PLAYING HARDBALL

HOW TO RESIST THE HARD DISCOUNT THREAT TO NORTH AMERICAN GROCERY

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For food retailers in Europe, intense competition from hard discount formats like Lidl and Aldi is an established part of the competitive landscape. In North America, however, hard discounters remain on the market fringes and show slow growth rates. But current developments indicate that they are poised to make their move.

This article takes a closer look at the hard discount challenge. It explains why the hard discount model works and reviews what is happening in Europe. It then lays out possible strategies that North American food retailers might use to help them adapt successfully to a market where companies new to grocery play by different rules.

HARD DISCOUNT HAS A STRONG TRACK RECORD

The hard discount economic model is an extremely powerful one. Efficiency ensures that low gross margins translate into strong bottom-line profit. Exhibit 1 shows a comparison of the hard discount profit and loss account compared with other grocery formats.

Exhibit 1: Cost advantage of low-cost competitors

	TRADITIONAL SUPERMARKET	TRADITIONAL HYPERMARKET	LOW-COST HYPERMARKET	DISCOUNTER
Sales	100.0%	100.0%	100.0%	100.0%
Cost of goods sold and shrink	-69.0%	-73.5%	-76.0%	-81.0%
Gross margin	31.0%	26.5%	24.0%	19.0%
Store labor cost	-13.5%	-12.5%	-8.0%	-4.0%
Central costs	-14.0%	-12.5%	-10.0%	-8.0%
EBITA[1]	3.5%	1.5%	6.0%	7.0%

1 EBITA: earnings before interest, taxes, and amortization

Once hard discounters get going in a market, they start a positive cycle: they attract customers with fantastic prices; increase sales volume and customer numbers, while reducing operating costs; and deliver enough return on capital to reinvest in the customer proposition and fund expansion.

The hard discounter model has been replicated successfully across international markets, including highly saturated ones with established market leaders. It is unique in its ability to enter mature markets and win customers from incumbents. And, as we will describe later, the hard discounters' offer of low prices with good-quality private-label products attracts customers across the economic spectrum, resulting in decreased sales for grocers near them.

Aldi and Lidl have learned how to balance customization while sticking to a winning formula. Individually their growth patterns are slightly different: Aldi slow and consistent; Lidl more aggressive and prepared to take risks. Both have a proven formula of establishing successful new stores, which in turn encourage more growth.

7,000

The number of stores Aldi and Lidl have opened globally in the past ten years

Discounters can offer great value because they have worked closely with food manufacturers for decades. They control how their products are produced, who can produce them, and what trade-offs to make. Having entered and grown their businesses in several countries, discounters have gained the additional advantage of working with regional manufacturers who are artisanal experts, e.g., pasta from Italy, which they can sell with great provenance across their entire estate.

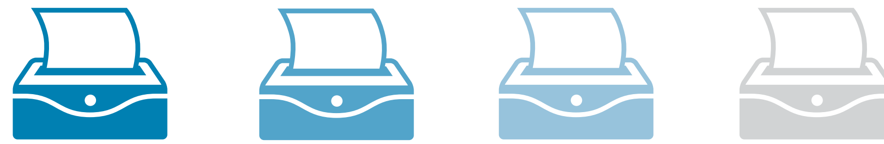
They have scale, too: Aldi and Schwarz Group (Lidl's parent) are the number one and number two sellers of own-brand grocery products worldwide. This allows them to take a hard-line approach to costs, removing every last element of cost while retaining good quality.

Discounters exploit the traditional grocers' dependence on complex product ranges. A typical supermarket will give customers a huge breadth of options within each product category: for example, think of the range of instant coffee, filtered coffee, coffee beans, and coffee capsules available in the hot drinks aisle. The lower-selling niche variants may drive a small amount of sales (and a smaller amount of profit) but will also drive up operation costs for the retailer.

In comparison, hard discounters provide perhaps just one leading brand for each category plus an own-label version at a much lower price but with much higher margins. They may not win the fraction of customers who want a decaf latte capsule for their specific coffee machine, but they will satisfy the bulk of the other coffee drinkers by stocking the main brand and impress with the quality and price of their own-brand product.

Discounters' own-brand goods are high quality, attractively packaged and a tremendous value. Established grocers, wanting to avoid enticing customers to trade down, typically compete with entry-price own-brand products. These are often of low quality and packaged unattractively to differentiate them from the store's higher-margin range, creating a wide value gap that customers readily perceive. Exhibit 2 shows how the discounters' own-brands compare to a traditional UK supermarket's own-label products on cost and quality.

Exhibit 2: Comparison of price and quality of own-brand baby wipes



	Aldi	Lidl	Supermarket own label	Supermarket budget own label
PRICE	**£0.59 for 64** 0.9p per wipe	**£0.79 for 80** 1.0p per wipe	**£0.70 for 60** 1.2p per wipe	**£0.60 for 80** 0.8p per wipe
AWARD COUNT	2nd 2nd 3rd	2nd	3rd	

Hard discounters have also been successful at attracting customers from all income brackets, taking market share from traditional retailers. Low-income customers do shop at Aldi, but they are not alone. Middle-class customers are also enjoying the experience of attractive prices without compromising on quality.

In the UK, the financial crisis helped Aldi and Lidl get traction. It is now perfectly acceptable to be seen shopping there and have own-brand products in the cupboard at home. The evidence is that consumers are content to squeeze food budgets if it helps them fund life's little luxuries, and hard discounters play up to this trend.

THE RISK IS REAL

10,000

The number of stores expected in the next decade, mainly in the US

Incumbents in North America do not sense an imminent threat from hard discounters, citing that they are a tiny fraction of the market and then adding, "My customers wouldn't shop there." These are the same themes mentioned years ago in Germany, where today over 40% of the grocery market is held by hard discounters, and by UK supermarkets, who have more recently experienced a loss of market share due to the same erroneous assumptions.

Perhaps it's true that the North American threat is still low. Aldi Süd and Aldi Nord's banner Trader Joe's are still small in terms of US market share (1% combined, nationally) and Lidl is one to two years away from entering the market with a significant number of stores. But Aldi Nord's purchase of 66 Bottom Dollar stores in Pennsylvania from Delhaize at the end of 2014 ought to be a signal to everyone in US food retail that Aldi is preparing to up its game.

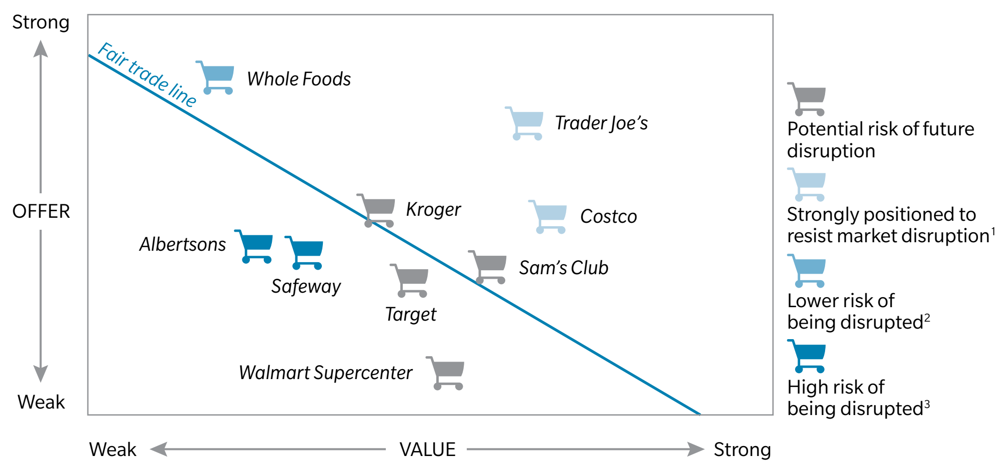
The Bottom Dollar deal cuts against the typical pattern for Aldi, which has always expanded with its own stores and maintained consistency across its estate. This suggests that Aldi is anxious to broaden its footprint as quickly as possible – perhaps trying to make the most of the limited window of opportunity before Lidl enters the US.

If the hard discounters are finally able to crack the massive untapped potential in North America, it will seriously disrupt the retail market. We regularly assess customer perception of grocers in the US market and, using these results, we can predict which areas of the market will be most vulnerable to disruption from hard discounters (Exhibit 3).

"You only have to look at where they are putting their stores to know they think they can win with a higher demographic."

CEO, $BN US GROCER

Exhibit 3: Predicting vulnerability in US grocery using a customer perception map



Customer perception mapping (CPM) distills customer satisfaction into two fundamental, independent aspects: offer (what customers get) and value (what it costs them). It illustrates how customers view each of the players in the market relative to one another. The CPM is based on statistically valid interviews with shoppers across the US, Canada, Germany, France, and the UK covering hundreds of grocers. The data shown here is for a particular head-to-head market. Data for all grocers is available from Oliver Wyman's Retail practice.

Over the past decade, we've applied this approach across many different retail markets and have found the results to be a good indicator of financial performance.

1 Grocers who exceed their primary customer expectations on value and offer
2 These grocers' offer and value equation insulates them during the early stages of hard discount market entry and growth
3 Grocers who are below the fair trade line are much weaker than Aldi and Lidl on value, and lack a strong offer to counteract losing customers

LEARN FROM EUROPE WHICH BASES TO COVER

Time and again the hard discounter model has acted as a catalyst for a price war. On top of other competitive pressures, such as current wage strategies aimed at retaining the best employees, this is the last thing the existing North American superstores and supermarkets need. To resist, they should take note of what happened in other countries and be aware that doing nothing is not an option: German grocery was the first to experience hard discounting, and retailers there ignored it and have never recovered. The same is true in the UK, with the exception of Walmart-owned Asda, where waiting too long to respond allowed the hard discounters to establish price gaps so large that closing them would be ruinously expensive for the incumbents.

But some grocers have had success in resisting moves from Aldi and Lidl (see Case Studies 1 and 2). It is from retailers like these that North American grocers may learn. We believe there are several actions they can take to change things in their favor in advance of Lidl and Aldi's growth:

- Drive down costs (sales and administration, goods not for resale, logistics) and invest the profits into improving customer experience as well as lowering prices to minimize the price gap with discounters
- Integrate vertically by making your own-brand product ranges that are great value and matched to local demand
- Strengthen your organization's expertise in sourcing so you can deliver to your customers a discount own-brand that can stand up to the competition; the sourcing team's skills should go far beyond just picking products from a catalog
- Invest in a high-quality fresh counter – an area of the store where hard discount cannot match the supermarkets' quality and experience (see our report *Getting fresh: Lessons from the global leaders in fresh food*)
- Don't be concerned about cannibalizing existing sales – the hard discounters will take market share anyway so it is better to use a hard or soft discount format to compete against adjacent markets
- Take a hard look at your real estate portfolio and get ready to make adjustments.

CONCLUDING REMARKS

With the hard discounters preparing to make a move on the North American grocery sector, incumbent food retailers must put in place their own game plans to ensure a profitable future. It can be done by working closely with manufacturers of basic products and streamlining store operations. Offer unbeatable prices on selected major brands and replace the rest of the basket, including fresh produce, with better quality.

The good news is that taking these steps will help supermarkets win against any type of market disruption and a drastic change in strategy is not needed. But, for many, what is needed – and urgently – is a radical increase in awareness of the risk to the market and profits. Hard discount is going to become more of a factor in North America; now is the time to prepare for an even tougher competitive environment.

Further reading from Oliver Wyman:

- How to beat lower-priced competition
- The discounter threat: A conversation on front-line retail strategy
- Evolution, growth, and revolution: Lifestage changes in retail
- Getting fresh: Lessons from the global leaders in fresh food
- Making the right choices: SKU rationalization in retail

CASE STUDY 1
An own-brand discount format taking on the hard discounters

Reitan operates REMA 1000 in Norway and Denmark as a “soft” discount concept, focusing on a limited offer and a simple shopping experience. (“1000” stands for the typical number of SKUs when the concept was launched.) Their slogan roughly translates to “the simple is often the best,” and customers love their stores despite low investment in aesthetics.

While prices are comparable or slightly higher than Aldi and Lidl, REMA 1000 wins customers through a better shopping experience, compelling own-brand products in the Økologi range, and excellence in its fresh produce.

To deliver this attractive customer proposition, they focus on cost control in the store and throughout the supply chain. Their successful formula has allowed them to grow their estate to 250 stores in Denmark while protecting their profitability amid the hard discounter competition.

CASE STUDY 2
Winning the high-quality, low-cost product battle

Mercadona is the biggest grocery retailer in Spain (with 35% of the market share). It offers own-label products that are perceived to be as good, if not better, than the top brands, reinforced by a consistent communication strategy of “everyday low prices.” Behind these excellent products is a strong relationship with suppliers based on cooperation, mutual trust, and stability.

In store, Mercadona has established something of a cult status among employees and consumers. Staff receive an annual bonus; customers experience a clean and tidy shopping environment with very attentive staff. Customers are also able to participate in weekly focus groups to ensure their needs are being met.

ABOUT OLIVER WYMAN

Oliver Wyman is a global leader in management consulting that combines deep industry knowledge with specialized expertise in strategy, operations, risk management, and organization transformation.

In the Retail practice, we draw on unrivalled customer and strategic insight and state-of-the-art analytical techniques to deliver better results for our clients. We understand what it takes to win in retail: an obsession with serving the customer, constant dedication to better execution, and a relentless drive to improve capabilities. We believe our hands-on approach to making change happen is truly unique – and over the last 20 years, we've built our business by helping retailers build theirs.

www.oliverwyman.com

CONTACTS

JAMES BACOS

Global Retail Practice Leader
james.bacos@oliverwyman.com
+49 89 939 49 441

PAUL BESWICK

North American Retail Practice Leader
paul.beswick@oliverwyman.com
+1 617 424 3259

BERNARD DEMEURE

French and Iberian Retail Practice Leader
bernard.demeure@oliverwyman.com
+33 1 4502 3209

NICK HARRISON

European Retail Practice Co-Leader
nick.harrison@oliverwyman.com
+44 20 7852 7773

SIRKO SIEMSSEN

European Retail Practice Co-Leader
sirko.siemssen@oliverwyman.com
+49 89 939 49 574

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