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European grocery retail 2020

Winning ways to play

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About the authors

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Executive summary

European grocers currently face a significant and growing problem of overcapacity, which threatens their future earnings. Consumers in the region are reducing their per capita spending, yet grocers have continued to build out new locations, leading to a drop in per-store and per-square-meter productivity.

Despite this challenging environment, we believe that large traditional retailers can shore up earnings and improve their competitive footing for 2020 and beyond. To do this, they must focus on three specific levers at their disposal: (1) merchandising excellence (in pricing, promotions, and assortment), (2) better store performance management, and (3) developing strategies that address five distinct "ways to play" (the food experience play, the proximity play, the branded value play, the low-cost play, and the one-stop-shop convenience play). Today, many retailers don't have a clearly defined position in the market, instead offering elements of all five models. Going forward, they need to focus on the selected way (or ways) to play, leveraging their core strengths to stave off competition, win over shoppers, and boost their own earnings.

The pressure on productivity

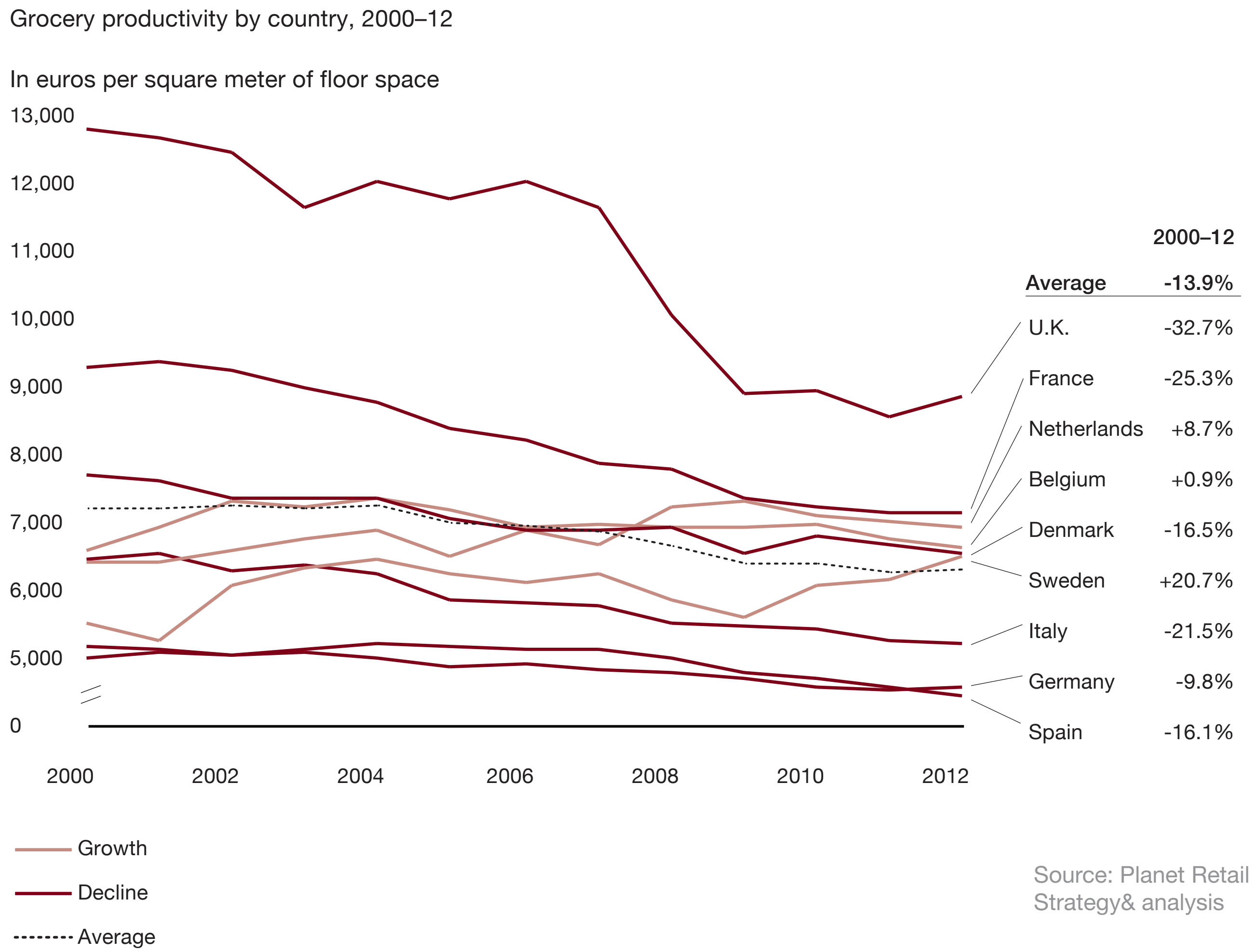
Judging by the decline in per capita spending, one might think all of Europe is on a diet. Between 2000 and 2012, spending on food stagnated or fell — both at the country level and on a per capita basis. To put this anemic growth in perspective, consider that Sweden is the region's most robust market, with a compounded annual growth rate (CAGR) per capita of just over 1 percent during those 12 years (adjusted for inflation). More countries have seen declines than have seen increases, including the big economies of the U.K., France, and Italy.

Retail grocery companies have aggressively opened new stores, adding significant capacity.

Retail grocery companies have responded rather counterintuitively to this constrained growth. They have aggressively opened new stores, adding significant capacity. Between 2000 and 2012, sales at grocery store chains managed to grow 16 percent, thanks to an increasing focus on selling nonfood items such as household products, but sales capacity grew at the even faster clip of 40 percent. As a result, productivity has fallen across Western Europe. Between 2000 and 2012, productivity fell by 13.9 percent (measured by sales value per square meter). The U.K. and France led decliners, at 32.7 percent and 25.3 percent, respectively (*see Exhibit 1, next page*).

To make matters worse, retailers have also stretched into a variety of store formats, often undermining the efficiencies of existing operations. During that same time period, sales capacity increased for hypermarkets (38 percent), supermarkets (18 percent), and discount stores (72 percent). But capacity for convenience stores —

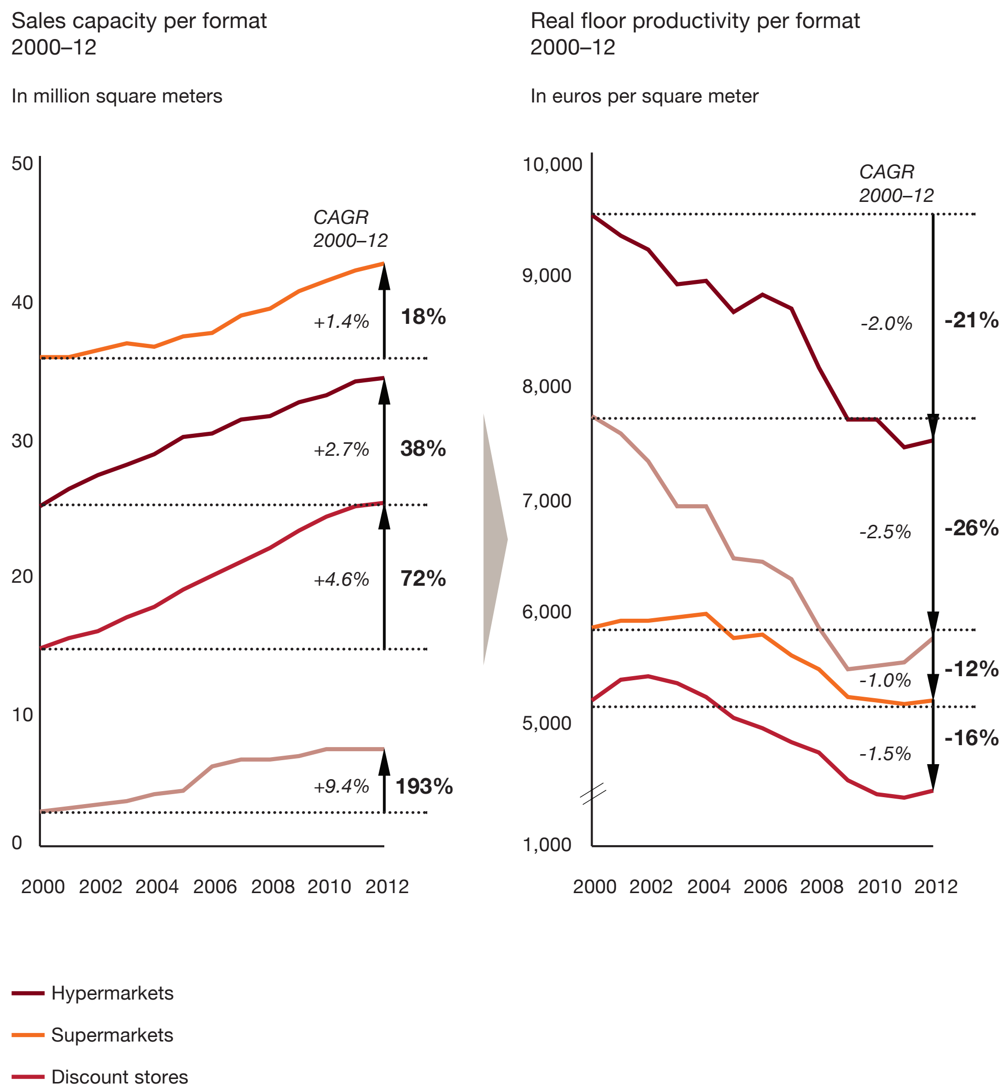
Exhibit 1
Productivity has declined steadily for grocers in most European countries



Source: Planet Retail, Strategy& analysis where economies of scale are the hardest to flex — jumped 193 percent. As expected, productivity of all formats declined, with the biggest drop of 26 percent occurring at convenience stores (*see Exhibit 2*).

There are some logical reasons for continued capacity expansion. Opening a store is usually based on local circumstances and opportunities, and most companies are always on the lookout for

Exhibit 2
Expansion in nontraditional store formats has contributed to productivity declines

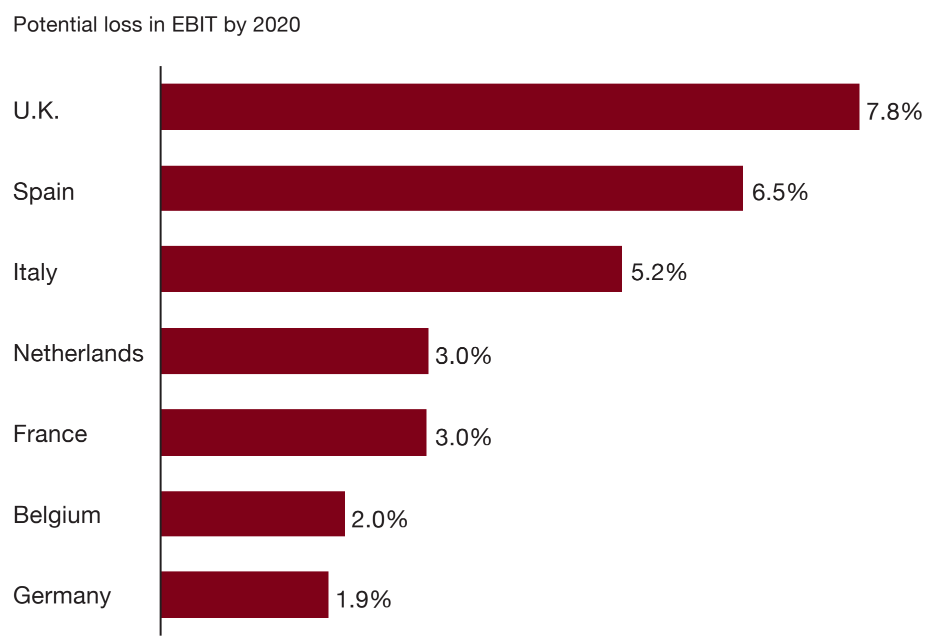


Note: Analysis based on Western European retailers included in Planet Retail: Belgium, Denmark, France, Italy, Germany, the Netherlands, Spain, Sweden, and the U.K.

Source: Planet Retail, Strategy& analysis promising new locations. At the same time, assessing store performance and closing or relocating underperforming stores is difficult. Most retailers are locked into long-term real estate leases and also fear losing market share.

Nevertheless, the industry cannot continue to add capacity at the current rate without putting earnings in serious jeopardy. By our calculations, earnings before interest and taxes (EBIT) in the U.K. could tumble by as much as 7.8 percentage points by 2020, if current trends continue. In Spain, earnings could decline 6.5 percent, and in Italy they could fall by 5.2 percent. In all countries where data is available, losses in EBIT are more likely than gains (*see Exhibit 3*).

Exhibit 3
EBIT risk for large European grocery retailers

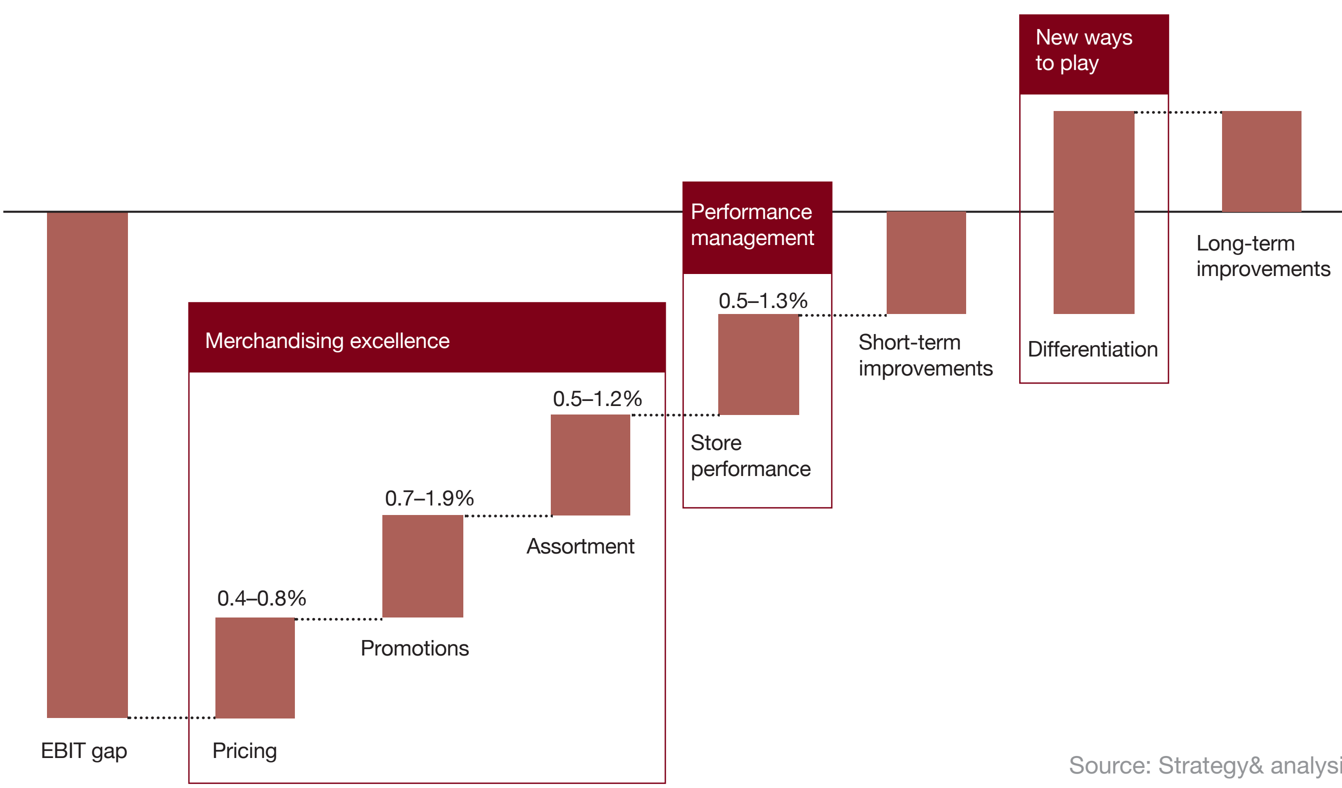


Source: Planet Retail, Euromonitor, IGD, Strategy& analysis

Closing the earnings gap

We believe these projected losses in EBIT are just that — *projected* losses. They are not written in stone. To close the EBIT gap and improve their competitive footing for 2020 and beyond, traditional retail grocery chains need to focus improvements in three key areas: (1) merchandising excellence, (2) store performance management, and (3) developing strategies that address the five distinct "ways to play" that are emerging in the industry. We have calculated how improvements in each of these areas can add EBIT and improve the retail grocer's performance (*see Exhibit 4*).

Exhibit 4
Three initiatives to close the EBIT gap



Source: Strategy& analysis

Merchandising excellence

In years past, many merchandising decisions regarding assortment, promotions, and sometimes even pricing were made based on little more than the gut feelings of store managers and category managers. But the environment today has become far too complex to rely on hunches. Merchandising excellence depends on fact-based decision logic, which in turn requires data and analytics in areas such as consumer buying behavior, promotional pricing, and competitive responses.

In regard to pricing, key questions include the following: *Should I adjust pricing on products with low or negative margins? Can I adjust the prices of products to steer customers toward a more profitable margin mix? And how much can I change product prices before eliciting a competitive response?*

For example, the margins might be higher on a store's private-label product than on the premium brand. With this in mind, a grocery retailer could decide to increase the price gap slightly, lowering the price of the private label and increasing the price of the premium brand. The idea is to entice more customers to shift from the name brand to the private label. The customer spends less money on the product, but the store benefits from the higher margins on those sales. Done right, this can improve total gross margins.

The environment today has become far too complex to rely on hunches.

As for promotions, these are the key questions: *How many promotional campaigns should we undertake? What product lines should we promote and how often? What is the best timing for the campaign? And what is the best type of promotion for each campaign?*

It sounds obvious, but retailers need to understand the success of past promotions in order to plan future promotions effectively. Yet many retailers struggle to understand results because it's not simply a matter of counting the numbers of cans sold off the shelf. A company needs to analyze a breadth of other data, including spending on each promotion, how much manufacturers might have paid into the promotion, and the volume that customers didn't buy because they bought the promotional item instead (i.e., the cannibalization rate), among others.

On the issue of assortment, a retail grocer can substantially improve decisions by analyzing local demographics, buying patterns, and other data. Key questions include these: *What price segments merit further analysis? Should we expand the product range with top market sellers? Where should we reposition or develop new products? Where should we increase product distribution? And where should we delist products?*

For instance, the space constraints of convenience stores force a retailer to be far more selective about the assortment, compared to a hypermarket environment where the retailer can include a larger range of products.

All three merchandising levers — pricing, promotions, and assortment — must be closely coordinated. Merchandising optimization and excellence is not achievable if a company attempts to manage these levers in isolation from one another.

Store performance management

Identify local best practices and apply them throughout the store network.

In any store network, there are differences in store performance, in terms of both sales and profitability. An assortment of factors drive this variation — location and demographics, merchandising and marketing support, and staff quality and local promotions. To improve overall corporate performance, it's necessary to identify store differences, describe best practices, and disseminate those best practices across the store network to standardize and improve operations.

The first step is to use agreed-on metrics to compare store performance. This transparency facilitates analysis, highlighting each store's strengths and weaknesses. Once a best practice has been identified, it must be codified and described in a way that all store managers can understand and replicate. Finally, the company must disseminate that best practice through publications and face-to-face gatherings, and support it with any necessary changes in store processes and technology.

For example, it's useful to analyze clusters of stores that are similar in terms of size, demographics, traffic, competitors, and so on. This analysis might reveal that a certain store in the cluster excels in some key performance indicators, such as conversion, basket size, or average price per item. If this is the case, it's critical to understand why. Has the store manager had some fantastic idea that's improved basket size? Maybe he or she has designed a new floor plan that prompts customers to purchase more impulse items? Whatever the cause, management needs to describe that best practice so that stores in the same cluster can replicate it.

New ways to play

Besides limited market growth and increased sales capacity, another trend challenging large traditional retailers is the convergence of their value propositions. Large retailers are steadily looking more and more alike, which is making differentiation and pricing power harder to maintain. For example, discount chains are improving their offerings by adding elements like fresh, in-store bakeries. All grocery chains, not just discounters, are working hard on their price images, offering "everyday low prices." Most grocery store chains have two to four private-label brands, and loyalty cards are omnipresent.

Large retailers are looking more alike, making differentiation and pricing power harder to maintain.

At the same time, smaller competitors and new entrants are defining distinct value propositions — or ways to play — to grab market share from the traditional retailers. Specifically, five distinct ways to play are emerging in the industry: the food experience play, the proximity play, the branded value play, the low-cost play, and the one-stop-shop convenience play.

Food experience play: An inspiring and fun shopping experience where consumers shop, taste new foods, and receive suggestions and advice about food types and recipes. These stores, where consumers "top off" their food needs with a few high-end purchases, can exist both online and offline.

Proximity play: A premium, though shallow, assortment of fresh food in close proximity to customers. These stores are also geared toward topping off food needs, and exist both online and offline.

Branded value play: A broad but shallow assortment with multiple tiers of high-quality private-label offerings in a pleasant atmosphere. This category of supermarket, where consumers go to stock up on items and also top off their food needs, exists online and offline.

Low-cost play: A no-frills, low-price offering for consumers deliberately shopping for the lowest price. These stores are exclusively for stock-up shopping and exist largely offline.

One-stop-shop convenience play: A shopping platform where consumers can get advice and place orders to stock up on both food and nonfood items. These stores exist in large hypermarket formats and also as pure online plays.

Today, many traditional retailers operate in a sort of ill-defined middle ground, offering elements of all five ways to play without even realizing they are doing so. Due to their size and breadth of market, many retailers will probably need to continue to offer multiple ways to play. But they need to sharpen their approach to each in order to better defend against newcomers and companies from outside the industry — such as Amazon — that are laser focused on just one way to play. Large traditional grocery retailers also must contend with the rise of online grocers. The online segment hasn't gained much market share yet, but could eventually add to the pressure on productivity.

Retailers need to strengthen their way to play in order to defend against newcomers.

A company's right to win in any of these five ways to play depends on having a set of distinctive capabilities. For instance, if the company wants to excel at food experience, it needs a world-class, fresh supply chain; an innovative assortment of the latest products; and a knowledgeable, high-quality staff. A proximity play, by comparison, relies less on a great supply chain and more on localized assortment and productivity management (*see Exhibit 5, next page*).

Large traditional grocery retailers shouldn't make radical shifts and focus on one way to play exclusively, even when threatened by new, smaller retailers with a more clearly defined value proposition. In fact, large retailers risk alienating current customers and weakening their competitive position by making bold moves too quickly. They need to deliberately and visibly add specific elements of the ways to play to their current offering, and do so cost-efficiently, by leveraging existing operations. For instance, a company might decide to establish

Exhibit 5
Each way to play requires focusing on specific capabilities

	Supply chain	Merchandising	Marketing	Digital	Store management
Food experience	Fresh supply chain	Innovative assortment	Branding		Quality staff and service
Proximity		Localized assortment		Multichannel	Productivity management
Branded value		Private label	Branding	Multichannel	
Low cost	Standardization and scale				Low-cost operations
One-stop-shop convenience	Pickup and delivery network	Wide range		Multichannel customer insights	

Source: Strategy& analysis

a new format to defend itself against a competitor with a very successful food experience play. Instead of creating a new supply chain to source products to this new store format, however, the company could leverage its current supply chain (carefully selecting certain high-end products), add some "food experience" elements (such as tastings), and improve the skills and knowledge of its employee base through hiring or training.

2020 and beyond

The concurrent trends in grocery retail — particularly the declining per capita spending and aggressive capacity build — have created a challenging earnings environment in Western Europe for large traditional retailers. Meanwhile, the emergence of five distinct ways to play, as well as the rise of the Internet, is creating new competitive threats. However, by focusing on merchandizing excellence, improving store performance, and bringing a sharper approach to each of the five emerging ways to play, traditional retailers can expand their customer base, close the earnings gap, and position themselves as stronger competitors for 2020 and beyond.

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