PROGRESSIVE**GROCER**'s

The Evolving Retail Landscape

Retailing Thermodynamics

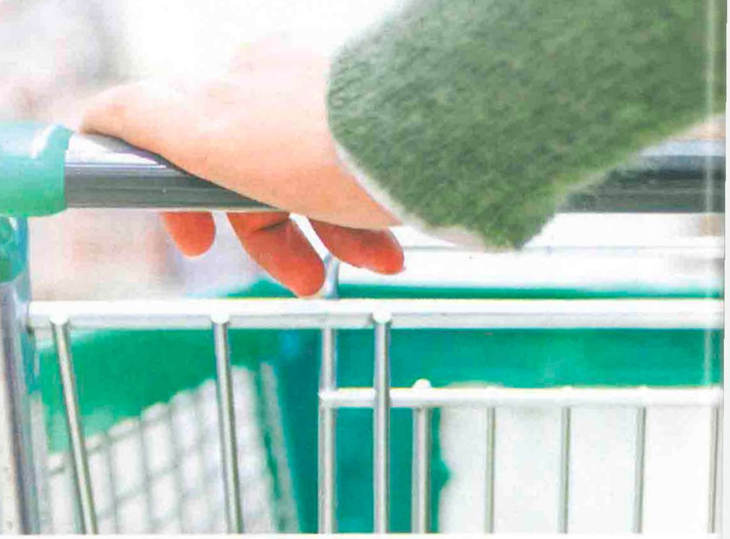
These are the concepts grocers must embrace to stay relevant and thrive in the coming years.

The retail landscape is arguably more dynamic than ever before. The rapid development of digital technology, combined with fundamental changes in the way people shop, has forced the hand of the traditional brick-and-mortar retailer: Adapt or die.

Retailers no longer sell things — they sell experiences. So grocers need to leverage their food competencies and combine them with technology and showmanship to deliver an experience that shoppers can't get anywhere else, digitally or otherwise.

Progressive Grocer tapped the insights of six industry analysts to break down the key elements of the evolving retail landscape: how to win in the face of new threats, personalized customer engagement, a world beyond channels, loyalty through differentiation, harnessing Big Data and localizing marketplace needs.

Retailers need to up their game by shaking off their reluctance to experiment with new initiatives and learning — just as innovators like Google have — that true failure is opportunity missed for fear of risk.



The Next Wave of Competition

Online, discounters represent potential threats to traditional grocers.

By Joel Rampoldt

Food retail has low margins and high fixed costs, but what makes it a really tough business is the frequency with which retailers have to contend with new waves of competition. This past year, we've seen signs that two niche formats are poised to go mainstream and significantly disrupt the grocery market: online and hard discount.

As is always the case when a format comes on the scene, incumbents face both threats and opportunities. Companies that adapt and survive new forms of competition will come out the other side stronger. Companies that ride consumer trends by offering discount or online formats of their own can drive significant new growth.

Online Grocery

Our modeling suggests online grocery can be profitable in markets that serve 50 percent of U.S. consumers. To put it another way, this is a way of selling food that's going to work in a lot more markets than people think. Where there's an opportunity for profitable growth, someone will take it.

AmazonFresh, based in Seattle, is now available in four cities, with announced plans to expand rapidly. Bentonville, Ark.-based Walmart is expanding its home delivery and drive grocery formats. These two players have the capital, skills and will to change the market rapidly.

It won't take a major shift in market share to be disruptive. Since traditional grocers today run with 2 percent earnings before interest and tax (EBIT) and a 20 percent volume variable margin, a 10 percent market share to online would erase their aggregate profitability at current footprint.

Discounters

Hard-discount formats in Germany grew from nothing to more than 40 percent of the market today. Beyond Germany, Aldi, Lidl and other discounters have made major inroads across Europe, but it's the U.K. market that's the proverbial "canary in the coal mine" for U.S. operators. There, Aldi and Lidl have changed, almost overnight, from niche stores serving only low-income customers to mainstream choices that attract middle-class households and routinely win independent awards for their product quality.

We believe the United States is next. Aldi has seen healthy, profitable growth for years and continues its aggressive expansion; Lidl has announced plans to enter the U.S. market; and other traditional grocers are trialing their own discount formats.

When we benchmarked the typical hard-discounter P&L versus traditional grocers, we found that the discounters turn a 12 percentage-point disadvantage in gross margin into a 3.5 percentage-point advantage in EBITDA. They do this with carefully designed operations that leverage deep sourcing expertise, massive sales intensity per SKU on a small number of "bull's eye" lines, low-labor merchandising and very small-footprint stores. The result is a store that can be profitable with prices up to 20 percent below Walmart's, and in locations that are too densely populated to support a Walmart Supercenter.

Upper-income households have seen their income grow, while middle-class and lower-income households have stagnated. *The Wall Street Journal* recently reported that some U.S. companies are giving up on lower-income segments to focus on the wealthy. For traditional food retailers, this isn't an option: Their dense store networks can only be viable if they're attractive to a broad range of customers.

In the United Kingdom, Aldi and Lidl went from slow to explosive growth when the financial crisis and attending recession squeezed middle-class and low-income customers' pocketbooks. In the United States, these customers are continuing to struggle, creating opportunities for the grocers that can offer superior value.

Some of the plays we see food retailers running include increasing the prominence of entry-level private label (PL) products. In some categories, these brands offer extraordinary value because they have similar specifications to the store's national-brand equivalent (NBE) own brand. The difficulty retailers face in driving entry-level PL is trade-down: If they make these products too attractive, customers will switch over from higher-margin NBE products.

Winning in the Face of New Threats

Online and hard discount will never appeal to everyone, but they don't have to. These are formats that are inherently attractive to a broad enough set of consumers that they'll succeed and grow. The lion's share of this growth will come from today's winners. Inevitably, the total square footage of traditional grocery formats will have to decline.

Hard Discount vs. Supermarket: Comparative P&L

	Supermarket	Hard Discounter	Discounter Advantage (Disadvantage)
Gross Margin	30.9%	19.1%	(11.8% pts)
Operating Costs	(25.6%)	(11.2%)	
Store Contribution	5.3%	7.9%	+2.6% pts
Overhead	(1.7%)	(0.9%)	
EBITDA	3.6%	7.0%	+3.4% pts

Source: Oliver Wyman Benchmarking

Traditional grocers that survive and thrive will do these things well:

Invest in price in the meat case: Winning lower-income customers requires winning their protein shop. Grocers are finding ways to invest in lower beef and chicken prices, either by heating up promotions or, in some cases, reducing everyday prices. With commodity prices under pressure, investing often means just holding prices constant and accepting lower margins.

Experiment with these new formats: Historically, the grocery industry has been halfhearted about format innovation, and as a result, much of the value created from new formats has gone to new entrants. Be that as it may, several of the big grocers are now operating value-oriented formats, with varying degrees of success. To be successful, however, these formats can't be simply smaller, tweaked versions of the main concept. To compete with Aldi, and eventually Lidl, they need deep expertise in sourcing, a superefficient in-store operating model, and enough network density to drive down the costs of distribution and drive up leverage from advertising spend. Of course, it's painful to cannibalize existing sales and profits with experiments with online or hard discount, but winning retailers must constantly try new approaches. This will require developing a new mindset to testing and learning, as well as bringing on board the kind of people who thrive in times of change.

Win the ground war: Traditional grocers *will* survive. To be one of them, you don't have to outrun the "bear," you just have to outrun the store next to you. Through a combination of investing in value and constantly improving the customer offer, successful retailers will win the store-by-store battles for customer traffic, ensuring that the other guy feels more than his share of the pain. The survivors will regain much of the sales per store lost to new formats when their in-format competition has to rationalize square footage.

Customers are increasingly showing that they value many of the things a traditional grocer can provide: high-quality fresh items, innovative prepared foods, convenience and service. Traditional grocers that are realistic about the threats they face and take steps to be the best at their format in their market can expect growth as lagging players fall behind.

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