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*Four forces
shaping
competition in
grocery retailing*



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Executive summary



Grocery retailing is a dynamic and highly competitive industry, and it's becoming more so. With the economy seemingly emerging from the downturn, industry leaders are looking for a heightened understanding of shoppers' mind-sets. Indeed, grocery retailers will have to respond to four increasingly important trends that will reshape competition over the next several years: the permanent shift to value seeking among consumers; the rise of technology-enabled shopping; greater online encroachment; and format and merchandise innovation.

For grocery retailers to respond to these forces successfully, they need to rethink their strategies. This means assessing their overall strategic value proposition and the key capabilities system that will distinguish them from competitors. Those in the industry not willing to foster the right capabilities risk the loss of market share, declining profits, and perhaps even extinction.

Introduction

In early 2012, Strategy&, along with Food Marketing Institute, collaborated with leading data providers the Nielsen Company, SymphonyIRI Group, VideoMining, and Intelligent Clearing Network (ICN) to gauge the current state of food retailing in the U.S. market. This study included interviews with about a dozen grocery CEOs and senior executives (as well as Strategy& experts from around the world) and, most important, fielded custom consumer research to 2,000 grocery buyers across the country representative of the U.S. population base.

At one level the results were unsurprising. Grocery retailing is a dynamic and highly competitive industry requiring increasing merchandising and marketing expertise, heightened understanding of and attention to a new shopper mind-set, innovation in all dimensions of retailing and manufacturer collaboration, and a renewed focus on operating costs. However, the study also surfaced four increasingly important forces that will reshape grocery competition over the next several years. Retailers that respond to and exploit these forces will prosper and grow. Those that do not will risk share losses, declining profitability, and perhaps even extinction.

Those four forces will have significant impact as grocery retailers and manufacturers navigate the uncharted waters of Retailing 2012 and beyond.

Value seeking

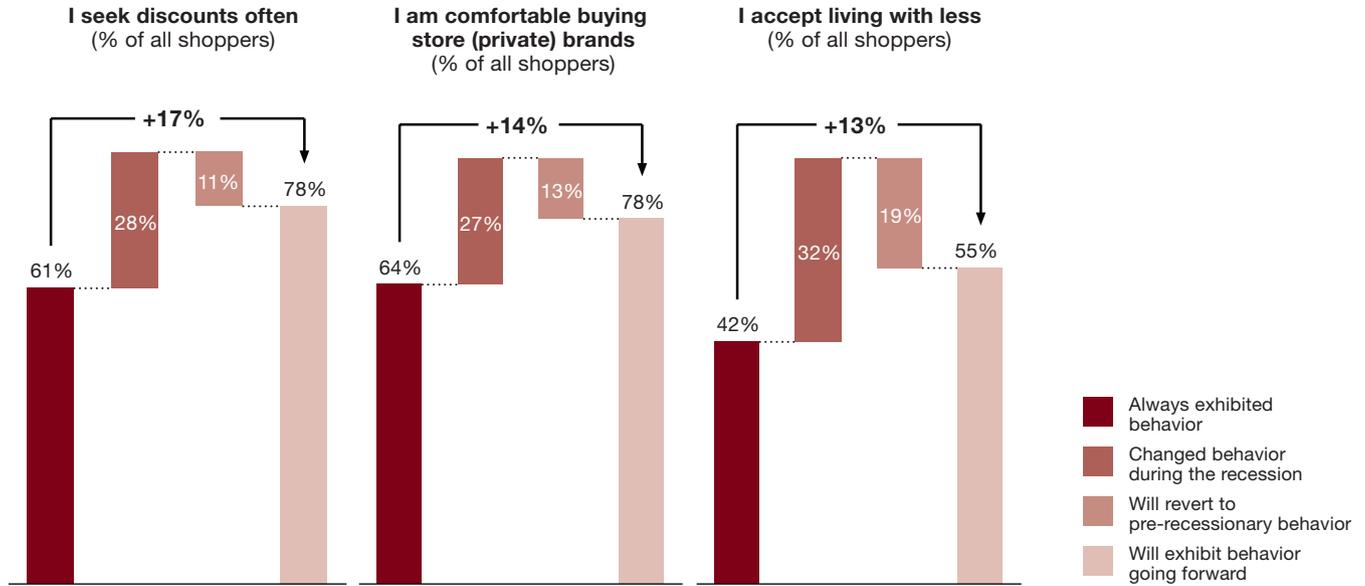
Many grocery shoppers — probably a majority — have always described themselves as seekers of value. They shop around for the best grocery deals (the new shopping trip is the “trip route,” with the average grocery shopper visiting 2.8 to 4.2 stores per week), clip coupons (including the increasingly important electronic variety), buy private-label products, cook at home (perhaps even from scratch) rather than eat out, consume leftovers, and reduce their pantries to the items they consume regularly. However, the current recession — a deeper and sharper one than any in most grocery shoppers’ memories — has unquestionably resulted in a marked increase in the prevalence of value-seeking behaviors.

Asked about an entire range of grocery shopping activity, 50 to 60 percent of shoppers describe themselves as “value-seeking and always have been.” The recession caused about 20 to 30 percent more shoppers to adopt these behaviors as they adjusted to straitened personal circumstances or simply followed a set of perceived “acceptable” frugal behaviors. Today, 75 to 90 percent of consumers are exhibiting these frugal shopping behaviors. What’s important is that a majority — perhaps two-thirds — of the newly frugal shoppers report that they will not revert to their previous behaviors as the recession ends.

Marketing leaders in this industry have observed the same shift. “The customer has changed forever,” says one executive, “and I think our business has. Because of the economy, shoppers have really started looking for value and they are going to keep doing that.”

The permanence of this shift relates to a phenomenon called “unpunished experimentation.” As consumers try out new value-seeking behaviors, they find that in most grocery categories the trade-offs they had perceived before (lower quality, inconvenient, time consuming, etc.) are not necessarily trade-offs at all. For example, they find that product quality is as high as ever and slight adjustments to travel patterns can make one store just as convenient as one closer to home. As a result, the current recession has very likely driven a permanent change in behavior for these grocery shoppers (*see Exhibit 1, next page*).

Exhibit 1
Reported changes in shopper behavior



Note: "Which of the following statements best describes how the uncertain economic environment of the last few years has affected how you shop?" (a) I have always shopped this way and still do; (b) I started shopping more this way than before in last few years and expect to continue shopping this way even after times get better; (c) I started shopping more this way in the last few years than before but expect to stop shopping this way when times get better; or (d) I don't shop this way now and I never did.

Source: Strategy&/Food Marketing Institute survey

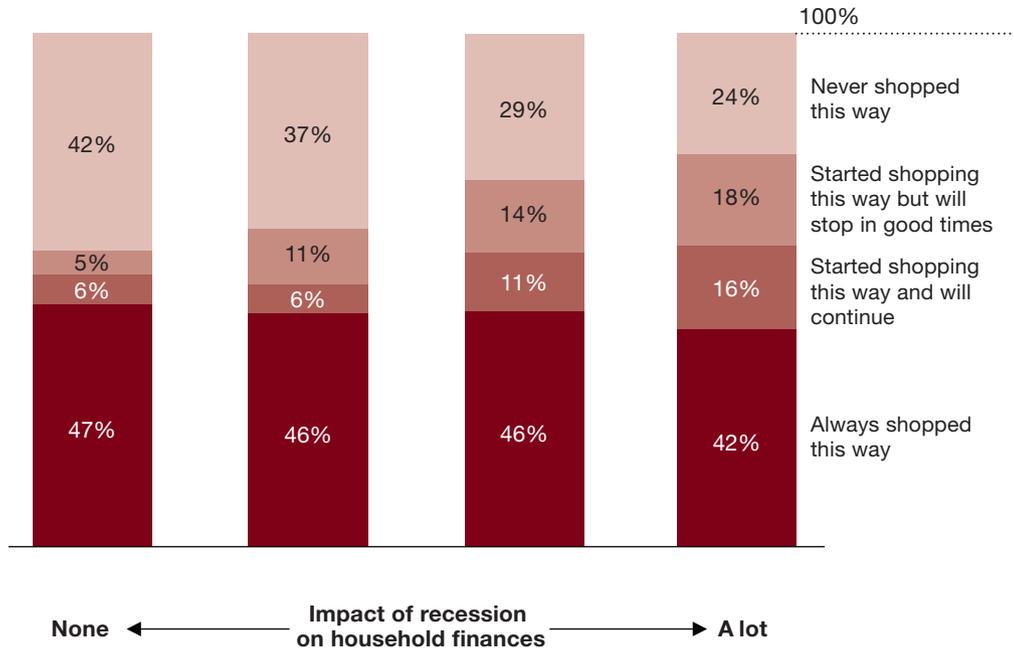
Much has been written about the “new normal” of value-seeking, frugal behaviors, but there is still a great deal of uncertainty about whether consumers will revert to their previous, more profligate ways when economic times improve. Even when consumers indicate in surveys that they expect to change their habits permanently, those results aren’t conclusive. After all, questions about frugal behaviors, like questions about whether people expect to lose weight or keep their New Year’s resolutions, often provoke overly optimistic answers. Affirmative answers provide little guidance to consumers’ actual future behavior.

But in this regard, the Strategy& and Food Marketing Institute survey findings are robust for two reasons. First, the questions covered a very wide array of grocery-related behaviors, and all 18 sets of responses resulted in very consistent results. Second, the timing of the survey is fortuitous. For the first time in several years, unemployment is falling and the majority of economic news from Washington and state capitals has been good. There is a palpable sense that the economy is finally improving to at least a slight degree. Therefore, most respondents answered the questions based on actual experience, rather than relative to some far-off recovery.

The recession has affected households differently, and not surprisingly, those who felt the most severe financial impact are most likely to have changed their shopping behavior during the recession. However, regardless of the recession’s impact, the same proportion of shoppers expect to maintain their current value-seeking behavior going forward — further reinforcing the “unpunished experimentation” phenomenon (*see Exhibit 2, next page*).

Exhibit 2

Reported expectations that value-seeking behavior will continue



Note: Responses aggregated across 18 statements describing grocery shopping behaviors.

Source: Strategy&/Food Marketing Institute survey

Technology-enabled shopping

Digital technology is now pervasive in consumers' lifestyles, and grocery shopping is no exception. However, the approach that various grocery shoppers use in selecting their prime shopping technology is driven by their experience with personal technology. Technology for use in grocery shopping is in its early stages of application and will surely expand as shoppers become more familiar with the technologies and intensify their demand for shopping simplicity and efficiency.

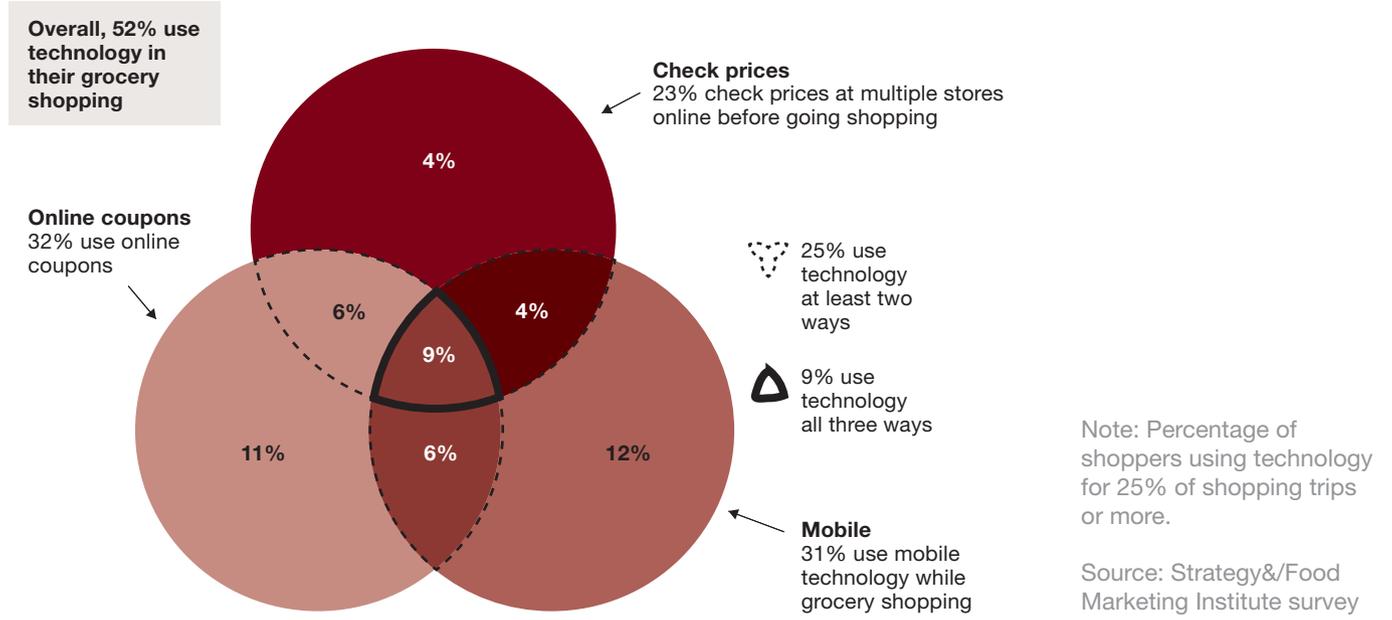
“We are seeing a different behavior in our stores,” says one marketing executive. “Shoppers are using their smartphone to gain a much deeper understanding of not only what they buy but, as well, the value of each purchase to them every time they shop with us.”

Many consumers now employ technology as a routine part of their end-to-end grocery shopping experience (*see Exhibit 3, next page*). At its most basic level, this might involve going online with a home-based personal computer and searching for deals and recipes from local grocery stores' websites. More sophisticated shoppers might download and print coupons from the retailer's or manufacturer's website, while the more tech-savvy might load these coupons onto their frequent shopper card. The most technologically advanced shoppers are accessing these tools not only from home but also on their smartphones — thus gaining true shopping mobility, including the ability to check prices and acquire coupons in real time while in the store aisles.

While some of the online and mobile activity is related to making lists, searching for recipes, and similar activities, the majority of shoppers' technology use is around value discovery — finding and acting on the best deals to stretch their grocery budgets. From a microeconomist's perspective, digital technology is dramatically increasing price transparency in a heretofore confusing world of discounts and specials.

By making the price/value trade-off easier to discover for any particular product category, technology will expand the segment

Exhibit 3
Reported use of digital technology by consumers



of price-sensitive shoppers who search for and find the lowest prices coupled with the greatest convenience at all times. As mobile technology in particular becomes mainstream and sophisticated, intermediaries will increasingly offer online services that allow consumers to find the best prices and values for their shopping lists.

Possibly an online grocery service will emerge that is somewhat akin to the travel site Kayak.com, which allows consumers to find the best airfares depending on where they are going, when they are traveling, their desired class of service, and how many stops they are willing to make. In a grocery context, a customer might upload his or her personal shopping list (perhaps itself compiled by scanning barcodes in the consumer's pantry) and then select options such as "no more than two stores," "within five miles of my current location," and "include private-label alternatives." The service would then parse the shopping list into store-specific merchandise groups and help the shopper organize a route to find the best deals and values.

These emerging technologies will challenge retailers to respond in several ways. First, in a competitive industry like grocery, increased price transparency is unlikely to enhance margins, so retailers will need innovative strategies to maintain their margins (merchandising, marketing, assortment, new item introduction, pricing/promotion, shopper contact, etc.) and/or look to reduce operating costs to allow them to continue to thrive at lower margins. Second, retailers will need to decide strategically whether to participate in these emerging price/value schemes by making store-level pricing available on their websites, for example, or whether to resist by obfuscating price levels and developing/demanding unique SKUs from suppliers. And, finally, there is the question of whether to lead this coming wave of innovation or follow it.

Online encroachment

A decade ago, online grocer Webvan slipped beneath the waves and signaled the end of the first dot-com bubble. In the ensuing years, U.S. full-assortment online grocery retailing has persisted in only a small, questionably profitable niche. Safeway.com, Peapod, and a few others continue to operate full-assortment home delivery businesses, but these e-grocery businesses remain small.

However, in the meantime and almost unnoticed, a new form of online grocery shopping has quietly encroached on the traditional industry and is now enjoyed by a very surprising 50 percent or more of grocery category shoppers. In contrast to the full-assortment offering, today's online grocery shoppers are much more likely to be shopping for specific categories or SKUs. The average online grocery consumer spends only a small portion of his/her current grocery budget online (a total of 4 percent), but fully 54 percent of consumers report shopping for at least some grocery categories in this emerging grocery category channel (see Exhibit 4, next page). "The Internet has changed the way people think about buying," says one marketing leader. "I think the propensity to buy once you are online is much higher [than offline]. All of this has changed the customer's mind-set."

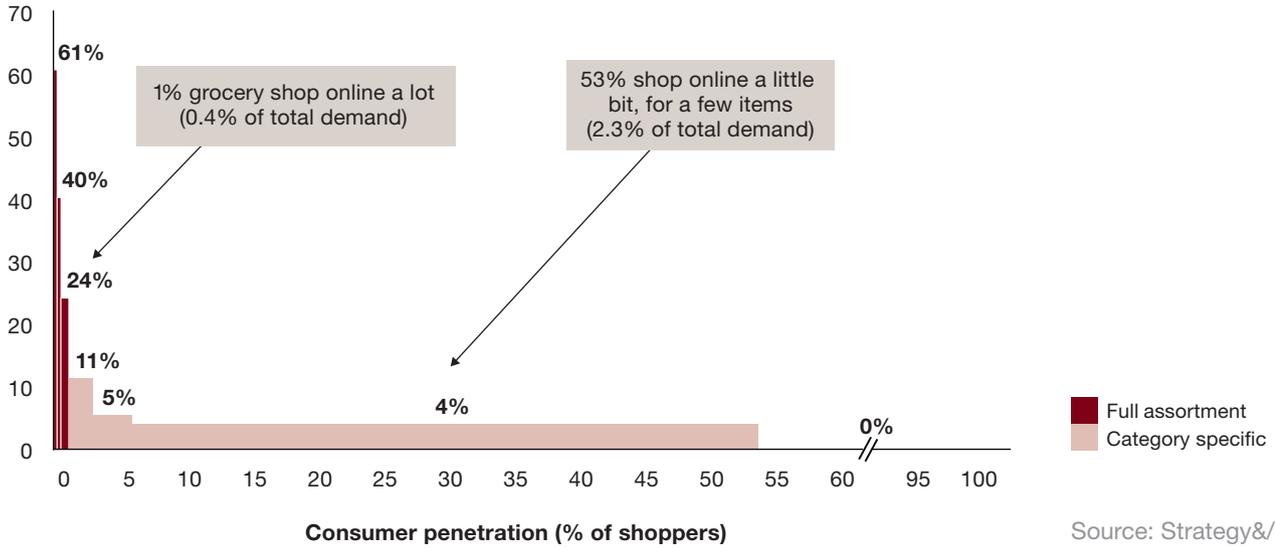
This new use of online channels might seem surprising at first glance. However, experience with a variety of demographics — from young singles to families to empty nesters — suggests that this new shopping behavior is indeed pervasive. The family with a new baby uses Diapers.com for much of their "ratable demand" baby products (diapers, wipes, formula, etc.). Another family purchases much of their pet care products online, while others buy Nespresso coffee capsules (only available online in the U.S.) and HBC brands online. A growing number of consumers use Amazon's Price Check smartphone application in their local grocery stores and then buy nonperishables online through Amazon.com. "Our scariest competitors," says one grocery chain executive, "are Amazon, Soap.com, and Diapers.com, because there are so many things in [our] assortment that are conducive to online shopping."

Exhibit 4
Online grocery shopping

Share of wallet and consumer penetration

Estimated

Share of wallet (%)



Source: Strategy&/Food Marketing Institute survey

In the long term, the outlook for online grocery shopping remains somewhat uncertain: Low-value, low-margin, bulky goods will always struggle to justify the shipping costs (especially if the current sales tax treatment of many online purchases is amended), but as online retailers innovate in both their merchandise offerings (for example, specialist olive oils at iGourmet.com) and logistics (such as shipping directly from the manufacturer to a pickup point, cutting out both inventory and last-mile logistics costs), only a brave executive would dismiss online groceries as irrelevant. In Europe, full-assortment, home-delivery online grocers are growing fast (examples are Ocado and Tesco in the U.K.), though profitability is somewhat unclear. Others are experimenting with “click and collect” models with apparent success.

Today, with broadband at home being almost ubiquitous (dramatically reducing the time it takes to shop online) and online retailing itself estimated to be at least eight to 10 times larger in aggregate than in Webvan’s day (providing the baseload volume to spread last-mile fixed costs), the time may be right for a big and diverse expansion in online grocery formats. Some food retailers are correctly concerned that the online experience, when designed well, can be simpler and offer better pricing and a broader and more relevant assortment.

Format and merchandise innovation

Over the last five years, the grocery retail industry has added about 150 million square feet of overall capacity (selling space). This was a continuation of a decades-long trend of capacity growth outstripping real sales growth — decreasing space productivity and SKU velocity across the industry (*see Exhibit 5, next page*).

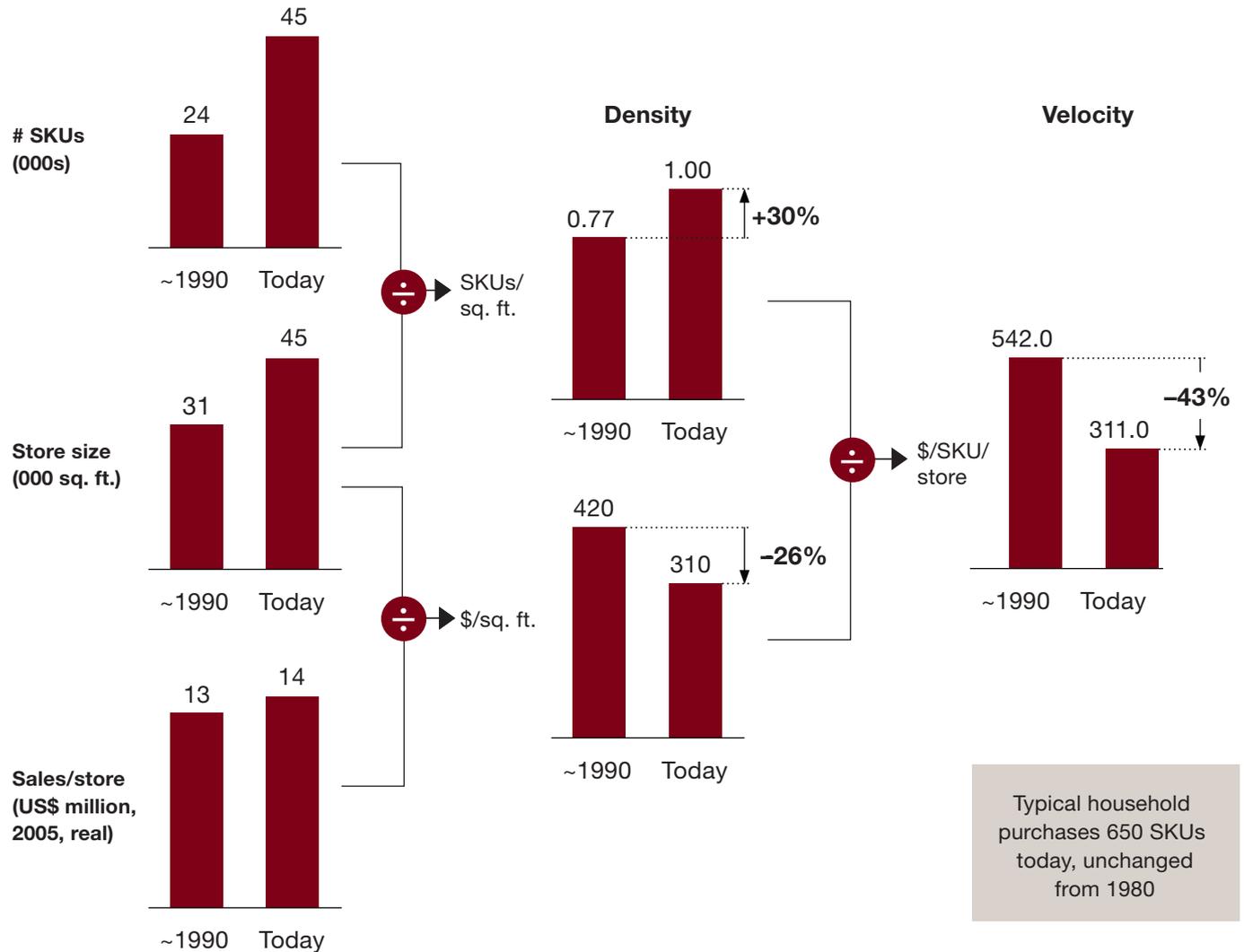
Of all the capacity added in the last five years, however, essentially none was added in traditional supermarket formats. Supercenters (especially Walmart and Target) continue to account for the lion's share of new grocery capacity (even when counting only the space allocated to grocery categories). However, the supercenter trend is well understood and may finally be slowing as these players find it harder to secure suitable locations (*see Exhibit 6, page 17*).

Perhaps more interesting is the substantial space added by smaller formats, particularly dollar and hard discount stores. These retailers have added thousands of outlets over this five-year period, and while individually quite small (typically less than \$100,000 per week in sales), in aggregate they are quite significant. These formats have made lower operating cost structures a competitive advantage as they captured the wallets of many shoppers across the nation. They are responsible for mopping up much of the industry's anemic growth. However, not every incumbent can manage them effectively. "We operate smaller stores about the same way we operate larger stores, which may be why we aren't successful with them," says one food retail executive.

Today about a quarter of all consumers frequent these small-format grocery outlets, though not all shoppers have the opportunity, since these formats are not present in many markets. Not surprisingly, very few consumers use these small-format stores as a primary outlet — instead, most use them as fill-in locations or to pick up a few bargains. There appear to be three distinct formats of these small stores, and consumers perceive them very differently (*see Exhibit 7, page 18*). Dollar stores are used by consumers to access the lowest prices on branded items (typically nonperishable food and non-food). Hard discounters are shopped for their low prices on their strong private-label ranges,

Exhibit 5
Supply-side dynamics for the food retail industry

Long-run industry supply-side dynamics (~1990–today)



Source: Strategy&/Food Marketing Institute

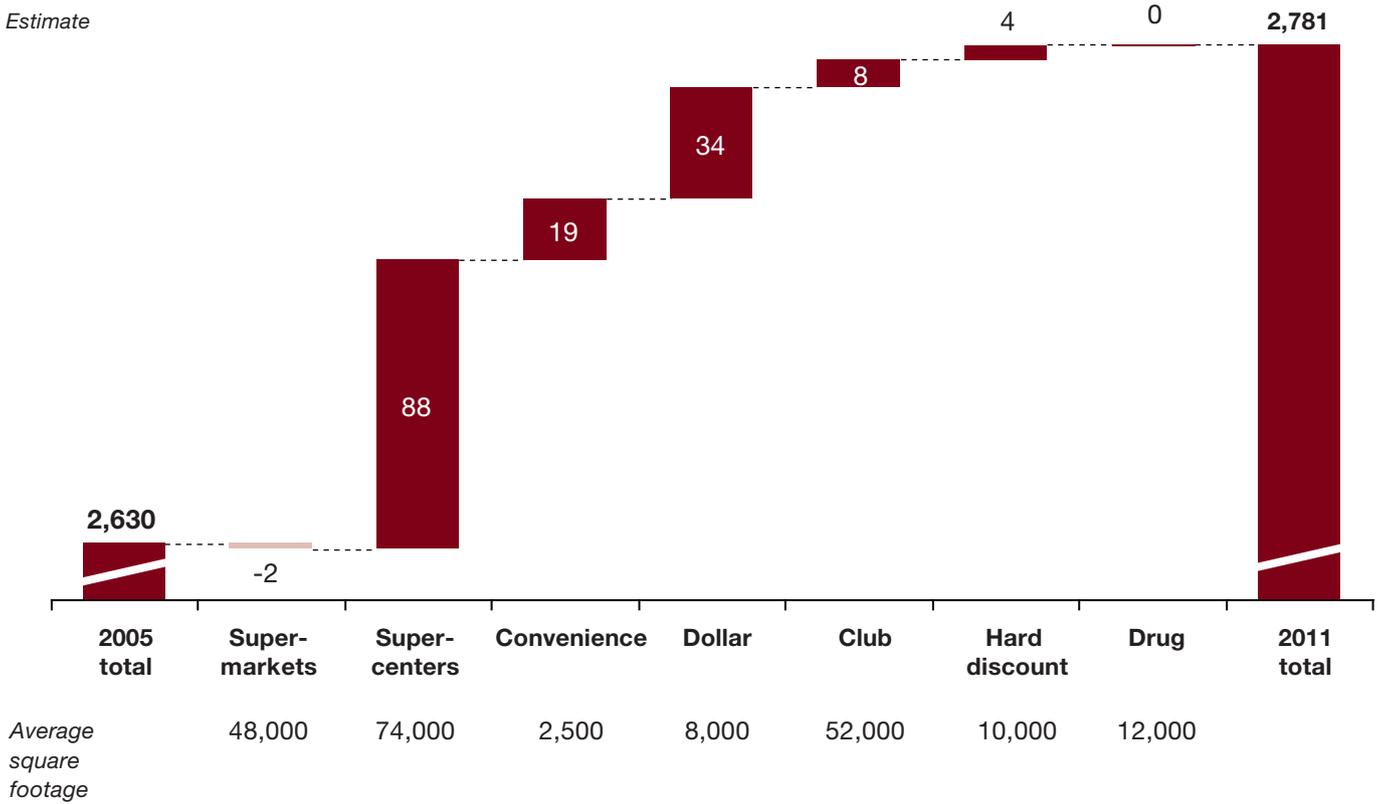
Exhibit 6

U.S. grocery capacity growth

U.S. grocery capacity growth, 2005–2011

(millions of square feet)

Estimate

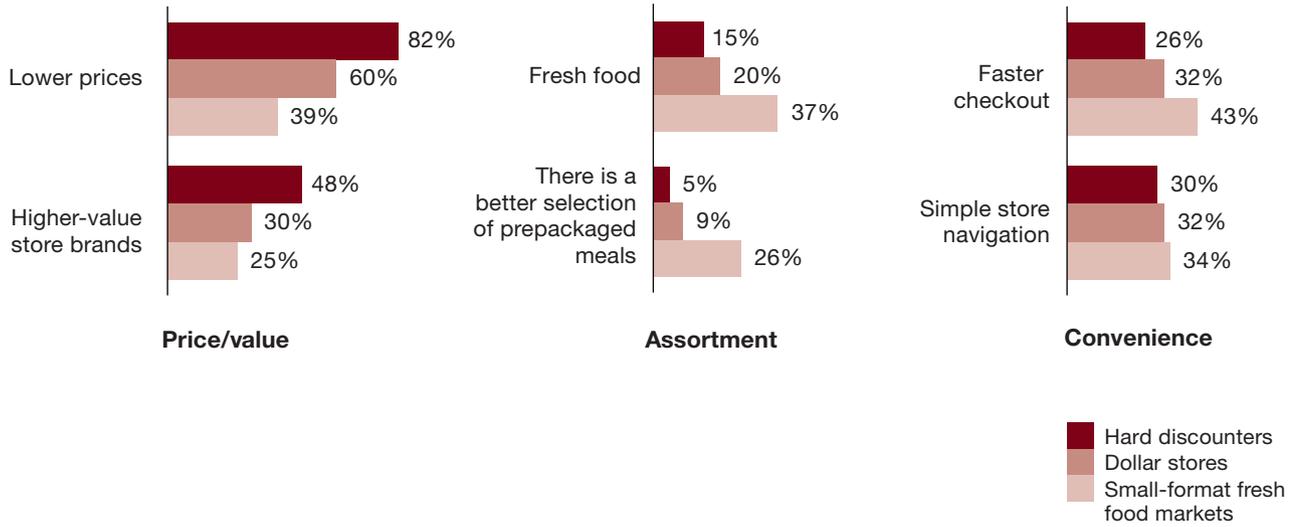


Source: Nielsen U.S. Retail Trends, March 2, 2012; Nielsen TDLinX data set (store counts); Strategy& analysis

Exhibit 7

Why shoppers patronize small-format stores

Reasons for shopping smaller stores



Note: % of shoppers rating as important or very important.

Source: Strategy&/Food Marketing Institute survey

which consumers recognize as excellent value for the money. The third format, the small fresh food market, is well developed in only a few geographic areas. However, it is quite distinct from other small formats; shoppers seek it out for its convenience and fresh prepared foods in particular. Interestingly, in contrast to dollar stores, both this format and the hard discounter attract some shopper baseload volume (see *Exhibit 8, next page*). One retailer noted in an interview that small-format stores “have to offer something more than being small and convenient to be successful. Trader Joe’s is a good example.”

The economics of the simpler offerings (dollar, hard discount) are compelling, and these formats will continue to expand — especially in today’s nation-wide vacancy-rich real estate market. When there is a great amount of distressed real estate, small discount stores can open anywhere. The small fresh food format is more challenging. The operational complexity is high, driving up costs, and it seems likely that success requires significant retooling of the operating model (logistics, in-store operations, merchandising, etc.) to achieve profitability. “Candidly, we have wanted to go into this for some years,” says another retail executive, “but we are not sure we will be able to replicate the experience, due to logistics and a unionized environment.”

A simple “shrink to fit” adaptation of the larger store model is unlikely to succeed.

In addition to new store formats, an explosion in merchandising innovation from both retailers and manufacturers is occurring. This innovation is designed to do two things: get more shoppers in the store and get them to spend more in a given banner. Merchandising innovation might best be characterized as a new way to tell the shopper that the retailer fully understands his/her needs and wants, as well how he/she purchases items together.

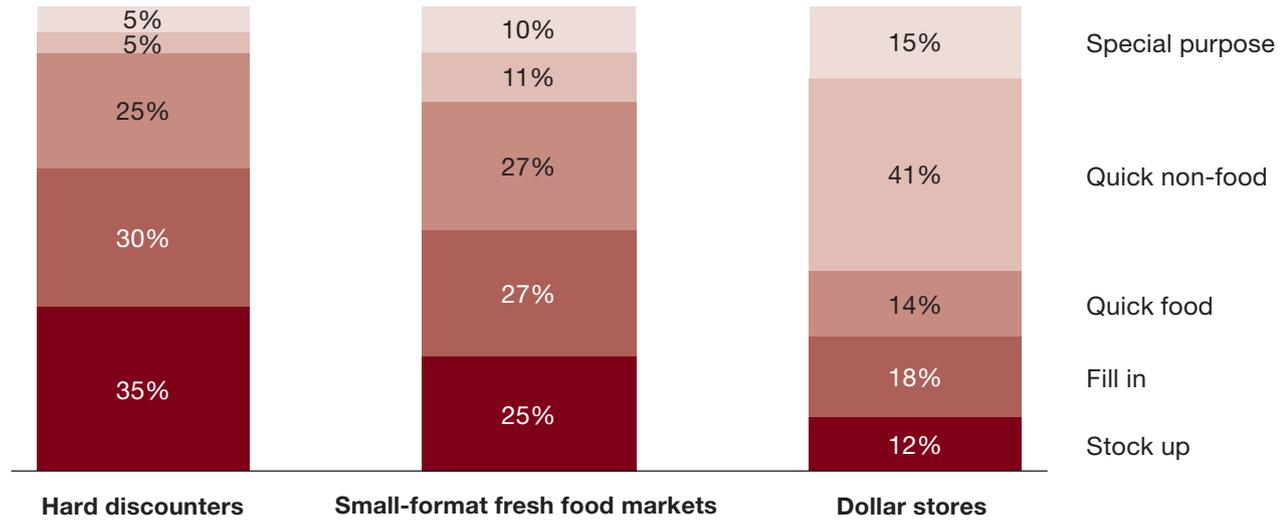
Manufacturers and retailers are dramatically improving their go-to-market platform strategies and capabilities. New platforms centered on home essentials, meal ingredients and components, health and wellness, and “home gating” are emerging at many banners. In addition, new capabilities like in-store dining, sushi bars, enhanced prepared foods, cooking academies, florists, and redesigning categories to shop more like departments are being used selectively as a way to drive a new and much enriched shopping experience.

In general, the research by Strategy& and Food Marketing Institute shows that a broad range of traditional grocery retailers are using merchandising as a way to create a new generation of value for the shopper, moving from a focus on promotions and pricing to a new focus on quality received per dollar spent (see *Exhibit 9, page 21*).

Exhibit 8

Distribution of small-format store visits

Distribution of small-format trips by trip type

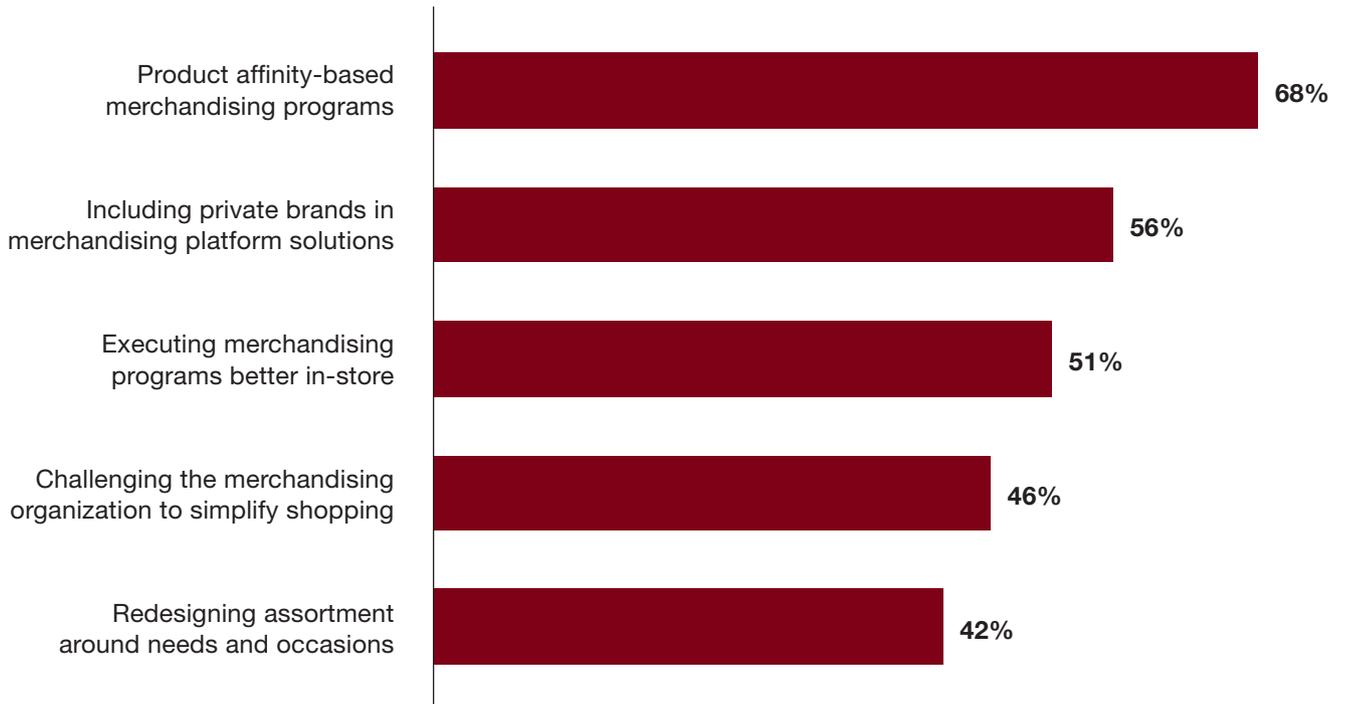


Source: Strategy&/Food Marketing Institute survey

Exhibit 9
Retailers' use of merchandising innovations

Merchandising innovations at work

(% of interviewees pursuing each method)



Note: Based on interviews with chief merchants and/or senior merchandising executives, January 2012.

Source: Strategy&/Food Marketing Institute survey

What should grocery retailers do next?

These forces will cause structural change in the grocery retailing industry over the next several years. From the shoppers' perspective, the recession or at least "recession-like" behavior will not end soon, if ever. Shoppers' value-seeking behaviors have become ingrained. At the same time, digital technologies will make "price shopping" ever easier and more convenient, and the Internet and other new formats will drain volume away from traditional channels.

Grocery retailers need to reassess their "way to play" — their overall strategic value proposition — on two dimensions at once. First is the strategic fit with the evolving market of consumers. How does your retail chain deliver value to shoppers currently? How will it do so in the years ahead? What types of demand exist in the market today that are worth fulfilling?

The second dimension is the key capabilities that the grocer will need to bring to bear to deliver this value proposition. What are the most distinctive things that you do better than anyone else? How are these capabilities for a grocery retailer positioned better than any of their competitors so that the capabilities system they build is truly advantaged and differentiated versus their competition?

Distinctive capabilities might include the following:

1. *Deep shopper understanding*: Winning with the shoppers — understanding and reacting to their ongoing behaviors — is a potential differentiating capability for some retailers. This might require enhancing shopper loyalty programs and/or developing new capabilities around data analytics.
2. *Digital and mobile marketing*: Digital and mobile technology may play different roles at different retailers, depending on their chosen way to play. For example, a hi-lo retailer might leverage mobile technologies to deliver targeted manufacturer-funded deals. Alternatively, a premium player might provide recipe help and information about new or unfamiliar products. Either way, mobile

technology can enhance the shopping experience for your target shoppers.

3. *Multichannel retailing*: The slow erosion of traditional grocery categories to online retailers will be a drag on comparable store performance for the foreseeable future. All retailers need to respond, whether by bolstering the in-store experience to defend their traditional business or by building a true multichannel capability themselves. A true multichannel retailing capability integrates in-store, online, and digital mobile offerings to meet shoppers' differing needs, supported by the appropriate back-office systems and supply chain capabilities.
4. *Innovation*: Innovation in products and merchandising can be a route to success for some retailers. New private-label products (beyond national-brand clones) can differentiate the banner in shoppers' minds and deliver distinctive value. In parallel, new merchandising platforms developed in collaboration with suppliers promise to increase shopper conversion at the shelf and drive basket size.

Assessing and choosing a way to play is not necessarily straightforward, especially if there is instability in the market and/or disagreement among the senior team. Indeed, it is possible that some of the established ways to play in grocery retail (e.g., EDLP, hi-lo, premium organic, high experience, customer intimate, etc.) will become obsolete. For instance, what does it mean to be a hi-lo retailer if 90 percent or more of your shoppers are seeking deals?

With a chosen way to play and a laser-like focus on the capabilities required to win with that way to play, retailers can then turn their attention to costs. By sharpening their focus on their strategic positioning and being clear about how they compete, we believe, retailers can not only reduce costs but drive stronger growth. By removing unwanted and unnecessary costs, retailers can simultaneously become more effective and more efficient. A focus on rewiring costs in merchandising, marketing, and supply chain is required to create the dollars needed to invest in capabilities and grow the business.

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