Drivers of Industry Consolidation — Learnings from Alaska Salmon

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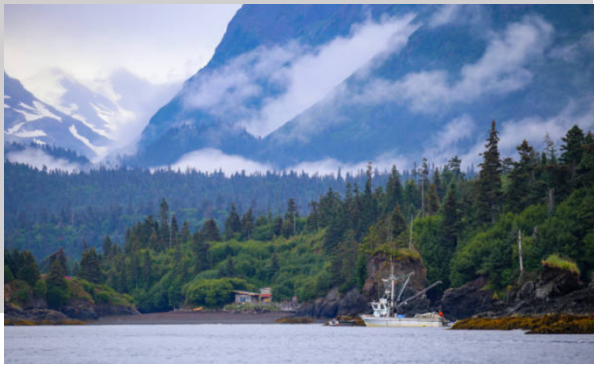
What a difference 25 years can make.



"Those who cannot remember the past are condemned to repeat it."

-George Santayana
Spanish-American Philosopher, 1905

Industries are not static, and neither can be the companies competing within them. Sometimes change is swift and obvious, and sometimes it is gradual and sneaky, but changes are inevitable. Even though every industry and its process of evolution is unique, sometimes we find that there are elements or lessons that are more broadly applicable to the business world at large. The Alaska wild salmon industry is one local industry that has undergone significant change over the past 25 years, change that for the most part has been painful for its participants and investors. Lessons may be learned from this that might have application to other industries (and perhaps save others some heartbreak).

First, a model to help guide thinking about the evolution of industries. Industries don't just change for no reason; there is always a driver that changes competitive dynamics and causes the economics of businesses to be modified, thereby leading to new actions in order to continue to compete.

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One easy model to use thinks of four phases in an industry as it moves from infancy to maturity:

- Stage 1 – Growth. Entrants emerge in a rush to meet unmet demand; the industry is highly fragmented as individual companies expand capacity.
- Stage 2 – Efficiency. As supply approaches demand, there is stabilization, with a growing focus on reducing costs to better compete.
- Stage 3 – Consolidation. Reducing costs independently is no longer sufficient, and further synergies through consolidation are necessary to optimize capacity, gain economies of scale, and lower costs enough to capture a profit margin.
- Stage 4 – Entrenchment. Emergence of an oligopoly composed of several dominant competitors having relatively stable market shares.

One may look at this framework and notice that not every industry seems to follow this pathway. Catalysts from the outside world—sudden change in demand, technological breakthroughs in production, a new industry entrant with a reimagined business model—can take an industry from Stage 3 right back to Stage 1 again (or vice versa).

At a high level, the Alaska wild salmon industry now finds itself in the final stage of its evolution. Three large competitors—Trident, Canfisco, and Silver Bay—dominate the industry and look to have entered a period of competitive balance where each participant has a viable future but none of them have much room for growth.

This landscape looks quite different than the dozen-plus major processors who made up the industry just a single generation of fishermen ago, which is a rather sudden development for an industry that didn't change much in its first century of existence. Such an evolution deserves investigation, and what better place to start than with a quick history lesson?

The Way Things Were

The Alaska wild salmon industry had its first commercial operation established in 1878, and by the early 1900s, was the largest salmon fishery in the world. For much of its first hundred years or so, the industry was in growth mode, as the domestic consumer discovered a growing appreciation and taste for salmon (as well as seafood more broadly, helped by better cold chains that allowed seafood distribution to penetrate further inland from coastal markets). The real limitation on the industry was supply, as wild salmon was (and is) difficult to catch and process, and generally speaking, whatever was caught could be sold at a price that generated a profit. A fisherman can only land so many fish during a brief salmon run, so the growth came from a combination of more fishermen and the addition of more processing plants, scattered around Alaska to be able to access a larger number of distinct salmon runs.

The Emergence of Aquaculture

Until around 1990, almost all of the global demand for worldwide seafood was driven by wild-capture fisheries. But in the 1970s, supply growth began to slow, as countries across the world started to recognize the natural limits of sustainable fisheries. It turns out that fishing to extinction is bad for business, existentially speaking. The United States began to more closely manage fisheries with a combination of permitting (and ultimately in some cases, quota systems), and wild salmon was no exception. In order to fill the supply vacuum and keep pace with increasing demand, aquaculture became an increasingly attractive area of investment. By 1990, aquaculture had grown across species and to meaningful economies of scale, such that farm-raised seafood had supplanted wild-caught as the growth engine for global seafood.

Processors Feel Price Pressure

Initially, farm-raised salmon wasn't seen as a direct competitor to wild-caught, as the quality and flavor was not a substitute for "the real thing." But as salmon farming methods improved and economies of scale were achieved, the farm-raised salmon product not only unlocked new demand (as it could be produced as a consistent product year-round) but started to compete directly with wild-caught salmon.

This price pressure is not what Alaska salmon processors needed at the time, as the cost to produce salmon continued to grow. This created an uncomfortable equation for processors: since 1990, the growth in wholesale prices of wild-caught salmon has been approximately 1% per year, on average, kept in check by the increasing scale and efficiency of farmed salmon as a viable substitute; meanwhile,

costs for processors (especially labor costs) have grown at a greater rate than inflation. There's no free lunch in economics, and the losing variable in this equation was profitability.

The Search for Efficiency

Desperate to stay viable, Alaska salmon processors embarked on a rapid quest for efficiency in the 1990s. By around 2000, individual companies had mostly exhausted the ability to cut costs independently, and began to combine. Consolidation had the objective of reducing indirect overhead (corporate overhead and the fixed costs associated with plant operations), as well as presenting some opportunities to increase utilization of plants (and shut down underperforming locations).

An additional event happened in 2007 that spurred even faster consolidation: the emergence of Silver Bay Seafoods. Silver Bay was founded by frustrated fishermen on the principle that economies of scale could be gained at the plant level by building large single plants in a fishery using automation to gain production efficiencies. Its thesis has proved correct, but not without ripple effects: the industry already had too much processing capacity in the mid-2000s, so the addition of Silver Bay's facilities squeezed the available throughput for other plants. Plants, like any major fixed infrastructure, can only break even with a minimum amount of volume—so the additional competition for supply forced many older facilities onto the negative end of the unit cost curve.

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Winners and Losers

In the last 25 years, the major players in the industry started with 47 plants, added 4 new more efficient plants, and closed 21, implying a nearly 40% net decline in number of processing operations. Companies exited the industry as well, either through insolvency or acquisition (and sometimes the former disguised as the latter). Since 2000: Wards Cove, North Pacific, Peter Pan, Ocean Beauty, Icicle, EE Foods, Alaska General, Red Salmon, Leader Creek, Snopac, Inlet, Kenai Packers, NorQuest, Whittier and numerous smaller operations have either closed their operations or become part of another company. The industry is now dominated by Silver Bay, Canfisco, and Trident, and has arguably entered a new age of stability. The rationalization was painful, but necessary.

Looking Forward

Not all costs in the industry have yet been optimized, but the three large remaining companies will lead the way in squeezing out efficiencies. The consolidation has unlocked enough profit margin that the industry can invest in itself again: innovation will spawn capital investment to apply greater automation and new technologies and systems to lower costs and improve quality. Further plant-level consolidation is likely, although within entities, as new highly efficient plants will replace old infrastructure. With all the indirect costs having been squeezed out, direct production efficiency is the only remaining path to higher profits and a sustainable future.

The gut-wrenching reformation of this industry meant a lot of money was lost and gained, with a majority of the parties in the "disappointment" column. It is not unique in its evolution, and it's difficult to say what the next 25 years will bring. If we can learn anything from our front-row seat, it's that the survivors saw the writing on the wall and took action when they could, instead of when forced to. Things that can't continue forever won't, and being on the right side of the cost equation matters.

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