L.E.K.

EXECUTIVE INSIGHTS

VOLUME XVI, ISSUE 35

Beating Back Hard Discounters: Lessons From France for the U.K.'s Big Four Supermarkets

The U.K.'s big four supermarkets, Sainsbury's, Tesco, Asda and Morrisons, grew rapidly in the 1990s and 2000s. While they adopted varying strategies, the macro environment for all of them was strong as consumer expenditure was growing. All of the big four invested in their footprint, supersized their stores and expanded both their grocery and non-food ranges. Most also invested heavily in a multi-channel strategy, including e-commerce, convenience stores and, more recently, click-and-collect. They also expanded and aggressively promoted their own private label ranges, primarily targeting market share gain from branded goods also sold through their stores. Price leaders Tesco, Asda and Morrisons responded by setting keen prices. The story has been reviewed extensively recently and is well known.

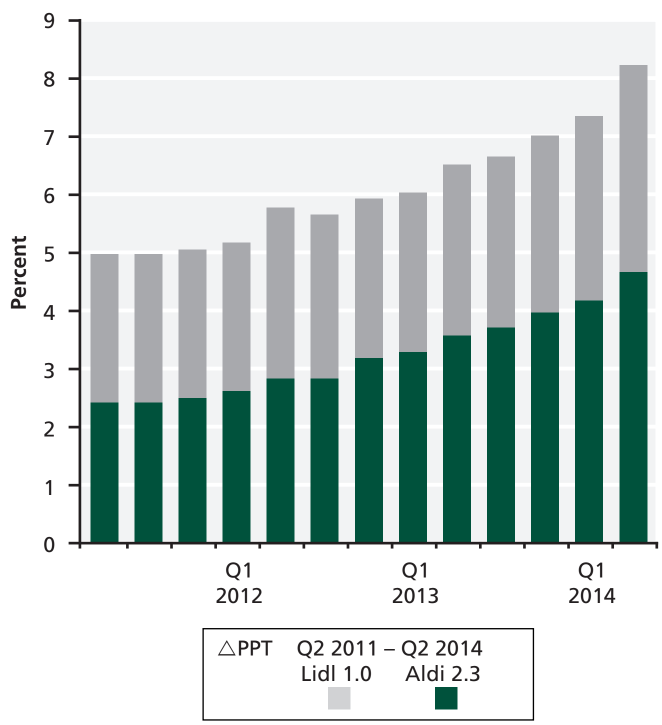
A combination of factors since the financial crisis has negatively impacted revenue and profit growth as consumers have seen their incomes squeezed and have become more fuel and cost conscious. The market has been split, with a growing gap between the premium and value segments, while the middle has shrunk. The same effect has occurred in other consumer categories, such as fashion.

Hard discounters, such as Aldi and Lidl, have capitalized on this "value gap," offering customers low prices while moving away from the spartan customer experience, which had inhibited their growth in the 1980s. They have done this through investments in store layout, improved service, fresher and higher quality foods, selected branded goods, and some higher-end products.

The favorable environment for them and their successful strategies have allowed discounters to increase their U.K. market share from 5% at the start of 2012 to more than 8% now (see Figure 1). Meanwhile, revenues and profits at the big four are stagnant or declining and pressure on CEOs has become intense.

Figure 1

U.K. Grocery Market Share of Hard Discounters



Source: Kantar Worldpanel

Beating Back Hard Discounters: Lessons From France for the U.K.'s Big Four Supermarkets was written by **Jonathan Simmons** and **Vassilis Economides**, Partners in L.E.K. Consulting's London office and **Remy Ossmann**, Partner in L.E.K. Consulting's Paris office. Please contact retail@lek.com for additional information.

The four major U.K. supermarkets largely ignored discounters until recently, continuing to focus on competing with each other. They also made large investments to drive multi-channel and were distracted by non-core strategic initiatives to expand into ancillary offers, including financial services, mobile phones and digital services.

We believe that the three price-led supermarkets have all made a fundamental strategic error by not recognizing the blurring of the lines between supermarkets and discounters. Their persistence, at least until very recently, in benchmarking offers and prices against one another – e.g. Asda's guarantee of being 10% cheaper than Tesco, Sainsbury's, Morrisons and Waitrose – runs contrary to strong evidence that consumers have expanded their consideration set and are now making different comparisons and trade-offs.

This has left major supermarkets uncompetitive against discounters on core ranges. For example, a basket of own-label goods at Aldi is c.15% cheaper than similar Asda private label goods, with national brands also being more expensive at the major supermarkets (see Figure 2).

If it is clear that U.K. supermarkets need to lower prices further to compete more effectively against discounters, why are they only now picking up the gauntlet? Faced with declining revenues and profits, the decision to reduce prices significantly can be difficult for a CEO to make as it will always be uncertain that a volume increase will offset the reduction in prices.

However, with current strategies failing, lowering prices increasingly appears to be the only available option. U.K. supermarkets should look to their French counterparts for lessons on how price cuts can be implemented to ensure the long-term viability of the business, while protecting margins in the short-term.

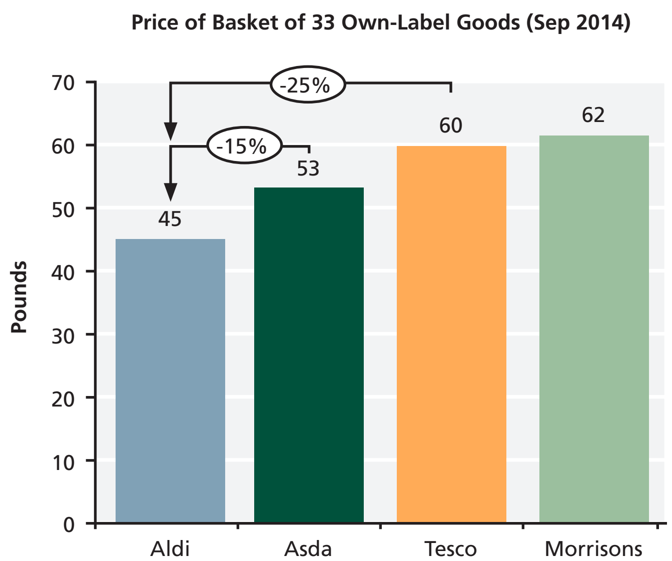
French Supermarkets Beat the Hard Discounters by Making Deep Cuts in Prices

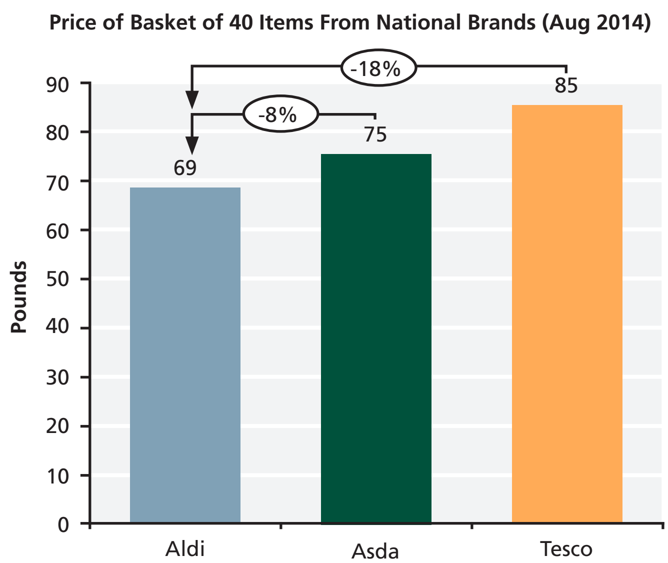
Hard discounter market share in France grew briskly in the 1990s and 2000s. It peaked at 14% in 2009 and is now down to 12%. The trigger was a change in French law in 2008, which allowed supermarkets to freely negotiate the prices they paid to individual suppliers.

In competing in the market and against discounters, French supermarkets tried the same strategies as the U.K. big four, including building their convenience store presence and developing multi-channel initiatives such as click and collect,

Figure 2

Price Comparison of U.K. Supermarkets vs. Hard Discounters





Source: L.E.K. Research

known as “drives” in France.

Importantly, they also adopted a comprehensive new price strategy to increase their competitiveness against discounters:

- Expanded budget product lines
- Reviewed their pricing for private label
- Significantly reduced prices of branded goods

In doing so they also simplified their offer and made pricing a clearer part of the message, moving from a proliferation of promotions to Every Day Low Pricing (EDLP) and re-focusing multi-tiered private label to fewer tiers, with clear quality and value-for-money price points.

A basket of budget private label goods is now about 13% cheaper at a French hypermarket and 9% cheaper at a supermarket, than at a hard discounter. A basket of branded goods is only 5% more expensive at Carrefour than at Lidl, vs. the c.20% premium in the U.K. (see Figure 3).

This has helped keep food and non-alcoholic consumer price inflation (CPI) in France to 1.4% per annum since 2008, compared with 4% per annum in the UK over the same period (see Figure 4).

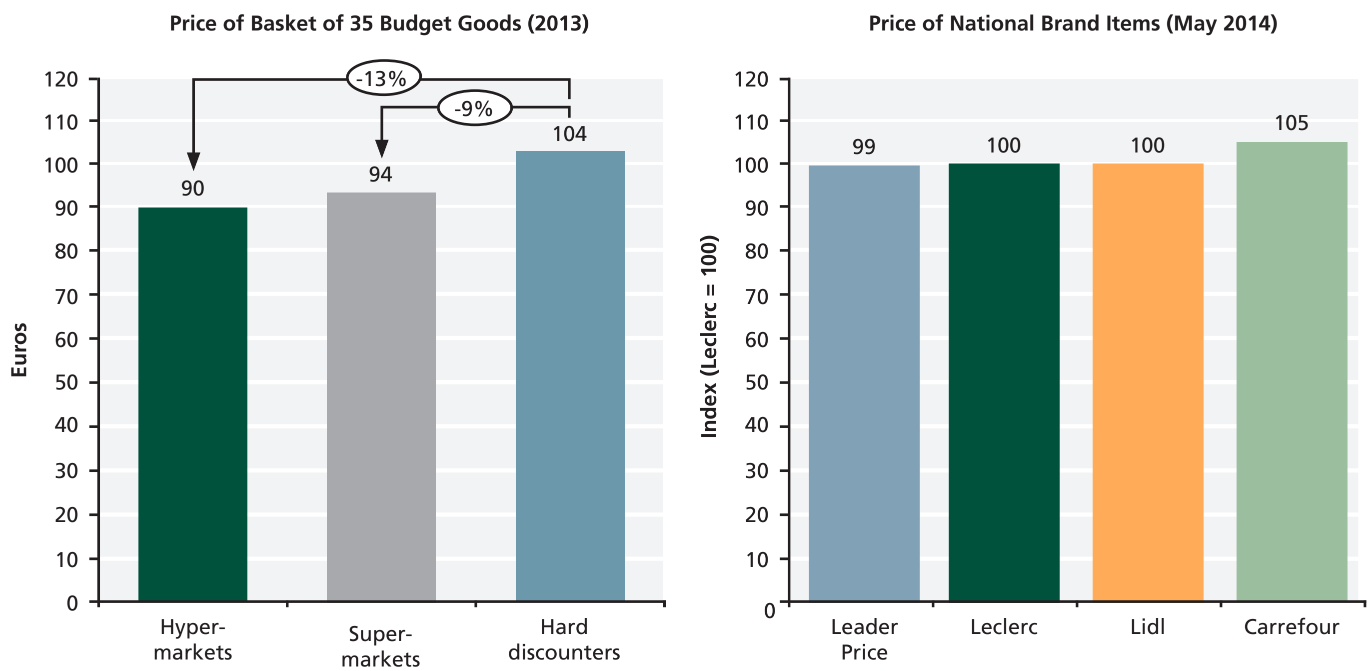
The results? Discounters are now falling back in France: their market share is down almost 2 percentage points over the last four years, closing c.150 stores in 2013 (see Figure 5). Lidl has dramatically slowed its expansion, now opening about 20 new stores annually compared to 80-100 in previous years. Dia is exiting the market and Carrefour has announced that it will buy the 800 Dia stores in France.

Given the alternative – a strategically untenable business model – French supermarkets worked with their suppliers to reduce prices, share the burden of lower margins and fend off discounters. The French supermarkets managed to thereby stabilize their businesses, despite some revenue and profit decline in the short-term, and return to domestic sales growth. Carrefour returned to sales growth in 2010 and to margin growth in 2013, while Leclerc, which has been the most aggressive on prices, has seen revenue growth of 6% per annum, the strongest for French stores since 2009.

Faced with the same strategic challenges, U.K. supermarkets now have to make the same investments to drive price competitiveness, and can take some comfort from the recovery

Figure 3

Price Comparison of French Supermarkets vs. Hard Discounters

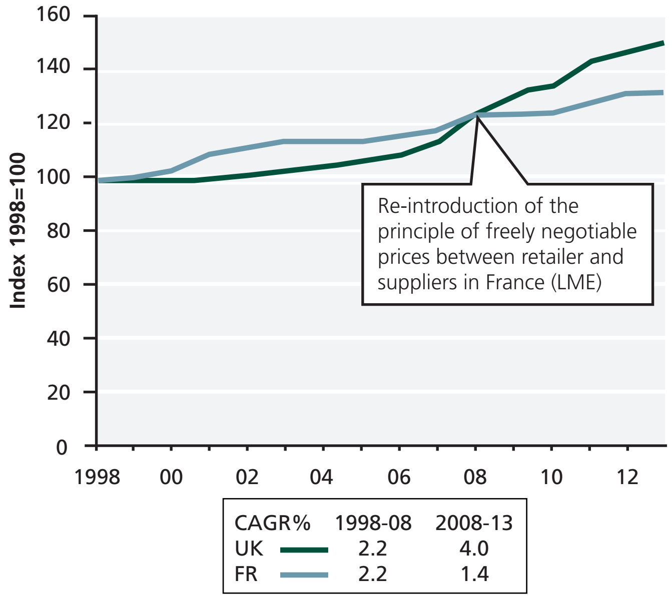


Source: Familles rurales; Lineaires; A3Dist'ib / Ed. Dauvers of the French supermarkets. There is undoubtedly a big price gap to close: a basket of similar branded goods at Tesco is today c. 22% more expensive than at Carrefour.

U.K. supermarkets will need careful planning and management of a holistic strategy to ensure success and profit recovery.

Figure 4

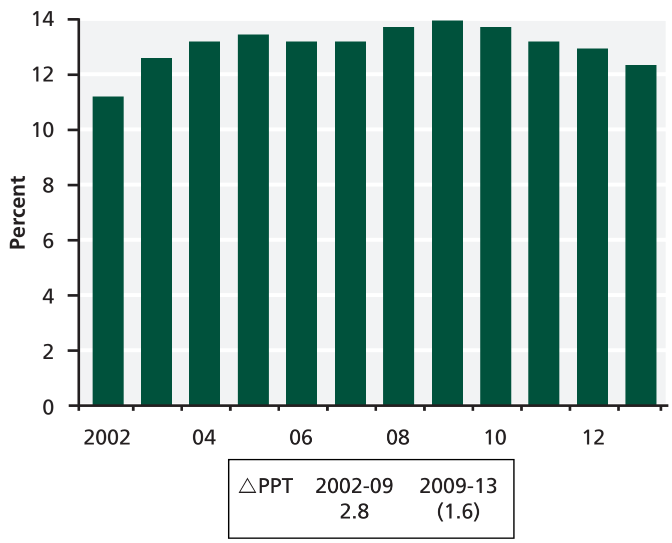
CPI: Food and Non-Alcoholic Beverages (1998-13)



Source: ONS; INSEE

Figure 5

Market Share of Hard Discounters in France (2002-13)



Source: Kantar Worldpanel

Strategic Implications for U.K. Supermarkets and Suppliers

There are six key strategic initiatives U.K. supermarkets should focus on, all aimed at passing efficiency gains to consumers through lower pricing, while ensuring profit protection and an eventual return to growth.

1. Redefine consumer pricing strategy and collaborate closely with suppliers to scrutinize all elements of supplier costs and pricing

U.K. supermarkets need to redefine their consumer pricing strategies to offer and communicate better value to consumers, benchmarking both quality and prices against discounters in addition to their traditional competitor set.

Supermarkets will need to work closely with suppliers to carefully review all elements of supplier product costs and pricing in order to ultimately share the burden of lower prices. All elements of supplier trade investment need to be ruthlessly rationalized to eliminate activities that do not directly contribute to sales and margin expansion and significant trade promotion spend should be re-focused to reduce headline prices.

Ultimately both supermarkets and their suppliers will need to adapt their expectations and business models to a lower margin reality. Through close collaboration, however, they are likely to identify important drivers that genuinely contribute to mutual value creation (e.g. arrangements that can lower the suppliers' cost to serve supermarkets, supplier activities that can drive both product sales and increased footfall to stores, etc.).

2. Drive rigorous zero-base cost reduction across their operations and supply chain

U.K. supermarkets need to focus on cost efficiencies across their footprint and pass on savings to consumers, not unlike Tesco's successful strategy of the 1980s and early 1990s. This should include rationalizing the product portfolio by eliminating SKUs that do not directly contribute to the customer experience or to margin (while remembering that appropriate product depth and breadth is an advantage they have over the discounters), improving space utilization and finding cost efficiencies across their supply chain. This would be another key area of collaboration and innovation between supermarkets and their suppliers.

3. Review private label strategy to offer better value and compete more effectively against discounters' own ranges

Supermarkets will need to redefine and simplify their private label offer architecture across the three key tiers (entry level basic, core mid-tier, premium), recognizing that consumer expectations have changed and private label is no longer equivalent to lower quality. Sainsbury's success with their "Taste the Difference" range indicates the potential for supermarkets to succeed if they get the quality vs. price equation right. The economics of successful offers indicate that private label is no longer equivalent to higher retailer margin compared to branded goods, but may be an essential component of a strategy to retain consumers that seek a better price-to-quality balance.

> *The shopping experience is what drove consumers to supermarkets and hypermarkets in the 1990s and it may very well be a driver of future growth.*

4. Continue review of store footprint and format to drive increased footfall and consumer expenditure in store

The shopping experience is what drove consumers to supermarkets and hypermarkets in the 1990s and it may very well be a driver of future growth, if supermarkets can get it right again. Consumer expectations on experience may have changed, with increased focus on convenience and reliance on multi-channel, and they remain cognizant of the trade-off they are making by switching to discounters.

The right shopping experience can again provide a clear advantage to supermarkets over discounters when coupled with the right pricing strategy. This will, however, mean that supermarkets need to move away from a focus on floor space utilization to focus instead on delivering the essential components of a differentiated customer experience. This will be particularly important in the absence of promotion-driven footfall.

5. Clearly define target consumer segments and deliver a differentiated proposition

Supermarkets need to clearly understand their core consumer base, understand the reasons behind their store choice and strengthen the value proposition for each segment. This proposition will naturally be different for price-led chains like Asda vs. quality-led supermarkets, such as Waitrose.

Implementing this proposition is likely to entail a number of elements, including repositioning their brands, rethinking their marketing campaigns, reviewing their product ranges, aligning their non-product offers and refining their loyalty schemes.

6. Rationalize non-core businesses that do not directly support the fundamental customer proposition

Supermarkets will need to carefully consider opportunities to divest activities that are not directly linked to their core value proposition. Doing so will both release value that can be reinvested in what they do best and eliminate detrimental management distractions.

Morrisons has starting doing this with its recent sale of childcare and maternity product retailer Kiddicare. Other supermarkets should similarly consider whether their non-core activities, including financial services, mobile phones and digital offers, support their value proposition, and whether the value generated justifies the opportunity cost from both a financial and an organisational perspective.

Re-taking the Initiative

Acting now to re-define a value-oriented proposition can allow the supermarkets to compete against the discounters.

U.K. supermarkets can succeed if they recognize they now operate in a fundamentally different market, where traditional lines have been blurred. Although the market context for them is challenging, the priorities are clear and the experience in France provides reassurance that the challenges are addressable. Both consumers and investors will reward retailers that make the right decisions and investments to reverse the decline and create a sustainable model for the future. The time for supermarkets to act is now.

INSIGHTS@WORK®

L.E.K. Consulting is a global management consulting firm that uses deep industry expertise and analytical rigor to help clients solve their most critical business problems. Founded more than 30 years ago, L.E.K. employs more than 1,000 professionals in 21 offices across the Americas, Asia-Pacific and Europe. L.E.K. advises and supports global companies that are leaders in their industries – including the largest private and public sector organizations, private equity firms and emerging entrepreneurial businesses. L.E.K. helps business leaders consistently make better decisions, deliver improved business performance and create greater shareholder returns. For more information, go to www.lek.com.

For further information contact:

London
40 Grosvenor Place
London SW1X 7JL
United Kingdom
Tel: +44 (0) 20.7389.7200
Fax: + 44 (0) 20.7389.7440

Milan
Piazzale Biancamano 8
20121 Milano
Italy
Tel: +39 (02) 8646.2761
Fax : +39 (02) 8646.2791

Munich
Neuturmstrasse 5
80331 Munich
Germany
Tel: +49 (89) 922.0050
Fax : +49 (89) 922.0520

Paris
3 rue Paul Cézanne
75008 Paris
France
Tel: +33 (0) 1.4703.1950
Fax : +33 (0) 1.4296.1138

Wroclaw
ul. Pilsudskiego 13
50-048 Wroclaw
Poland
Tel: +48 (71) 790.16.30
Fax : +48 (71) 790.16.35

International Offices:

Beijing
Boston
Chennai
Chicago
Los Angeles
Melbourne
Mumbai
New Delhi
New York
San Francisco
São Paulo
Seoul
Shanghai
Singapore
Sydney
Tokyo