight financial control via timely monitoring of margins and variances.

The problem is that this all-round capability set is beyond most SMEs and hard to acquire in the early stages of expansion. This is particularly acute in small firms on tight margins and turnover below £5 million; these firms usually rely on an owner manager because they cannot afford the extra salary cost of a professional manager. Food and drink SMEs also need an external infrastructure of electricity, water and effluent treatment which is problematic on many Welsh sites where even the basics like three phase electricity can be lacking.

Typically, behind each successful firm is one driven entrepreneur, as in Radnor Hills, South Caernarfon Creameries, Puffin Foods or Hilltop Honey. These entrepreneurs are diverse in background: some have corporate careers behind them, others have specialist expertise, and one or two are completely self-made. They all combine drive with realism: for example, above £10 million turnover, a firm needs to develop local talent and hire specialist assistance. The right choice of outsider as finance director or production manager then allows progress to the next stage.

The average level of micro and SME capability is very different and generally lower. Castell Howell outsources to processor partners like Mario's Ice Cream but makes its own sandwich fillings, meat pies and cooked ham in house because of a lack of local suppliers which meet the required standards. Welsh Government can and does provide high quality business advice and support but that only works to produce growth where there is management in place with the ambition and capabilities to realise this.

### ***Exit is easy***

In a narrow margins business with a few powerful customers things can go wrong easily and then profits collapse or supermarket delisting looms. A recent example is Narberth-based Princes Gate bottled water, where the family owners sold out to Nestle which added the brand to its portfolio which already included Buxton and Pure Life waters. Princes Gate had expanded with three phase electricity and a bottle blowing machine<sup>20</sup> when sales and profits dipped, the firm cut back on investment and the family sold out<sup>21</sup>.

Successful family-owned grounded firms are routinely approached by large corporates looking to extend their reach or consolidate the sector with bolt on acquisitions. Abergavenny Fine Foods with £30 million of turnover in goats cheese is the latest to accept an offer of this kind. Alarmingly, we cannot see any clear plan for dealing with an upcoming succession issue in one of the larger, grounded Welsh firms in food processing and distribution.

The private incentive to sell is strong because most families would not wish to hold their wealth in a precarious low margin business and potential family successors may lack an

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<sup>20</sup> <https://www.walesonline.co.uk/business/business-news/19m-investment-narberth-based-princes-gate-2032208>

<sup>21</sup> <https://www.thegrocer.co.uk/results/princes-gate-water-sales-slump-6-prior-to-nestle-acquisition/570956.article>

interest in continuing. The social and economic cost is that, after corporate acquisition, an independent grounded firm with PMF capabilities is usually reduced to a production site or distribution branch.

## **The default business model**

### ***(a) prudent reliance on retained earnings and limited distribution***

Most Welsh food SMEs have a financially prudent business model in that they are debt-averse, make limited distributions (dividends) and rely on retained earnings as their major source of investment funding. If we take the weighted average of our group of grounded Welsh firms, less than 20% is distributed in the form of dividends or interest payments and much of the rest is applied to investment in tangible assets.

These grounded firm behaviours are understandable in context. Firms have to live with market uncertainty because Welsh food processors sell to more powerful customers and Welsh food distributors live with much larger competitors. For many firms, substantial external borrowing and leverage would then add unacceptable financial risk because interest and principal repayments have to be made, even if sales have turned down and cash flow has dried up.

Private equity and PLC parents of subsidiaries are routinely more extractive and would expect more by way of distribution in dividends or interest payments. The MNC subsidiaries in the sample are more extractive but interestingly the eight private equity and PLC owned mid-sized subsidiaries actually distribute fractionally less than the 18% of cash distributed by the nine grounded Welsh firms (Appendix 4). This narrow margin and high market uncertainty activity is (in the absence of a strong brand premium) difficult for extractive operators whose ventures in food processing often end in exit or distress restructuring.

A minority of grounded SMEs (Abergavenny, Capestone, Puffin and South Caernarfon) or branches with fund or corporate parents (Deeside and FEI) have enough confidence in the market to borrow or draw down parent resources to expand ahead of cash flow. But in a family-owned firm this is only for the brave because high street banks lend against the security of assets, which will be lost if things go wrong.

### ***(b) the constraints on borrowing to invest in next step growth***

Business opportunity for a food processing SME typically comes in the form of a new contract or a realistic prospect which requires expansion through investment in a new production line and maybe a new building; or new technology to help manage labour costs. Growth tends to take the form of quite large steps, rather than incremental increase in turnover. It is very risky to build ahead of demand in a narrow margin business where sustained underutilisation of capacity has a heavy cost.

Borrowing for the next step is then constrained by a funding gap. Commercial banks will only lend against the security of assets with Welsh plant and buildings valued at market value, which will be less than their original cost where land and property values are low. This is the case everywhere in Wales west of Bridgend or Wrexham, Thus, one firm told us that they had over the previous 8 years spent £14 million on state-of-the-art plant and equipment but in October 2017 this was valued at £4.4 million by a high street bank, which would lend no more than 80% of this market value<sup>22</sup>.

In interviews, at least four capable, growing SMEs told us that they had relied on Welsh Government grants to bridge the funding gap on next step growth. For example, between 2012 and 2018, Puffin’s capital expenditure of £24 million was supported by £10.6 million of government grants. No firm considered that the Development Bank of Wales was an alternative funding source; indeed, high street bank loans were cheaper. Equity (from venture capital or private equity) was described by one interviewee as “an expensive loan” because these equity investors will want to sell the firm on within five years.

### **Policy implications:**

- If food system analysis reveals system wide structural constraints, our business model analysis adds firm level complications as it identifies the multiple market difficulties which stand in the way of building and growing an SME.
- Against this background, it is not surprising that Wales has not many more than 50 SMEs and corporate subsidiaries with the PMF capability to maintain a volume position in intermediary supply chains. From ONS data in 2020, Wales had just 50 SME enterprises in food and beverage processing with more than 50 employees and no more than 35 with more than £10 million turnover. Equally it is not surprising that Wales has many micro firms which are unwilling or unable to do more than operate in small niches. Using ONS data in 2020, 190 of the 495 enterprises in food and beverage processing were turning over less than £100,000 and many of these will be below the VAT threshold.
- At the same time, business model analysis is instructive and constructive because it identifies multiple points of difficulty which WG policy is not addressing (or could address more effectively) through different interventions at various points along the supply chain. The list includes: (a) enlisting supermarkets and incentivising food service distributor intermediaries to source from Welsh processors; (b) addressing succession and the problem of early family sale; (c) facilitating the growth of micros to replace the inevitably lost SMEs; and (d) fixing the funding gap and the constraints on SME step change expansion. If that is what we need to do, how to do it is the big policy problem.

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<sup>22</sup> <https://busnes.senedd.cymru/documents/s86331/Puffin%20Produce%20Saesneg%20yn%20unig.pdf>

# Action priorities:

1. Supermarkets as the largest volume opportunity
2. Food service distribution as another volume demand opportunity
3. Soft infrastructure to build PMF capability on the supply side
4. Hard infrastructure to ease the secured lending constraint on SME expansion

## What's to be done? Interventions based on a problem definition

Welsh Government policy towards SMEs in food and drink should be based on a shared, broad problem definition about the food system and producer business models. Ineffectuality or irrelevance will result if policy makers pull on policy levers or establish institutions without making the connection to focused and system specific problem definitions. On food, postcode localism through the PSBs will achieve little and the Development Bank does not serve the needs of family-owned SMEs.

The foundational economy analysis of food SMEs in the previous sections is intended to provide the concepts and evidence on which we could build a shared problem definition and then develop a suite of demand and supply side policies. The foundational economy approach is dual in that the emphasis is on analysis of the Welsh food system and the business model problems of SMEs. A brief recap is in order.

- Policy makers should distinguish between three different local policy objectives. Local sourcing is of limited overall volume relevance in a high import/ export food system. Local provenance is a marketing differentiator for intermediaries like supermarkets and food service intermediaries when producers can make the price point, as well as for direct sales in low volumes. Local value-added is necessary if Wales is to have a stock of more and bigger SMEs.
- Policy makers should clearly separate policies which have socio-cultural and micro-economic impact and those which have volume economic reach: for example, policies for quality school meals vs increasing supermarket stocking of Welsh product lines. Both are valid in their different ways, but we should not confuse them and recognise that the food system is organised so that small-scale, alternative innovation is unlikely to produce the necessary value-added base, unless there are feasible routes to growth for some of these smaller firms.
- Policy makers should recognise that policy limits are set by the small magnitudes of some flows in the food system. Public food procurement is too small in value to have a significant direct economic leverage on the SME stock through postcode policies of switching contracts to local firms. In that case, there is scope for indirect leverage, as with using public contracts to persuade food service distributors to stock more Welsh lines. Procurement can also be used strategically to encourage diversification of the products available.
- Policy makers should recognise that large magnitudes in the food system define opportunities so that the supermarket and food service intermediaries are the gateway to volume sales and value added in Wales and the UK export market, now and for the foreseeable future. On the demand side, developing WG policies which influence supermarket and food service stocking of Welsh lines should be a first priority.
- Policy makers should accept that the supply side capacity of Welsh SMEs to respond to opportunity is limited by the difficulty of step change growth under the present business

model. Specifically, policy has to address the SME problem that internal cash generation is limited, and secured borrowing is difficult because of market value vs cost problem on the firm's plant, buildings and land.

When these issues are clarified, it becomes clear that point policy interventions will not solve the problem. Growing and sustaining the population of food and drink processing SMEs requires a suite of connected interventions which on the demand side open up new volume opportunities for SMEs, and at the same time on the supply side shift business model constraints on growth.

This picks up on earlier approaches insofar as the aim is to change the environment around micro and SME firms so that productive expansion becomes easier and more attractive. Thus, in the era before financialization elevated shareholder value, *Why are the British Bad at Manufacturing*<sup>23</sup> argued for changing “the conditions of enterprise calculation” around UK PLCs. Or, in the era before globalisation undermined flexible specialisation, authors like Bianchi<sup>24</sup> emphasised the importance of institutional infrastructure in Third Italy.

The approach taken in the action sections of this report is in line with *Why are the British* but goes beyond Bianchi et al., who take demand conditions as a given. The argument below is that changing demand conditions in supermarkets and food service distributors is the first prerequisite and the precondition for getting a return on new forms of institutional support and existing investments in business support.

### ***(1) Supermarkets as the largest volume opportunity for SMEs***

The first action priority for Welsh Government should be to get several large supermarkets to shift permanently into carrying more Welsh food product lines. There is huge potential here because Welsh households spend £3.8 billion on food and non-alcoholic drink each year and over 80 percent of this spend is with UK wide supermarket chains.

The supermarkets are increasingly talking the talk on local provenance because they tell us that their customers want it (though without paying a premium). Most UK supermarkets also operate some form of supplier development or incubator schemes for domestic agricultural producers or promising SMEs. In these, retailers typically assist targeted suppliers with capability development to achieve the efficiencies and quality the supermarkets need, while offering supportive supply arrangements, such as shorter credit terms, longer contracts or stable pricing.

Trade interviews suggest that local provenance is taken more seriously in Scotland and Northern Ireland than in Wales because of the long-standing tendency of English headquartered corporates to treat Wales geographically as an adjunct to their English market. Our interviews suggest that Morrisons and the Co-op are currently in the lead on commitment

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<sup>23</sup> J. Williams, K. Williams and D. Thomas (1983) *Why are the British Bad at Manufacturing?*

<sup>24</sup> P. Bianchi et al., (1997) *The Italian SME Experience* .

to local provenance in Wales with Aldi following. Some of the progress is meaningful: for example, Morrisons has introduced a system of direct to store (not regional distribution centre) delivery, which is much more convenient for small regional suppliers.

However, it is hard to judge commitment and improvement when only the Co-op currently publishes annual measures, and even these in a highly aggregated form; and we also lack comparative data on Scotland and Northern Ireland which would allow benchmarking. Both local provenance and supplier development initiatives typically lack transparency over tangible outcomes.

Industry insiders add that in the past, the commitment of some chains to local sourcing has not been sustained as policies and personnel churn. The chains have taken it in turn to do something for a while, with individual firms taking two steps forward and one step backward. The result is an incoherent, opaque, shifting patchwork of initiatives which – despite the laudable features of individual schemes – will not achieve meaningful change in the food system.

The problem is illustrated by Tesco's record. From 2008 to 2013 Tesco located a senior buyer in a Welsh store with a mandate to build up the firm's list of Welsh suppliers. They were supplying goods worth £100 million a year at the point when corporate policy changed, the buyer left and was not replaced. In 2021, Tesco reinstated a Welsh store-based buyer who has a set out ambitious targets to increase both the number of local suppliers and product lines on Tesco shelves in Wales. But this once again depends on a single individual.

The need is for creative policy which builds upon the evident goodwill and momentum among supermarkets toward more local provenance (and the supportive supplier development programmes that enable this local provenance), but which extends the levels of ambition, transparency and coordination. This can make supermarket initiatives more than the sum of their parts. The aim would be to get beyond more Welsh dragons on packs of food with a process that helps supermarkets, as the most powerful actors in the Welsh food system, overcome their collective action problems and contribute to more meaningful, long-term change.

Welsh Government could here use its authority and take the lead in opening a high-level conversation with senior management in the supermarket chains. The conversation with each chain would be different and could start with the two chains - Morrisons and the Co-op - which are "leading the way" because local provenance is already part of their identity. There is also an opportunity to engage with Aldi and Lidl, which both plan significant additional store openings across Wales.

The strategic aim should be commitments to targets for Welsh provenance, based upon common metrics and transparent reporting processes. The corollary would be supermarket commitments to long-term Welsh supplier development initiatives, involving supportive measures to overcome the obstacles faced by SMEs entering supermarket supply chains. This could include measures such as assistance with mentoring and capability development, less onerous credit terms, shelf space allocations, and enabling direct to store delivery.

The commitment of supermarket organisational resource through the forming of local Welsh teams for buying and for supplier development is the key precondition for sustained change because that is the only way of breaking with the treatment of Wales as an adjunct. Many chains still operate centralised buying from UK headquarters, and a significant part of what Lidl does in purchasing is still decided at European level.<sup>25</sup>

The organisational commitment of the supermarket chains to Welsh sourcing and supplier development could be ranked and published annually in an officially sponsored league table (as, for example, in the annual *Good Food for London* report, which informs citizens about what each borough is doing to promote sustainable food in public places). Commitments and audit of supermarket performance and achievement in local sourcing can be made visible to consumers and the Welsh political classes, with performance on various criteria ranked as “leading the way”, “making satisfactory progress” or “unsatisfactory”.

This could ultimately be coordinated through a Welsh multiple retailer charter, developed and managed jointly by government, industry and civil society, all providing increased levels of public awareness and broader legitimacy. This is the logical outcome of a conversation where Welsh Government emphasises that it expects more from the retail chains than bringing the produce in and taking the money out from Wales. The expectation of Welsh Government should be “something for something”.

## ***(2) Food service distribution as another volume demand opportunity***

The second action priority for Welsh Government should be to get food service distributors to shift permanently into carrying more Welsh food product lines. There is huge potential here because household restaurant and takeaway spend is £2.8 bn on food and non-alcoholic drink each year; but the potential has to be unlocked by focusing on the two grounded SME food distributors – Castell Howell and Harlech - and persuading PSBs to use the relatively small Welsh public sector spend strategically to incentivise these firms to stock more lines with Welsh provenance.

The opportunity is that Wales has two food distributors which want to support Welsh processors and also to carry Welsh product over the border. Public sector contracts are already a significant part of their business: Welsh public sector food contracts in 2019 accounted for £18 million of Castell Howell’s £143 million turnover. Both distributors are aiming to increase their public sector food service business inside and outside Wales. They tell us that they can and will stock more Welsh lines if they are incentivised to do so with public sector food supply contracts that put less weight on price and more on social value of local provenance.

There is an opportunity here to use public sector food and catering spend strategically with Welsh Government brokering formal “something for something” agreements with the distributors about the terms of their public sector contracts with local authorities and health

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<sup>25</sup> <https://www.lebensmittelzeitung.net/retail-update/Management-reshuffle-Lidl-restructures-purchasing-department-146428>

boards. The precondition is that Welsh Government divisions (foundational economy, agriculture and food, procurement) need to work together and through the PSBs on changing the food contracts.

What Castell Howell and Harlech want is a shift in the price/ quality weightings on Welsh public sector food contracts away from quality weightings as low as 20% in some current contracts and towards a 50% quality weighting in new contracts, where quality would be understood primarily as local provenance. In return, for that concession, the distributors would have to accept targets for: stocking more Welsh lines; taking some responsibility for supplier firm development to expand the product range and avoid over-reliance on a small number of producers; and for expanding their networks so that they can carry Welsh produce into adjacent regions.

The structural limit here is the small size of Welsh public sector food and catering demand which as we have seen is no more than £90 million and split between many categories and different authorities. This small, diffuse purchasing power can only be used strategically if there is demand aggregation so that Castell Howell and Harlech are offered a small number of heavily quality weighted contracts for longer terms than is usual in food service. In the first instance, this involves getting the larger local authority purchasers on side and selectively backing some of the new models of procurement that are already underway. For example, a new shared services approach is emerging in WLGA circles, as in the Welsh NHS.

Effectively, demand aggregation is a matter of local authority and health board co-operation because together these two sets of public authorities account for 90% of Welsh public sector food and catering public sector demand. The PSBs provide a forum within which the local authorities and health boards already meet and are the forum where changes of practice in food and other reliance systems could be pressed as part of a useful next step of moving beyond the generic policy of postcode localism and focusing on interventions in specific systems like food and care.

Some purchasing professionals are sceptical about the possibility of re-weighting contracts away from price and aggregating demand. Such aggregation may present a challenge where local authorities are unused to collaborating in this way, while least cost imperatives in the underfunded health boards militate against weighting quality. If demand aggregation for lower prices was unsuccessful in an earlier period, the same conditions of silo working may undermine policies of demand aggregation for social value.

In this context, the Welsh Government could have a Plan B in case aggregation disappoints. It may be politically difficult though practically necessary to explore the potential of arm's length trading companies as an alternative, if reform of public sector purchasing through the PSBs proceeds slowly. As with Newport Norse or Newydd Catering in Flintshire, local authority trading companies can bundle catering and cleaning procurement and service provision into one SME which under professional management combines commercial acumen and social values; these companies can also search for additional business which increases their spend.

Plan B may be unnecessary if local authorities and health boards can through the PSBs develop a shared understanding of relevant magnitudes and the importance of differentiating between policy for different foundational reliance systems. They need to recognise that the amounts which can be switched to local postcodes are too small to sustain food SMEs and, if they can sustain a few micro firms, this does not address the problem of transition to SME.

Of course, there may be other, strategic uses of public procurement in food. For example, procurement might be helpful in broadening the diversity of the product offer and helping to support micro and small processor firms (and growers) in developing new products or those not currently available in Wales;/ While there will also be private sector up market opportunities in hospitality and independent retail which will allow further growth. These strategic opportunities should not be allowed to distract from the basic point that a larger stock of SMEs requires a volume base in products which meet the price points required for mainstream markets.

### ***(3) Infrastructure to build PMF capability on the supply side***

If Wales wants to build out “the missing middle”, the first pre-requisite is sorting new volume opportunities on the demand side and, as we have argued, that will take Welsh Government into new areas with supermarket chains and the PSBs into new areas about “something for something” contracts with food service distributors. But that will only result in more SMEs if at the same time policy addresses soft and hard infrastructure issues on the supply side and removes the obstacles to firm development.

The part of supply side policy which should be relatively straightforward is defending and developing the soft infrastructure of business support and advice which builds productive, market and financial capability so that micro firms and SMEs are not limited by their internal capacity. This is in principle relatively easy because Welsh Government here has only to build on and extend in terms of micro and SME business advice and support; in practice, it is like everything else complicated.

Welsh Government resources are limited, and the development of soft and hard infrastructure will have to be co-funded with the four regions of Wales and delivered in a way that is sensitive to the new polycentric polity that is emerging in Wales. Here, it is possible to build on the prescience of progressive local authorities which have led the way on the provision of infrastructure, as Ceredigion Council did with Wales Food Centre at Horeb and Carmarthenshire Council did with Cross Hands food park

As we have noted, Welsh Government already provides an excellent advice service for micro and SME food businesses backed by the support of three food innovation centres in North East, South West and South East Wales. These provide practical support on food technology and, in Horeb’s case, a flexibly configured maker space. The task here is to defend and extend existing provision which helps micro firms get over existing hurdles and provide ongoing support for the building of capabilities (or the circumventing of incapacity) by micro firms and SMEs. For the smallest firms, this could also include new ideas around shared access to

professional management support to help ambitious firms get around the predicament that they are too small to afford to hire managers yet need this resource to successfully develop.

In all this, Wales has the makings of a distinctive new, sector specific, industrial policy appropriate to an unglamorous mundane sector. Support and advice aiming to build out the missing middle in food will involve continuing (probably episodic) support of SMEs through successive stages of expansion. This is something very different from the English model of industrial policy as financial support for discrete early-stage innovation projects for large corporates with the capability to commercialise whatever comes out of a state funded innovation centre.

But the existing Welsh infrastructure for building PMF capability has not developed as part of a conscious political design. The risk is that Welsh policy makers will not appreciate the value of what they have, as well as recognising that it depends on grant funding. This applies as much to business intelligence, data and systems support as it does to the services of a food technologist. For example, Welsh Government subscribes to Kantar grocery market data which many grounded Welsh SMEs then have access to at low or no cost; interviewees were very clear about the importance of such data given rapidly changing consumer tastes in food and drink.

The challenge of defending existing provision is most acute with the innovation centres like the Wales Food Centre at Horeb, whose existing grant funding runs out in two years' time. There is no commercial business model which would allow the food innovation centres to provide the same services to SMEs at prices they could afford. In 2001, for example, funding from the National Assembly for Wales' Welsh Capital Challenge Scheme enabled the construction of the £1.7 million Horeb Food Centre facility with fully equipped and reconfigurable processing equipment that can be hired by the day at modest rates because capital costs do not have to be covered.

While business advice can be organised and co-ordinated nationally and sectorally, innovation centres have to be regionally distributed if their support is to be relevant to micro firms and small SMEs. Wales needs a properly funded food innovation centre in at least three of the four Welsh regions to help support growth pathways. These innovation centres are essential infrastructure which requires public funding.

#### ***(4) Infrastructure to ease the secured lending constraint on SME expansion***

Soft infrastructure is important for capability building but capability comes to nothing if the SME that wins the order with a supermarket or food service distributor cannot then fund the new production line and the building to scale up. This financial constraint needs to be set in the context of our larger problem definition with a recognition that the direct approach of softer loans to individual firms are unlikely to be part of the broader solution; and public policy needs to think more imaginatively about how to support groups of firms.

The problem here is traditionally framed as one about adding finance to fix a "funding gap" for individual mid-sized firms; a framing that goes all the way back to the Macmillan

Committee in 1931. But the implication of our analysis is that offering finance on favourable terms to food SMEs will not deliver the desired results if they do not already have the internal capability and the volume orders. And, in many ways, the traditional British high street bank insistence on secured lending recognises this; the bank lender with limited knowledge of the SME food business covers the downside risk by reserving the right to take possession of saleable property assets if things go wrong.

The result in Wales is a finance bottleneck in the form of the construction cost versus market value problem. This limits the SME firm's ability to obtain secured loans for the next stage of expansion because the bank will only lend a fraction of the market value of the firm's assets which is much lower than their cost of construction. The constraint relates not to any performance deficiency of Welsh SMEs but to the gradient of English and Welsh property values which slopes downwards from London and the Southeast towards the North and West where lower property values act as a brake on expansion.

Matters are complicated in Wales by the addition of a national development bank - Development Bank of Wales (DBW) - funded by loans from Welsh Government of £1 billion and equity of £200 million, whose operations are more or less irrelevant for grounded Welsh food SMEs.

- The DBW currently provides twice as much assistance in the form of equity than it does as loans; however, family-owned firms generally do not want equity because they fear loss of control. In this respect, the DBW website claims about "profitable exits" could only confirm their worst fears.
- DBW loans are relatively expensive when in 2020 the DBW's (business and non-business) loans have an effective average rate of 7.3%. Grounded Welsh food firms therefore prefer to go to high street banks which we were told are substantially cheaper.
- The DBW has no specialist knowledge of the food and beverage sector and could not justify making unsecured loans when the credit risk attached to its existing loan portfolio is considerable; in 2020 the £117 million of the DBW's existing business loans were down by £38 million due to impairment losses.

The DBW illustrates the Welsh propensity for creating institutions without any clear specification of the problems they are to solve and how they might do it; and in this case, the result is mimetic default onto what private institutions like high street banks and private equity are already doing. A lot of energy can then be spent on trying to reform the institution without much progress being made in providing relevant services to client groups.

The first step in our specific case is to specify the problem as funding of next stage expansion for food SMEs (which is incidentally a problem for many other SMEs because Welsh property prices create a more general problem about secured lending when market value is less than cost incurred). Providing unsecured finance for expansion on soft terms is no solution because it will inevitably end in disappointment as it will attract SME chancers who default with the lender left with irrecoverable, bad debts.

If we are then thinking divergently about how to make the costs of SME expansion more manageable, why not rethink the solution in terms of what the private sector would think as an op co/ prop co model. We could reduce the fixed costs of expansion for the expanding food SME by making it an operating company in a new build facility which it rents from a property company and ideally then installs leased equipment. If the tenant's business fails, the property company relets the unit and taps a continuing income stream and, where the equipment is reusable, the leasing company re possesses.

Of course, the devil is in the detail with such financial engineering mechanisms. In care homes, the op co/ prop co division was used by private equity to fund expansion of care chains through serial acquisitions which ended in a crash, as with the collapse of the Southern Cross care chain in 2011. In this version of the model, the property from each newly acquired care home was sold on to a property company incentivised by a care home operating company willing to sign long leases which offered rent increases that in due course could not be paid from the cash flow of the operating business. But it does not have to be like this.

The first necessity is a public interest landlord looking for modest, steady, long-term-returns from holding industrial units. Welsh Government and Local Authorities can come together to build and operate flexibly reconfigurable industrial units specified for food and beverage processing - with wipe down walls, coved skirtings, stainless steel drainage channels and non-slip floor etc - and do this on industrial parks where the basic infrastructure of three phase electricity, water and effluent treatment are all sorted.

In this case there would be a high chance of reletting and reusing any units which became vacant. The general view of interviewees was that there is a shortage of suitable commercial space across Wales for food and drink processing. And on the basis of previous experience, a progressive local authority like Carmarthenshire Council would almost certainly be prepared to consider using its borrowing powers to build suitable units. The DBW could then be brought in to assist with leasing equipment so that the capital costs of SME step change growth were further reduced.

The Welsh Government has been covering the secured lending problem (about incurred cost vs market value) mainly in an ad hoc way by making grants to expanding firms like Puffin Foods; but, in some cases, as with Peter's Pies for example, Welsh Government has ended up owning land and buildings in which an expanding food SME operates. At Haverfordwest, Welsh Government, Pembrokeshire Council and the ERDF have come together to offer long leases on serviced development plots in a new 23-acre Pembrokeshire Food Park. Why not go one step further and offer serviced plots and/ or buildings in locations like Newtown where suitable sites and units are unavailable according to one expanding food SME.

If Welsh Government needs encouragement it should look towards the Cross Hands Food Park which is one of the most successful initiatives in the Welsh food sector and currently houses firms employing some 1,500 workers. This involved public funding of a publicly owned asset with Carmarthenshire County Council covering the full cost of the initial £2.5 million investment before renting space to firms at both ends of the size spectrum, from Castell

Howell to micro firms; the site generates a steady rental income of £100,000 a year by way of return.

It will of course be necessary to experiment with the business model, as Carmarthenshire Council has done with Gower View Foods, a butter packaging company whose expansion involved hybrid public and private funding of a privately owned asset. As there was an upper limit of 45% on the amount of grant that could be awarded to the project on account of state aid rules, the company covered the remainder of the cost. This variant on the model allowed Gower View to take full ownership of the asset with a clawback clause which meant that if the company decided to sell the asset within five years, the County Council would recoup the value of the grant.

Carmarthenshire Council says it could fill another food park tomorrow, if it had the resources to do so. This prompts the question of why public sector consortia are not building four or five new food parks across the Welsh regions: and relating them to the three existing innovation centres in a hub and spokes arrangement. This would allow co-ordination of the soft and hard infrastructure that support SMEs.

## ***In conclusion***

It is time for a fresh start in policy on food SMEs where all the stakeholders in public policy get outside their comfort zone.

- On the demand side, the fresh start would involve putting less reliance on localised public sector food procurement as the main element of policy, where results are limited by fragmentation and scale; and putting more effort into the suasion of supermarkets and food service distributors where results are levered by volume. A modest increase in supermarket purchases of Welsh provenance of the order of 2.5% of total household spend would generate an annual increase in demand for Welsh SMEs equal to the total value of Welsh public sector food and catering procurement.<sup>26</sup>
- On the supply side, the fresh start would involve extending the existing constructive commitment to SME business support and advice and recognising that prop co/op co innovation is the way to get round the constraint of bank secured lending on SME expansion. The future is already with us in Cross Hands Food Park and our three food innovation centres, which show what the public sector can do if it engages with activity specific business model problems.

The underlying issue here is how does Wales generate the institutional capacity and political will to make a success of these action priorities. On these issues we are hopeful because all the policy makers and stakeholders we interviewed wanted a turn towards evidence-based policy which engaged with specific problems. But there is a real challenge about turning sympathy for this approach into a change of practice that boosts the number of local product lines on Tesco's shelves and builds units on a new food park.

The precondition for this change in practice is an alliance for change which brings together stakeholders - the food SMEs, Welsh Government and local authorities - around shared interests; and backs that up with the capacity to monitor outcomes like the stocking of local product lines. Welsh Government needs to work with the 22 local authorities on a regional basis and enlist support from the existing stock of SMEs who can and should be a source of continuing pressure for more relevant public policies.

National leadership from Cardiff Bay is essential for opening the conversation with the supermarkets; but the PSBs need to play their part in tilting local authority and health board food service contracts away from price. The capital investment in food parks will depend on a pooling of resources by Welsh Government and local authorities drawing on their borrowing powers. If the argument and evidence about food SMEs in this report are convincing, it's time to start converting good intentions into good practice.

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<sup>26</sup> Total Welsh household spend is £3.8 billion on food and non-alcoholic beverages: if local sourcing was increased by an amount equivalent to 2.5% of this spend, this would lead to £95 million of additional turnover for suppliers. Applying the same principle to restaurants and takeaways would add an additional £55 million and £15 million respectively.

It is of course true that our concern has been with the one narrow issue of how to increase the number of grounded SME firms in food processing and distribution. We have not addressed a series of related upcoming problems about land use and diet which have to be confronted to stand any chance of meeting the Net Zero goal. These include the implications of climate change and hot dry summers for land use inside and outside Wales; the problem of stranded assets in Welsh food production and processing given the reliance on meat and dairy; and the failure of the English public health approach of voluntary reductions in sugar and salt to make supermarket food healthier.

The Welsh food system is heading for enforced change and needs radical reform that is wider in scope than the focus of this report. But all these problems of change are best conceived of as inter-related. A stronger SME food processing sector would have the capability to negotiate the change so that our Welsh cheese makers could by 2035 also be producing lines (including plant based products) which the big corporates will be selling on price through new kinds of home delivery as well as in-store. Filling out the missing middle in food would provide Wales with a base of distributed processing capability which would allow us to negotiate a threatening and uncertain future.

# Appendices

1. The Welsh problem of the “missing middle”
2. The stock of Welsh enterprises in food processing and beverages
3. Welsh agriculture and food supply
4. Financial operating characteristics of 29 food and beverage processing companies
5. The Atamis database

## Appendix 1: The Welsh problem of the missing middle

The 2015 *What Wales Could Be*<sup>27</sup> report argued Wales had a problem of a “missing middle” of SMEs. The argument was updated in the *Enabling Renewal* report<sup>28</sup> of 2020 from which we take the empirics and argument below.

Wales has a dumbbell distribution of private sector employment by firm size. In 2019, small and medium firms accounted for just over one quarter of employment: 9,500 small firms in the 10-49 employee category accounting for 15% of employment and 2,200 firms in the 50 - 249 employee category accounting for some 12% of employment. The 250,000 micro firms and the 1,700 large firms each account for more than one third of employment (Exhibit AP1).

**Exhibit AP1:** Welsh private business structure: number of enterprises and share of employment and turnover by size band in 2019<sup>29</sup>

	Enterprises No.	Employment Share %	Turnover Share %
Micro (0 - 9)	253,640	34.9%	13.0
Small (10 - 49)	9,485	15.2%	11.1
Medium (50 - 249)	2,215	12.4%	13.7
Large (250 +)	1,705	37.6%	62.1
Totals	267,045	100.0%	100.0%

The small and medium sector has held but not increased its share of employment over the past twenty years. The main changes in the distribution of employment from 2003-19 were a decline in the share of large firm employment which fell from 42% to 36% from 2003-19, while there was a roughly corresponding rise in the share of micro firms from 31-35%. As in the rest of the UK but rather more sharply, Welsh employment is being decanted into the micro sector where the average Welsh enterprise employs just 1.6 people and is not so much a firm as a small business-person-with-helpers operation.

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<sup>27</sup> L. Brill et al. (2015) *What Wales Could Be*. Report for FSB Wales.

<sup>28</sup> J. Buchanan et al. (2020) *Enabling Renewal*  
<https://www.colleges.wales/image/publications/reports/Enabling%20Renewal%20-%20FE/Enabling%20Renewal%20-%20FE.pdf>

<sup>29</sup> Source: 'Business structure in Wales by size-band and measure', StatsWales.  
<https://statswales.gov.wales/Catalogue/Business-Economy-and-Labour-Market/Businesses/Business-Structure/Headline-Data/latestbusinessstructureinwales-by-sizeband-measure>

Note: The classification of firms by numbers employed is straightforward for micro, small and medium firms which most probably have a single establishment or a few establishments within the region. But it is more complicated in the case of multi-site large firms. In this series, 'large' means firms employing more than 250 workers on all sites inside and outside Wales. These firms may employ less than 250 in their Welsh branch establishments.

Given similar processes of deindustrialisation across the North and West of England, Wales has a similar share of small and medium enterprises in terms of enterprise count as in these other regions, and these firms actually account for a higher share of employment and turnover than the UK average.<sup>30</sup> But this does not necessarily mean, as Munday et al have recently argued - that “there is no missing middle”.

The point of the “missing middle” argument is that the future of private sector employment in Wales depends on increasing the number of capable grounded SME firms. Raising the number of very small micro firms actually does little for firm capability and resilience unless they grow into SMEs. And, as argued in the 2015 FSB Wales report, the benefit is limited if Wales grows capable SMEs to sell them on so that they become production or distribution branches of large corporates.

As for large private sector employers, as we have noted, their share of employment has contracted, and it seems very unlikely that they will expand their operations in the coming years. Welsh private employment in ‘household name’ larger firms is manifestly precarious. After Covid 19 and Brexit, Airbus and GE Aviation are likely to downsize; while there is the possibility that Tata Steel may exit, as Ford has done at Bridgend in autumn 2020. More worrying, the Welsh large private enterprise sector is completely dominated by a second tier of mainly internationally-owned private sector enterprises with relatively small and vulnerable branch operations in Wales.

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<sup>30</sup> M. Munday et al. (2019) *Medium sized businesses and Welsh business structure*, p. 34.

## **Appendix 2: The stock of Welsh enterprises in food processing and beverages**

There is no one, simple and unproblematic way of counting firms. And the problems are compounded if the aim is to count firms that are based in Wales or add substantial value added in Wales. The 29-firm sample in Appendix 4 is based on companies registered at Companies House which must give an HQ address inside or outside Wales. The complete count of Welsh firms in food and beverage processing SIC categories below is based on “enterprises” individually making VAT and PAYE returns from a Welsh address, which we obtained from the ONS as a special run.

The ONS enterprise count comes with health warnings. Rounding issues lead to slightly different enterprise totals by employment and turnover in the same year. The SIC classification is also imprecise because changes of firm activity (e.g., from manufacturing to distribution) are often not captured. The ONS and Companies House totals will not be the same because larger companies may use more than one VAT number. The ONS does not record any enterprise in food manufacturing employing more than 500 employees; Companies House data includes employee counts and shows there are some larger Welsh based food processors like Memory Lane Cakes.

The ONS data is invaluable in two ways. First, it measures the stock because this is the only source which can give a comprehensive account of all the food and beverage processing enterprises in Wales, in size bands by employment and turnover. Second, it is the only source which gives comparable data year by year, to allow construction of time series and to separate out cyclical and structural change by measuring peak to peak or, as below, trough to peak.

Exhibit AP2 presents a cyclical trough to peak comparison of the number of Welsh food and beverage processing enterprises, from the 2010 trough after the financial crisis, to the 2020 peak just before the Covid crisis. We checked that (March) 2020 was the peak by cross checking against the 2019 data, which is also included in Exhibit AP2 for comparative purposes.

**Exhibit AP2: Welsh food and beverage processing enterprises by employment and turnover bands<sup>31</sup>**

(a) Employment bands:

	Food and beverage enterprises			Of which: beverages enterprises					
	2010	2019	2020	2010		2019		2020	
	No.	No.	No.	No.	%	No.	%	No.	%
0-9	270	360	390	35	13%	100	28%	105	27%
10 - 49	65	75	65	10	15%	10	13%	5	8%
50-249	35	35	40	0	0%	5	14%	5	13%
250-499	5	10	10	0	0%	0	0%	0	0%
Total	375	480	505	45	12%	115	24%	115	23%

(b) Turnover bands:

	Food and beverage enterprises			Of which: beverages enterprises					
	2010	2019	2020	2010		2019		2020	
	No.	No.	No.	No.	%	No.	%	No.	%
£0 - 99k	135	180	190	20	15%	50	28%	55	29%
£100k - £999k	170	205	215	15	9%	45	22%	50	23%
£1m - £9.9m	60	55	55	10	17%	10	18%	10	18%
£10m - £49m	15	35	35	0	0%	5	14%	5	14%
£50m+	5	0	0	0	0%	0	0%	0	0%
Total	385	475	495	45	12%	110	23%	120	24%

During a sustained cyclical upswing we would expect to see new entrants increasing the total number of enterprises, and also a growth in turnover and employment pushing existing enterprises into higher bands. In the 2010-2020 period, the focus of attention is on the distribution of the growth in enterprise numbers between firms of different sizes. Here the growth is heavily biased towards a larger number of micro firms in beverages, with limited upward mobility and uneven growth in the SME and large firm categories.

<sup>31</sup> Source: NOMIS. <https://www.nomisweb.co.uk/query/select/getdatasetbytheme.asp?theme=49>  
 UK Business Counts - enterprises by industry and employment size band  
 UK Business Counts - enterprises by industry and turnover size band

- The number of micro firms is increasing but few are transitioning into SMEs. The employment data shows that micro enterprises accounted for 120 of the 130 increase in number of enterprises over this decade. More than two thirds of the new micro enterprises were in beverages. Using the turnover measure, we have 110 extra firms and exactly half of those have turnover of less than £100k.
- Few micro firms transition upwards because over the decade the number of small SME enterprises employing 10-49 is the same (65) in 2020 as ten years previously. The number of enterprises with turnover between £100k and £1 million increases strongly with 45 extra firms, and 35 of those in beverages.
- The number of mid-sized SMEs does increase but, very weakly, using the classic indicator of employment. The number of firms employing 50-249 increases from 35 to 40 and again all the increase is in beverages. The number of enterprises with turnover of more than £10 million increases strongly, but the number with turnover of £1 – £9.9 million actually falls from 60 to 55.
- The large enterprise sector is chronically weak. The number of larger enterprises employing 250-499 is stuck at 5 for 9 years before a final year jump which doubles the number. But this is likely to be growth nudging firms just past the 250-employee threshold because the number of enterprises with turnover of more than £50 million falls from 5 in 2010 to none in 2020.

### Appendix 3: Welsh agriculture and food supply -export and import dependence

Welsh agriculture is highly specialised. Climate and topography explain the focus on the production of red meat (lamb and beef) and dairy products (mostly milk and cheese). Roughly four fifths of Welsh farm income comes from selling red meat and dairy products (Exhibit AP3).

#### Exhibit AP3: Welsh farm income by product (£ million)<sup>32</sup>

##### (a) Total Welsh farm income by type

	Share of total revenue £m	Share of total revenue %
Cereals	26	1.7%
Horticulture	49	3.2%
Livestock	715	47.1%
Livestock products	574	37.8%
Other agricultural activities	80	5.3%
Other crops	8	0.5%
Other secondary activity	54	3.6%
Potatoes	13	0.9%
Total Output (revenue)	1,519	100.0%

##### (b) Livestock and livestock products by type

	Share of total revenue £m	Share of total revenue %
Cattle	380	53.1%
Sheep	271	37.9%
Pigs	6	0.8%
Poultry	58	8.1%
Total livestock	715	100.0%
Milk and milk products	522	90.9%
Eggs	49	8.5%
Clip wool	3	0.5%
Total livestock products	574	100.0%

<sup>32</sup> Source: Statistics Wales, <https://gov.wales/sites/default/files/statistics-and-research/2020-04/aggregate-agricultural-output-and-income-2019-649.pdf>

The first, most obvious implication is high dependence on export markets in the rest of the UK and the EU. The Welsh population of just over 3 million can only consume a small fraction of the beef, lamb and milk produced in Wales (Exhibit AP4).

- Five percent of lamb from Wales is consumed in Wales, approximately 60% is consumed in the rest of the UK, and 35% is consumed in mainly European export markets.
- Five percent of beef from Wales is consumed in Wales, approximately 80% is consumed in the rest of the UK, and 15% is consumed in export markets<sup>33</sup>.

**Exhibit AP4:** Welsh supply of red meat to home and export markets, 2019 (%)<sup>34</sup>

	Wales %	Rest of UK %	Export Markets %
Lamb	5%	60%	35%
Beef	5%	80%	15%

With milk processing the issue is not simple export dependence but supply chains which are integrated across the border. Welsh milk production is estimated to have reached 1,971m litres in 2018/19, an increase of 123m litres (7%) since 2016/17. However, current Welsh processing capacity is now estimated at just 956m litres per year<sup>35</sup> and by 2020 it is estimated that roughly half of Welsh milk output is now exported rather than processed in Wales.<sup>36</sup>

There is no large Welsh liquid milk processor capable of meeting supermarket demand, given that supermarkets have captured the liquid milk market. Roughly half of Welsh liquid milk is transported to England for processing with English plants then serving Wales and the rest of the UK. 90% of the milk processed in Wales is made into cheese where Welsh production runs towards 100,000 tonnes a year, with 80 % or more exported.

The other corollary of narrow Welsh specialisation in meat and dairy is a high level of import dependence overall in the food system. The household demand for a diversified diet is met by imports from the arable East of England, Southern Europe and the Rest of the World. Equally, meat and dairy provide a very narrow input base for Welsh food processors who must import such basics as wheaten flour. A substantial part of the food processing sector turns imported raw materials into exported products like bread, breakfast cereal or snack bars.

The heavy dependence on meat and dairy products also raises questions about the long term implications of dietary change and the need to adjust production to meet climate change pledges.

<sup>33</sup> <https://meatpromotion.wales/en/industry-statistics>

<sup>34</sup> Hybu Cig Cymru – Meat Promotion Wales (HCC)

<sup>35</sup> <https://ahdb.org.uk/news/welsh-milk-surplus-set-to-reach-1-billion-litres-per-year>

<sup>36</sup> <https://ahdb.org.uk/news/balancing-welsh-milk-supplies>

## Appendix 4: Financial operating characteristics of 29 food and beverage processing companies

The two tables below summarise the financial operating characteristics of 29 mid-sized companies based in Wales that have achieved some kind of success by the measure of turnover. In 2019 this group of companies accounted, in aggregate, for £1.6bn of sales turnover and 8,300 employees. Of these 29 companies, 23 companies had sales turnover greater than £20 million, and the remaining companies are in the turnover range £10 to 20 million. We would have included smaller companies but cannot do so because smaller companies publish skeletal accounts from which we cannot calculate financial operating ratios.

27 of the companies are mainly or entirely in food processing and two are in food service distribution; the table at the end of this section provides brief vignettes of the different companies. The companies are either stand-alone Welsh owned or Welsh based subsidiaries of companies with assets and operations elsewhere. The Welsh subsidiary does usually give us a discrete Welsh based operation. The exception is Glanbia Cheese where the lowest level company consolidates two plants (Llangefni in Wales and Magheralin in Northern Ireland) and here we split turnover 50/50 between Wales and Northern Ireland.

We have divided the 29 companies into five groups on the basis of their ownership and control:

- Group 1: 11 Welsh grounded companies with 100% of assets in Wales, including 9 family owned and 2 Coop owned or with Coop antecedents.
- Group 2: 4 semi-grounded companies with assets split between Wales and England; family owned or closely held.
- Group 3: 6 subsidiaries of a multinational parent company; sometimes stock market quoted but all family controlled.
- Group 4: 8 subsidiaries of PLC companies or private equity investments.

The key ratios by group are summarised in Exhibit AP5.

**Exhibit AP5: Financial operating characteristics of a sample of twenty-nine food processing and distribution companies with operations in Wales, 2015-2019** <sup>37</sup>

	Grounded %	Semi-Grounded %	Family MNC %	PLC or PE %
Sales Growth 2015-19	53%	42%	30%	12%
Employment growth 2015-19	37%	31%	24%	10%
Distributions - interest and dividends - as a % of sales revenue (average)	18%	17%	47%	17%
Purchase costs as a % of sales revenues (average)	77%	81%	83%	70%
Employment costs as a % of sales revenues (average)	15%	13%	10%	24%
Cash margin as a % of sales revenues (average)	8%	6%	7%	6%

It should be noted that the 29 companies are not in any way a scientific sample because they are not chosen according to any set of characteristics or statistical rule which would justify the inclusion of these firms and the exclusion of others. It is effectively a random sample which includes nearly half the number of mid-sized SMEs active in food and beverages.

<sup>37</sup> Source: Companies House for annual financial reports, various years.

Notes: The share of cash distributions (dividends and interest payments) is the aggregation of all dividends and interests payments made by all companies in each category for the period 2015-2019 divided by total cash from operations.

Purchases costs are found by subtracting from sales revenue the total of value added for all companies (where value added is the addition of total employment costs including social benefits, operating profits before interest and tax and depreciation).

The residual cash margin is the summation of cash earnings (earnings before interest tax and depreciation) for all companies in each category divided by the total sales revenue for all companies in each category for the period 2015 to 2019.

Sale and employment growth is calculated as the difference between the two periods and cash distributed, purchase to sales, employment costs in sales and cash margin in sales are calculated as the average during the period.

According to the ONS count of mid-sized enterprises, there were in 2020 some 65 food and beverage enterprises with turnover of £10 -£49 million in Wales.

With these caveats, the point which we would emphasize is that the key operating ratios of purchase to sales are much the same in 3 of the 4 groups, with grounded, semi grounded and family MNCs having purchase/ sales ratios of 77-83% and employment costs of 10-15%. These are the kinds of ratios we would expect to find in food distribution companies (and do find in Castell Howell and Harlech); the surprise is that most of the processing companies look much the same in terms of ratios.

The PLC and private equity subsidiaries (in cakes, cereal bars and the like) are further into processing so that as a group they have a lower purchase/ sales ratio of 70% and a higher ratio of 24% on labour costs as a share of sales revenue. What this group gains on smaller purchases it loses on larger labour costs. The net result in all four groups is that the residual cash margin from sales is modestly between 6 and 8%. The conclusion is that food and beverage processing is, regardless of ownership, an activity with narrow financial margins which are the logic of the cost structure and activity ratios.

The similarity of cost structures with narrow margins limits the capacity to distribute cash to any kind of owner and the scope for asset renewal out of retained earnings. The family MNCs are outliers with 47% of the residual cash distributed to the parent; but PLC subsidiaries and private equity investments distribute just 17% which is more or less exactly in line with distributions on family owned Welsh grounded and semi-grounded firms. Again, we would interpret this as a constraint and the logic of the activity ratios.

Exhibit AP6 gives results for individual companies so that readers can consider the range of variation between companies. The two distribution companies are separated at the bottom of the table to allow comparisons. Exhibit AP7 adds the vignettes of individual companies.

**Exhibit AP6: Financial operating characteristics for twenty-nine food processing and distribution companies with operations in Wales (2015 to 2019)<sup>38</sup>**

	Sales Growth 2015- 2019 %	Employment growth 2015 to 2019 %	Purchases as a % of sales revenue %	Labour costs as a % of sales revenues %	Cash margin as a % of sales revenues %
Abergavenny Fine Food	121	80	72	19	9
Braces Bakery	-24	-13	67	30	3
Brighter Foods Ltd	44	78	56	23	20
Capestone Organic	94	53	76	19	5
Castle Dairies	102	60	86	11	3
Celtica Foods	4	-8	85	12	3
Dairy Partners Wales	149	52	88	5	7
Deeside Cereals	30	27	82	17	1
Easibake Foods	-17	-12	68	22	10
Eurocaps	37	44	69	20	11
Eurofoods	-12	16	91	5	3
FEI Foods	228	160	77	16	7
Glanbia Cheese Ltd	36	8	84	6	10
Halo Foods	16	-28	73	23	3
KK Fine Foods	66	81	66	25	9
Memory Lane Cakes	-3	1.5	68	24	7
Peters Food Service	-30	-22	69	29	2
Puffin Foods	65	47	70	16	14
Rachels Dairy	20	7	81	13	6
Radnor Hills	66	47	68	15	17
Randall Parker Foods	-3	-9	91	8	1
Ready Foods	1	45	79	18	3
South Caernarvon Creameries Ltd	102	57	87	7	6
The Burger Mfg Co.	25	2	74	10	16
Tillery Valley Foods	-5	2	70	30	1
Village Bakery (Coedpoeth)	-1	-9	58	31	10
Village Bakery (Wrexham)	40	25	55	21	23
Wholebake Ltd	43	32	78	17	5
Castel Howell Foods	53	74	82	13	5
Harlech Food Services	36	36	79	16	5
<b>All Companies</b>	<b>31</b>	<b>21</b>	<b>79</b>	<b>14</b>	<b>7</b>

<sup>38</sup> Source: Companies House for annual financial reports, various years. Notes: We have treated Village Bakery (Coedpoeth) Village Bakery (Wrexham) as one company for group purposes but show the accounts for both of these separately in this table. Glanbia Cheese has Welsh and Northern Irish plants and we have allocated half the sales to the Anglesey plant. Cash distributed, purchase costs and residual cash margin are calculated as explained in exhibit AP5.

**Exhibit AP7:** The sample of Welsh food and beverage companies grouped by type of ownership, 2020

		Turnover 2019 £mill
<b>Group 1 Welsh family owned (100% of assets in Wales): 9 firms</b>		
<u>Abergavenny Fine Food</u>	Built on goats cheese for supermarkets and claims to be the largest producer of soft goats cheese in the UK; family owned with professional management in MD role	31
<u>Braces Bakery</u>	Multi- generational family owned and managed	25
<u>Capestone Organic Poultry</u>	Family owned, premium chicken and turkey	25
<u>Castell Howell</u>	Elderly founder owns, family and professional management, invested in new warehouse at Cross Hands and growing in food services.	140
<u>Celtica Foods</u>	The wholesale meat subsidiary of Castell Howell.	15
<u>Castle Dairies</u>	Second generation family owned and managed, branded butter and has invested in a spreadable line which blends in rapeseed oil.	36
<u>Harlech Food Service</u>	Family owned and now has bought in prof management to grow beyond	33
<u>Radnor Hills</u>	Founder owned and managed. All kinds of water bottling and canning	48
<u>Village Bakery</u>	Family owned and managed sites at Wrexham and Coedpoeth.	37
<b>Group 1 Welsh co-op origins: 2 firms</b>		
<u>South Caernarfon Creameries</u>	Investing in modern lines to grow by supplying hard cheese to supermarkets; has had Tesco contract for 20 years.	65
<u>Puffin Foods</u>	Technology-based potato storer, packager and supplier with contracts including Aldi	30
<b>Group 2: Family owned (assets split between Wales and England): 4 firms</b>		
<u>Burger Manufacturing Company</u>	Builth Wells manufacturing subsidiary of Sparks, an Enfield based meat wholesaler/ food service distributor covering Southeast England; family owned and managed (Edwards or Welsh Sausage are smaller)	12
<u>Dairy Partners Wales</u>	Family owned and has two sites in Gloucestershire and at Newcastle Emlyn where produces pasta filata cheese and claims to be number one pizza cheese supplier in the UK	60

<a href="#"><u>Randall Parker Foods</u></a>	Abattoir and butchery for retailers and food service, sites at Andover and Powys (formerly Hamer International)	113
<a href="#"><u>Ready Foods</u></a>	Employs 100 in meat based ready meals, subsidiary of Meadow Vale Holdings processed frozen poultry and a joint venture between the Wintley family and Lloyds family of Lloyds Animal Feeds.	12
<b>Group 3: Family owned / closely held MNC subsidiary (parent has assets in several jurisdictions): 6 firms</b>		
<a href="#"><u>Deeside Cereals</u></a>	Corporate restructuring has created standalone operation producing own brand cereals for the supermarkets; wholly owned subsidiary of Agrotech Impex PTE, a privately held Singaporean trading company incorporated in 2013; £36 mill	36
<a href="#"><u>Easibake Foods</u></a>	Pontypool bakery of garlic bread and mock artisan products for food service and supermarket outlets Welsh operation runs in parallel with a Northern Irish Evron operation; since 2018 owned by BAMA, a family managed privately held US company supplying pies to McDonalds etc with > \$200 mill sales; Easibake has £16 million	16
<a href="#"><u>Euro Foods</u></a>	Family-owned Cwmbran Headquarters but UK wide and international manufacturing and distribution of ethnic food for food service	85
<a href="#"><u>FEI Foods</u></a>	Swansea based microwavable food pots and snacks subsidiary of French Marbour conglomerate which is privately held, still family run and emphasises autonomy of national subsidiaries.	73
<a href="#"><u>Glanbia Cheese</u></a>	Large scale producer of food service mozzarella and claims to take 20 % of Welsh liquid milk; joint venture with US family owned Leprino and Glanbia PLC which is 55% owned by an Irish Framers Coop; has two plants at Craigavon and Llangefni and if split turnover 50/50 Llangefni has £135 million.	135
<a href="#"><u>Tillery Valley Foods</u></a>	350 employees in Abertillery with ready meals for hospital and health care group; subsidiary of Sodexo majority family owned, French headquartered facilities conglomerate.	30
<b>Group 4: PLC subsidiaries and Private Equity investments: 8 firms</b>		
<a href="#"><u>Brighter Foods</u></a>	Ex CEO of Halo re started healthy snack bars in Tywyn in 2014 and then sold out in 2016 to Real Good Food PLC but remains as chief executive of the company	15
<a href="#"><u>Eurocaps</u></a>	141 employees in soft gel capsules; for health foods and OTC; since 1999 subsidiary of DCC Irish PLC DCC conglomerate	38

<a href="#"><u>Halo foods</u></a>	Pioneered healthy snack bars; moved from Tywyn to Newport; under various forms of ownership and since 2016 has had two private equity owners	35
<a href="#"><u>KK fine foods</u></a>	500 employees, all kinds of ready meals including sous vide; 2017 founder sold to Ter Beke a Belgian food conglomerate	51
<a href="#"><u>Memory Lane Cakes</u></a>	Part of UK plc Finsbury which is a holding company for a group of bakeries and has owned MLC since 2002; Cardiff based and employs 800 as Cardiff's second largest private employer	71
	(NB in 2018 Finsbury bought the gluten free baking. Pontypool based Ultrapharm with £ 11 million turnover from family owners)	11
<a href="#"><u>Peters Food Company</u></a>	900 employees in Bedwas manufacturing plus UK distribution of pies and savoury bakes from multiple sites; management buyout with Private Equity backing in 2014	59
<a href="#"><u>Rachel's Dairy</u></a>	See our 2015 FSB report noting ownership churn before ending up as JV of Lactalis and Nestle though website which presents it as family based + packaging emphasises organic not Wales	22
<a href="#"><u>Wholebake Ltd</u></a>	167 employees at two North Wales sites claims to be the UK's largest contract manufacturer of gluten free snacks; 2014 bought by Bridges Private Equity / Ronald Cohen's social mission Private Equity	27

## Appendix 5: the Atamis database of Welsh public sector procurement

The Atamis database brings together (invoice based) data on the purchasing of all Welsh public sector bodies. There are a number of operating modules to this system which is connected with Bloomberg, Thomson Reuters and Companies House so that the characteristics of supplier companies can be interrogated but it does not provide detailed category splits (e.g. on meat or dairy).

As external researchers we could not access the database directly. As we understand it, no regular reports are produced from Atamis data for relevant departments. This is part of a larger problem about Welsh Government's use of databases and commercial big data which needs urgent attention because there is not even a central register of whom is subscribing to what across different departments.

Following a data request, Atamis produced a printout report on Welsh public procurement for 2018-19 which answered a series of written questions we had submitted. A follow up session was also very helpful in clarifying issues arising from the report. The basics are fairly clear: public purchasing of food offers limited direct leverage because the total is modest and divided across many different categories and public authorities.

- The Welsh public sector food and catering services demand is in total modest. The Atamis database gives the 2018-19 total Welsh public sector spend as £94 million of which £71 million was for public sector food service and £23 million on bought in catering (Exhibit AP8)<sup>39</sup>. By way of comparison one mid-sized Welsh SME in food processing would typically have annual turnover of £ 10-£30 million.
- The total spend is divided between many different product categories so the demand available to any individual processor is much smaller. The Atamis database does not give category splits but the Strategic Marketing report for the National Procurement Service in 2013 calculated that meat, milk and dairy and fruit and veg were the three largest categories; with meat as the largest single category then accounting for less than 15% of the total spend<sup>40</sup>. These relativities are unlikely to have shifted markedly. If so, the Welsh public spend in the three largest categories (meat, milk & dairy, fruit & veg) is now worth no more than £ 10-15 million in each category across all of Wales.
- The total spend is divided between many different public authorities. 90% of the total annual spend is made by local authorities and health boards (Exhibit AP9). But Wales has 22 local authorities and 7 health boards. Some demand aggregation is going on but this is not being measured across the system and it will always be limited by Welsh topography so that regional aggregation is the only realistic option,

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<sup>39</sup> This division is approximate because the Atamis categories "catering" and "general supplies and services" do not exactly correspond with food service and bought-in catering.

<sup>40</sup> Public Sector Food Purchasing in Wales, Final Report 2013, p.19.

**Exhibit AP8: Welsh public sector spend on food and catering services and invoices split local and non-local<sup>41</sup>**

	Public sector spend	
	£ mill	Share of total spend
<b>Total public sector food invoices</b>	<b>95</b>	<b>100%</b>
Split by:		
Catering	72	76%
General supplies and services	23	24%
Split by:		
Local by Welsh invoice and post code	58	61%
Non-local by invoice and post code	37	39%

The information collected in the Atamis database reflects the long-standing preoccupation of Welsh policy makers with what we call “postcode localism”. The Atamis database counts Welsh suppliers on the basis of the postcode on the invoice and shows that 61% of Welsh public sector food invoices carried Welsh postcodes in 2018-19. The CLES consultancy in 2020 was hired to classify PSB invoices according to the postcode of the issuing company registered office. The CLES classification may be preferable, but no invoice-based measures can tell us much about product origins or where value is being added.

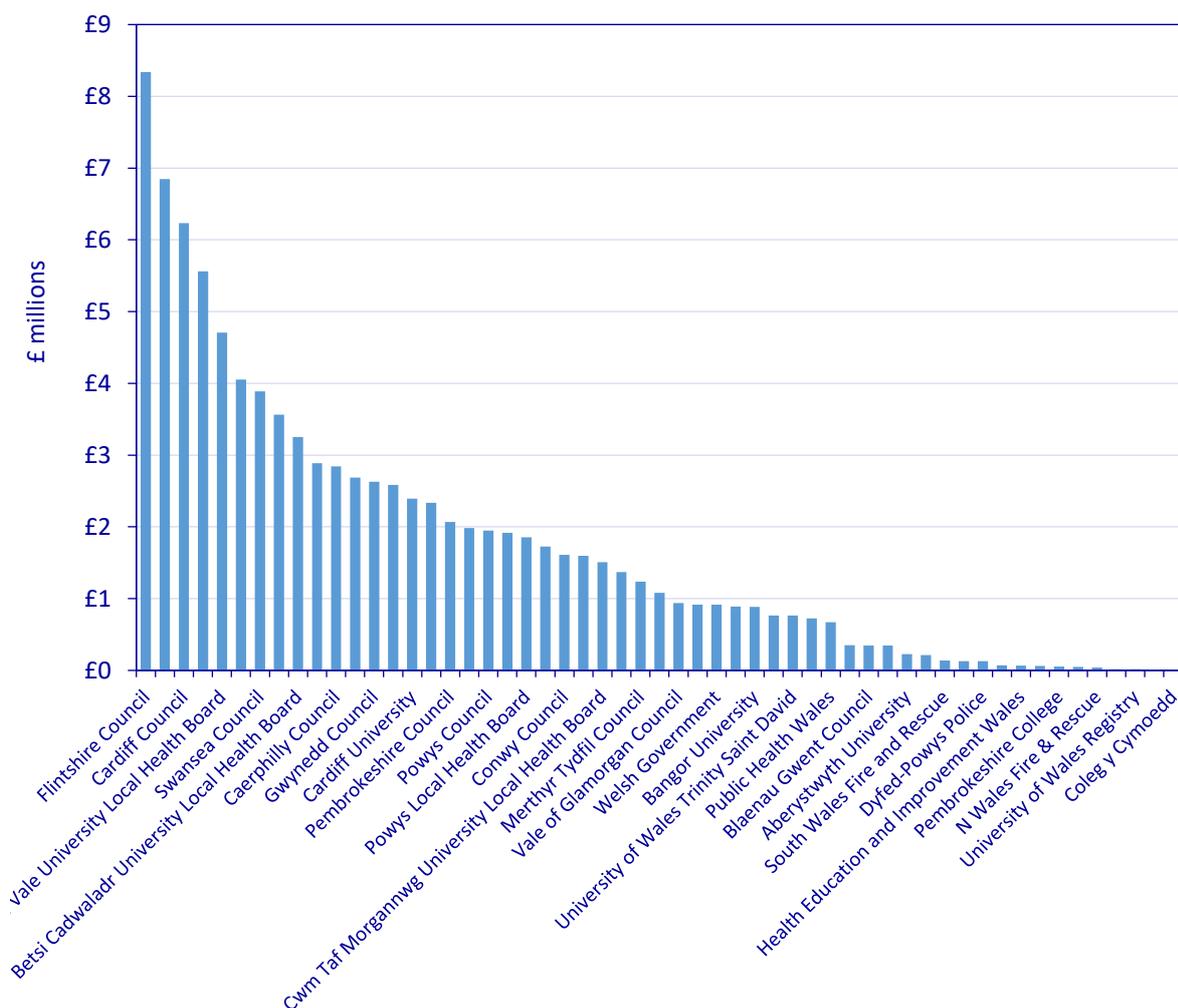
The proportion of food products originating in Wales or substantially processed in Wales is undoubtedly much lower than that indicated by postcodes of invoice or office. The only available measure of origin comes from the 2013 *Strategic Marketing* report. This asked first tier suppliers about the source of what they supplied in 12 categories including meat, milk and dairy, fruit and veg: in 2013, 69% by total value in these categories was then purchased in Wales but only 33% was “known to be reared, grown, processed or manufactured in Wales”<sup>42</sup>. No current invoice measure tells us whether and how this key ratio has been changed or can be changed.

<sup>41</sup> Source: Atamis database.

Note: Atamis financial year 1st April – 31st March. ‘Local’ means that the invoice is sent from a Welsh office or branch.

<sup>42</sup> Public Sector Food Purchasing in Wales, Final Report 2013, p. 19.

## Exhibit AP9: Public sector procurement by purchase



All this information needs to be set in the context of the Welsh food system. As we have noted, producers are narrowly specialised in meat and dairy, the system necessarily involves high levels of import and export etc. The food processing sector needs a larger value adding base but this cannot sensibly be obtained by stopping leakage and encouraging autarchy. As it is, Welsh Government is paying Atamis to collate information on food invoice postcodes which has little policy relevance.

Like all databases, Atamis does generate some interesting sidelight information. In this case, the sidelight is that the public sector is usually not an important volume customer for food processors whose main business is elsewhere with private customers. Also, the important public sector relations are with the food service distributors like Castell Howell who, as we argue in this report, are a gateway to volume demand.

The *Strategic Marketing* report in 2013 conducted a survey of 150 food and drink suppliers to the public sector which found that the public sector on average accounted for 10% of their turnover.<sup>43</sup> This result can be confirmed by cross reference to the current Atamis database

<sup>43</sup> Public Sector Food Purchasing in Wales, Final Report 2013, p. 6.

which brings out the point that the public sector's largest suppliers are not food processors but food service distributors who rack up the orders because they can supply many different product lines from one delivery; the largest single supplier is Castell Howell which in 2018-19 had public sector business of £17 million against turnover of more than £140 million.

Furthermore, the narrow preoccupation with postcodes and purchasing leakage distracts from the more interesting question of differences in how local authorities organise their spend and service delivery. The reform of public purchasing to benefit SMEs should not be pressed without at the same time considering the potential of trading companies which bundle purchasing and service delivery in one newly created and specialised SME.

The most striking point in the Atamis data is that (as in the figure above) there is no clear relation between the size of food spend and local authority population. Flintshire with a county population of 155,00 spends more on food and catering than Cardiff whose local authority area has a population area of 355,000. The explanation lies with service organisation. Flintshire and Newport have the highest food spend because they have outsourced catering and cleaning to arm's length local authority trading companies (LATCs) which are in effect professionally managed SMEs which bill their parent for labour and materials on catering and are free to seek non- local authority business.

Flintshire's Newydd Catering and Cleaning is a recent spin out with £8 million turnover and 415 employees. Newport Norse is a joint venture with Norfolk Council which pioneered the LATC. The Newport LATC has increased turnover from £7.3 to £12.4 million since inception in 2014, has a clean bill of health after CIPFA audit and pays all contracted staff the living wage<sup>44</sup>.

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<sup>44</sup> <https://norsegroup.co.uk/wp-content/uploads/2020/09/A-Guide-to-Newport-Norse-5f4f5c4550c52.pdf>