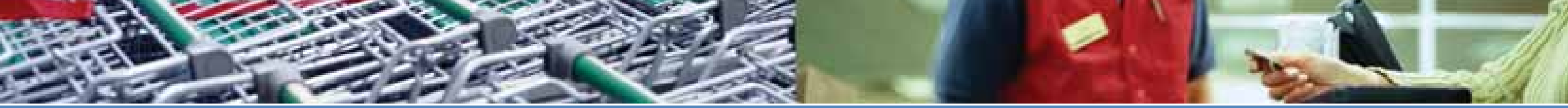
Responding to Discount

A New Business Model for Food Retailers?

Coca-Cola RETAILING RESEARCH COUNCIL EUROPE

Project XI August 2005
A Study Conducted for
The Coca-Cola Retailing Research Council Europe
by McKinsey & Company



About

The Coca-Cola Retailing Research Council, Europe

The Coca-Cola Retailing Research Council, Europe (CCRRCE) is dedicated to the development of a better understanding of the food retailing and allied merchandise distribution business in Europe. The focus of its energies is to identify and then to study selected critical issues and problems and, when appropriate, to present the findings in a suitable forum, so that full advantage of the information can be taken to further develop and enhance the effectiveness of the food retailing distribution business.

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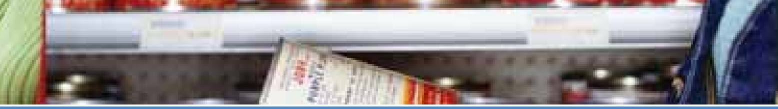
McKinsey & Company is a management consulting firm that helps leading corporations and organisations make distinctive, lasting, and substantial improvements in their performance. Over the past seven decades, the firm's primary objective has remained constant: to serve as an organisation's most trusted external advisor on critical issues facing senior management. With approximately 7,800 consultants deployed from eighty-five offices in forty-four countries, McKinsey advises companies on strategic, operational, organisational, and technological issues. The firm has extensive experience in all major industry sectors and primary functional areas as well as in-depth expertise in high-priority areas for today's business leaders, such as growth, globalisation, and the new economy.



Acknowledgements

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Pick 'n Pay South Africa

Kenneth Bengtsson
ICA AB Sweden

Peter Boros
Co-Op Hungary Limited Hungary

Ewa Borowska
Eurocash Poland

Ömer Bozer
Migros AS Turkey

Salvatore Dina
Gruppo PAM Italy

Guy Farrant
Marks & Spencer UK

Thierry Garnier
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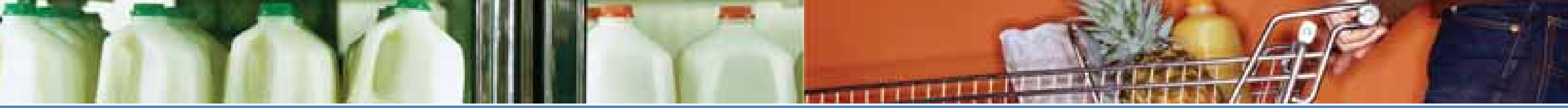

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I	Staffing Supermarkets in the 1990s
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III	Grocery Distribution in the 90s - Strategies for Fast Flow Replacement
IV	Building Customer Loyalty in Grocery Retailing
V	Supplier-Retailer Collaboration in Supply Chain Management
VI	The Future for the Food Store - Challenges and Alternatives
VII	Knowing Your Customer - How Customer Information Will Revolutionise Food Retailing
VIII	From Ingredient Shopping to Meal Solutions - Meeting the Customer Appetite for Change
IX	The Store of the Future - Customer Relationship Strategies and Evolving Formats
X	A Leadership People Strategy for Food Retailers

More information about the work of the Coca-Cola Retailing Research Council, Europe and about how to order further copies of this report can be found at www.ccrrc.org

Contents

Preface

The 2005 Report of the Coca-Cola Retailing Research Council Europe summarises the results of an extensive study on the growth of European discount grocery retailers and the implications of this growth for non-discount supermarkets and hypermarkets. The Project was commissioned by the Council and carried out by McKinsey & Company. It benefited from the extensive involvement of leading retailers who sit on the Council and discussions with a broad set of industry experts, as well as a major survey of 10,000 European grocery shoppers recently completed by McKinsey's European Retail Practice.

The Project's prime objective is to highlight the trend towards value, which both underpins the remarkable growth of discount and offers avenues for non-discount retailers to fight back. It focuses on how discounters successfully serve certain groups of price-focused shoppers as well as on some of the limitations of the discount model. And while the Report touches upon some of the many implications for manufacturers of consumer packaged goods, the core of its effort is centred on developing solutions for non-discount grocery retailers.

This topic is clearly central for grocers throughout Europe. The Council hopes that CEOs and others involved in setting strategy for these organisations will find the Report useful as they make their decisions in this complex arena.

Executive Summary

The underlying trend towards value

On the face of it, discounters look like the biggest challenge facing the grocery retail sector today. But dig a little deeper and you will find it is not the discount phenomenon alone that is changing the face of European grocery retail. The bigger disruptive force - and the greater opportunity - comes from shoppers' rising expectations of value.

Shopper segments define value differently

Discounters have certainly had an influence on shoppers' expectations. They have taught shoppers to expect quality products at low prices. The extensive shopper research that McKinsey & Company recently undertook shows that discounters are offering good value to European shoppers who care about price above all else. But that's only 20% of the total market. The remaining 80% of shoppers care about a lot more than just price. How well are they being served?

How the discount model works

The discounters have a powerful approach for delivering on the price components of value. Given that all shoppers are becoming more demanding on price, there is a lot that non-discount players can and should learn from the discounters in this area. Accordingly, in this report we take an in-depth look at the mechanics of the discounters' business model.

Limits of the discount model

At the same time, however, the limits of the discount model are becoming more apparent. One sign of this is the fact that discounters' rapid growth has been fuelled mainly by new store development rather than strong like-for-like sales. Discounters are growing largely because regulation allows them to open more quickly and easily than their non-discount rivals. Though this does not lessen the discount challenge, it does suggest that the appeal of the discount model to shoppers is not as strong as some may have thought.

Discounters are adjusting to shopper and marketplace trends

Perhaps realising this, discounters are modifying their approach to suit different market environments better and to appeal to a broader cross-section of shoppers. They are expanding their product ranges and including more branded products. They are also investing more than ever before to market their proposition to shoppers. How far they can travel down these routes without upsetting their business model remains unclear.

Even while that uncertainty remains, grocery retailers should pause and consider what can be learned from these low-price competitors. Most importantly, discounter success signals an underlying shift in shopper sentiment towards value. This trend towards value is changing the rules of the game for all retailers, not just those who face an imminent discount challenge.

Meeting the bar on price

Price is not the only component of value, but it is the largest one. Therefore, to win on value, a retailer must first have competitive prices on Key Value Items - the SKUs that most influence shoppers' price perception. Understanding the mechanics of the discount operating model offers other retailers a new mindset with which to approach cost reduction. While slavish imitation of them is unlikely to be a path to success, discounters can be an invaluable source of ideas for taking cost out to meet shoppers' rising expectations for low prices.

Raising the bar on value

Merely meeting the bar on price, however, will not be sufficient to thrive in an increasingly demanding environment. Retailers must also "raise the bar on value" by tailoring their offer to suit their target shoppers' definitions of value. To serve some segments, this will require a step change to actual and perceived prices. For other segments, a dramatic improvement in benefits is in order. In this report we offer some examples, from Europe and abroad, of retailers who have been successful by becoming "famous for" something that their shoppers care about. Bringing such efforts to life is an activity to which each retailer can and should apply its organisational creativity.

Setting your agenda – Success will mean winning on value

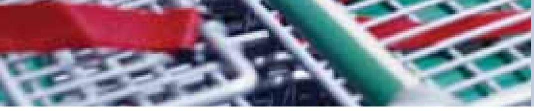
Whether a new business model is needed to compete successfully will vary based on the retailer's starting point, the segments it aims to serve, and the competitive environment in which it operates. Given that most retailers already run a large base of stores, the first line of attack should be refining the existing model. At the same time, the diversity of shopper needs may make serving very diverse segments within a single format impossible.

Grocery retail will continue to change, constantly revising expectations of value upwards and generating higher demands on operations. As the shift towards value continues, not all traditional grocers will survive: those who fail to respond risk opening space in their market, which discounters will readily seize.

To win in this new environment, grocers must adopt a relentless focus on delivering value to shoppers based on accurate and timely insight. The stakes are high and the challenge has never been greater. By responding decisively with an integrated approach centred on shoppers' definitions of value, non-discount grocers can secure their future in this new value-driven world.

CHAPTER 1

The Rise of Discounters and the Reign of Value



The Rise of Discounters and the Reign of Value

The rise of the discounters

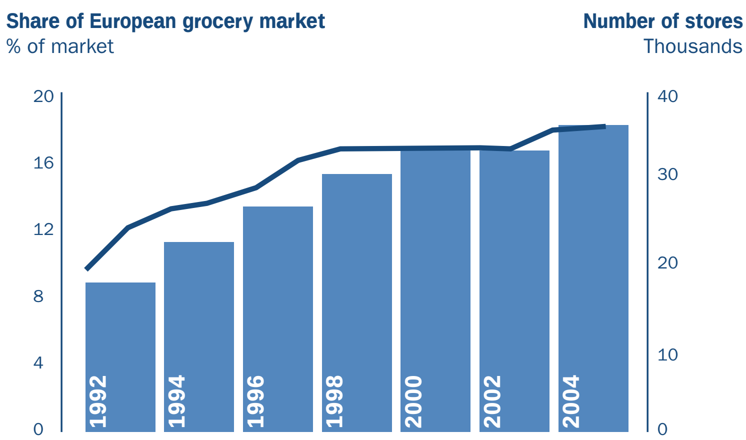
Discounters have been and remain a huge story in Europe. In Germany, they control nearly 40% of the grocery market. They have grown their share over the past decade in all but two of the top 16 European markets. They now account for more than 15% of the European grocery retail market.

Discounters' rapid growth is due largely to the extraordinary pace of their store openings. Some 47% of all new retail outlets opened in Europe since 1991 have been discount stores.[1] Collectively, they have opened an average of 3.5 stores every day since that year. Compare that to the equivalent number of new full-size supermarkets and hypermarkets, and it is no wonder many non-discount retailers feel the need to respond.

When people think of discount, they most often have in mind the German "hard discount" chains, Aldi and Lidl. These hard discounters share a common profile:

- Limited assortment. Very narrow range (600-1,500 SKUs), and limited fresh offer
- Private label. Vast majority of sales come from private label products
- Price-focused communication. Consistent and unambiguous emphasis on low prices
- Non-food promotions. “When-it's-gone-it's-gone” offers drive footfall and margin
- Strong cost control. Relentless focus on driving down cost, from head office to stores.

exhibit 01



Source: AC Nielsen, Goldman Sachs, IGD

Although Aldi and Lidl are often grouped together, there are real differences between them. In fact, Aldi is comprised of two independent companies, Aldi Süd and Aldi Nord. Aldi Süd has been more successful: in 2003, it operated 30% fewer stores than Aldi Nord, but achieved 15% higher revenue and an estimated EBIT of 5.9% versus 3.7% at Aldi Nord. In Germany, Lidl has a significantly smaller presence than Aldi, with €9.8 billion in German revenue to Aldi's €22.0 billion. However, it has been much more aggressive in pursuing international expansion. Operations outside of Germany already generate 48% of its total revenue, and this is expected to continue to grow. In addition, Lidl's parent company, the Lidl and Schwarz Group, operates more than 400 Kaufland hypermarkets. Recent acquisitions and strong sales growth have made Kaufland the largest hypermarket business in Germany, and it is also expanding quickly throughout Eastern Europe.

In addition to the hard discounters, there is a growing group of so-called "soft discounters", which have

[1] AC Neilsen

adopted selected elements of the hard discount formula. Carrying a more limited assortment than conventional supermarkets or hypermarkets, these soft discounters temper some of the bare-bones aspects of the hard discounters to suit a broader set of shoppers.

exhibit 02

Discounters' European operations

Leading discounter	Net sales 2003 € billion	Stores	Number of operating markets
Aldi	30.9	6,135	10
Lidl	18.9	5,531	15
Plus	8.1	3,545	7
Penny	7.9	2,996	8
Dia	5.1	3,969	5

Source: IGD Research

In this report, we use the term "discounter" as shorthand for any retailer that adheres to the discount economic model - the term applies to soft discount retailers as well as the hard discounters. When we refer to a characteristic that is particular to the hard discounters, we will make this explicit.

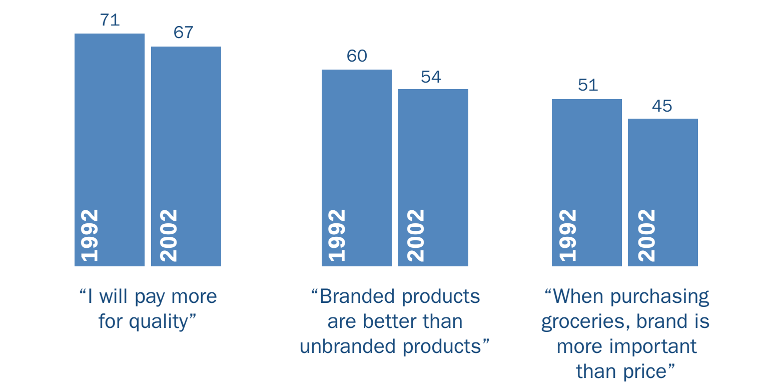
Discounters' impact on grocery markets goes beyond their accumulation of market share. In Germany, where discounters have grown from 23% of market share in 1992 to 37% today, they have influenced both shopper opinion and competitive dynamics. During this period there have been clear shifts in shoppers' preferences. Fewer German shoppers, for example, say that they are willing to pay more for quality, or that they prefer branded products over unbranded ones (see Exhibit 3).

Furthermore, our research shows that shoppers who visit discounters even infrequently are less loyal to their primary grocery store. A shopper who uses a discounter as a secondary or occasional store spends 5-10% less at their non-discount primary store than if they never visited a discounter. This is likely because, as shoppers are exposed to discount, they learn to shop around, selectively purchasing items at the store where they can get the best deal.

exhibit 03

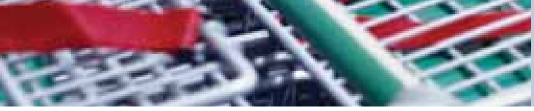
As discounters have grown in Germany, shoppers have become more price-focused

% respondents



Source: Axel-Springer verlag, IDG

The actual or feared growth of discounters is even capable of sparking price-based competition amongst non-discount players. As one retailer reacts to discounters by dropping prices, other retailers follow suit. Hans Reischl, former CEO of Rewe, described how "Lidl's mere announcement" of its plans to open 300 stores in the Czech Republic caused retailers to "sell many grocery items for 10% below purchase price." This downward spiral also seems to have occurred in the Netherlands and Sweden as well as in other markets.



Discount is not the only storm cloud

European grocery retailers have been forced to confront the discount challenge at a particularly challenging time. Several factors have combined to make grocery retail a difficult sector to succeed in:

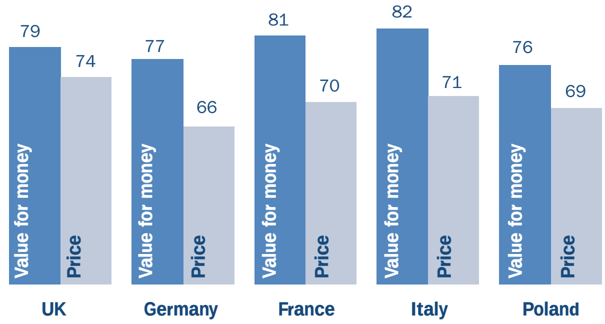
- Slowly shrinking market. Western European household spending on grocery has fallen 5 percentage points since 1980. Adjusting for inflation, food prices have declined in most markets.
- Rising shopper expectations. Shoppers are becoming more savvy and demanding. Surveys repeatedly show that shoppers not only expect better prices than they did 10 years ago, but they expect better selection, quality and convenience, too.
- Regulatory limits. In most markets, grocery retailers face a number of constraints to their growth and to their range of competitive responses. These include zoning regulations that disadvantage larger stores, limitations on below-cost selling, and restrictions on opening hours.

Recognising these challenges, capital markets expect less growth from major European non-discount grocers than they have in the past. Market expectations can be quantified by breaking down a stock's share price into base components: the value of current earnings extended into perpetuity and expectations of future earnings growth. An examination of eight of the major publicly-traded European grocers reveals that in 1993 approximately 30% of their share price was attributable to future growth expectations. By 2002, that figure had fallen to just under 10%: the stock market's expected growth in grocery retailing to slow or stop altogether. Capital markets are usually quite impartial observers, so their consensus - that current strategies will provide relatively little expansion - should be sobering.

exhibit 04

In all markets, value for money is more important to shoppers than price

Percentage of shoppers who choose as their primary store the store which they rank highest* on "Value for money" or "price"



*or tied highest ranking
Source: McKinsey shopper research

The threat is not discount, it's value

The rise of discounters does not, however, herald the end to the supermarket and hypermarket formats. Our new shopper research shows that many European shoppers still value assortment and service, provided it is made available at an acceptable price. The discount model is optimized for German shopper preferences. In other markets, the model's advantages are significantly neutralized by a lack of shopper interest.

Indeed, non-discount retailers can be just as successful as the discounters in meeting the challenges of today's environment (Exhibit 4). Using like-for-like sales growth as a proxy for success, we see that both discount and non-discount retailers can emerge as strong players. Though the winners vary widely by format, what they have in common is high perceived "value" amongst their shoppers.

Indeed, a major finding of the new research is that "value" is the most important determinant of store selection - more important even than price.[2] Some 80% of the time, the retailer that shoppers rank the highest on value becomes their primary store. Since shoppers tend to spend 60-70% of their grocery budget at their primary store, any retailer needs to be a winner on value in order truly to succeed in this difficult sector.

But what does it mean to deliver value? The hype over discounters has convinced many retailers that providing value means rock-bottom prices, even if that means slashing services and product ranges.

[2] Since shoppers were asked only about stores in their area, value is of utmost importance after adjusting for location

VALUE RETAILING AROUND THE GLOBE

Value is not just a European phenomenon. In fact, value-focused retailers are growing quickly in many different sectors and geographies.

North America. Wal-Mart has continued to grow its grocery share to 15% of the US market through its supercenters and the Neighbourhood Market format. Meanwhile, dollar stores have achieved a 9-year sales CAGR of nearly 19% and are expected to build 1,000 new stores each year for the next 3 years. Several US grocers, including Kroger and Albertsons, have begun to experiment with limited-assortment formats.

South America. Discount formats in this region cater to shoppers with limited financial resources. For example, at Guanabara, a Brazilian discounter, shoppers are willing to queue for 2-3 hours to take advantage of daily specials, where different categories are sold "at cost."

Asia. Daiso Sangyo's 100¥ store is one of the fastest growing Japanese retailers. The Don Quijote chain operates stores they call "Amusement Shopping Machines" that attract droves of fashion-conscious teenagers hunting for bargains.

Africa. Massmart, which operates discount and supercenter formats in 5 African countries, posted 17% growth (11% like-for-like) in 2004. Massmart also operates a unique discount format called "Game," whose tagline is "You Always Win." Whilst selling low-priced dry groceries and non-food items, Game also offers entertainment in the form of frequent in-store contests.

exhibit 05

Discounters are not the only players delivering on value
Ranking based on shoppers' value perception

	UK	Germany	France	Italy	Poland
#1	Hyper	Hyper	Discount	Super	Discount
#2	Discount	Discount	Hyper	Hyper	Hyper
#3	Multi format	Discount	Super	Hyper	Hyper

Source: McKinsey shopper research

Exhibit 5 identifies the retailers ranked highest by survey respondents on "provides good value for money," and shows that value is a more complex concept. And retailers of every format and brand can succeed. As it turns out, there is no silver bullet to winning on value.

To win on value, then, a retailer has to be familiar with its shoppers' own definitions of good value. For some people, value is mainly about buying goods of passable quality at the cheapest price possible. For others, many factors in addition to price - including a store's product range, its convenient layout, and its in-store services - all play a part in their perception of value.

Understanding shoppers' nuanced and varied definitions of value is therefore the most important step towards actually delivering and winning on value. Accordingly, in the next chapter we will provide an in-depth look at the results of our new shopper research.

Key Messages

Both “hard” and “soft” discounters have grown over the past decade thanks to their extraordinary pace of store openings.

Besides stealing market share, discounters influence shoppers’ attitudes towards grocery shopping, making them less loyal and more price-focused.

Discounters are a symptom of an underlying trend in retail towards value.

Grocers who win on value succeed in the market, but value is defined differently by different shoppers.

A BRIEF HISTORY OF HARD DISCOUNT

Aldi

In 1946, Karl and Theo Albrecht took over their mother's small grocery store in Germany's Ruhr Valley. Over the next decade, they expanded Aldi (short for "Albrecht Discount") across West Germany, growing to over 300 stores by 1960.

A year later, the brothers, purportedly disagreeing on whether to sell cigarettes in their stores, decided to split their grocery business along geographical lines. Karl took control of Aldi Süd while Theo led Aldi Nord; both exist today as separate businesses, operating according to the same principle of "absolutely no frills" grocery retailing.

By the 1970s, Aldi was expanding internationally, first into Austria, then into Benelux and the US. In 1979 Aldi Süd purchased Trader Joe's (formerly Pronto Markets), an American grocery store which has pursued a unique "upscale discount" strategy.

By the late 1990s, Aldi faced increasing competition from other discount chains. At the same time, the distinction between Aldi Nord and Aldi Süd become more obvious, with Süd being the more modern, expansive, and successful of the two.

In recent years, the sluggish German economy has actually supported Aldi's continued growth. By 2003, 90% of the German population lived within 15 minutes of an Aldi store. The reclusive Albrecht brothers had also become Germany's richest men, amassing a combined fortune of more than €30 billion.

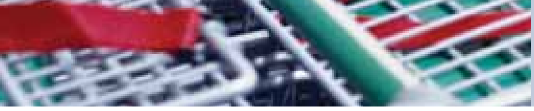
Lidl

Lidl & Schwarz began as a wholesale business in the 1930s. It was only in 1973 that it bought the rights to the name Lidl for DM 1000 and opened the first Lidl discounter in the Ruhr Valley (near the area that Aldi also got its start). Lidl stores imitated Aldi's basic "no frills" principles. In 1984, the Schwarz group also opened its first Kaufland discount hypermarket. Corporate restructuring in 1999 split Lidl and Kaufland into separate entities, though they share common ownership by Lidl & Schwarz.

1989 marked the start of Lidl's aggressive international expansion. Beginning with Italy, Spain and the U.K., the discounter then expanded into Benelux and the Nordic regions by the mid-1990s. Later in that decade, Lidl's expansionary focus had shifted towards the former Eastern Bloc, including Hungary, Poland, and the Czech Republic. By 2003, Lidl announced further aggressive expansion plans, not only in Europe, but also into Canada (plans which have yet to be realised, possibly as a result of trouble in Lidl's home market).

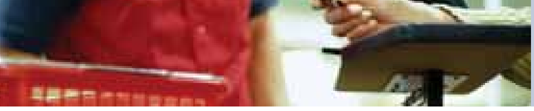
In the recent years Kaufland has grown in importance within the group. Its sales have increased thanks to acquisitions (Magnet/Grosso from Tengelmann in 2000 and Familia's Bremke and Horster chain in 2003), as well as strong organic growth. By 2003 it was the largest hypermarket operator in Germany, ahead of Metro's Real.

Today Lidl & Schwarz is the 7th largest European grocery retailer, operating in 15 countries, and generating combined revenue of €34 billion.



CHAPTER 2

How Shoppers Define Value



Value may seem like a simple concept. But the way that individual shoppers assess value is quite subtle and most often an amalgam of many aspects of the store. Using our new shopper research we have been able to group shoppers together into segments based on their own views of value. These segments help us understand which stores shoppers choose and why. More importantly, they serve as a guide to define what is needed to win (or win back) their loyalty.

Shoppers see value differently

Given the importance of value perception, it is crucial to gain a richer understanding of what value means to shoppers. Retailers have always known that some shoppers are very price-focused, while others are more interested in quality and choice. To gain a more sophisticated appreciation of what drives store selection, respondents were grouped according to their own description of their habits and preferences. We identified seven distinct shopper segments, each one possessing a unique view of what constitutes good value (Exhibit 6). Here we describe them in order, from the most price-sensitive to the least:

exhibit 06

Seven differentiated customer segments exist . . .
Percent of total respondents

Source: McKinsey consumer research

- Pure Price. These shoppers judge retailers almost exclusively on the basis of price, although they also value convenience. Because they care little about range or in-store experience, it is perhaps unsurprising that fully half of the Pure Price segment list a discounter as their primary store.
- Value Hunter. Value Hunters are willing to shop around to get the best possible deals. Many of these shoppers are "cherry-pickers" who take advantage of attractive offers at multiple stores.
- Value Loyalist. These shoppers tend to pick a single store as the place to buy most of their groceries. When deciding which retailer to pick, price is a key consideration, though convenience, quality, and in-store experience also become more important. Value Loyalists particularly care about an extensive product range, since a large selection allows them to satisfy all their shopping needs in one trip. For this reason, they tend to favour hypermarkets.
- Uninvolved Shopper. These are shoppers who do not think much about grocery shopping. Tellingly, they spend less on groceries than most other segments, despite having above-average income. As a result, when they do go shopping, their strongest preference is to experience the least hassle possible. Uninvolved Shoppers are fairly loyal to their primary store, since they are familiar with its layout and can thus navigate it quickly and with minimal effort.
- Demanding Shopper. Demanding Shoppers are shrewd, looking for a broad selection and convenient store experience but at a low cost. They are willing to shop around, and they are as likely as the two price-driven segments to compare prices scrupulously. Compared to the price-driven segments, however, they buy store-branded goods relatively infrequently.
- Quick Quality. These shoppers are cash-rich but time-poor. They are interested in buying high-quality products, and often enjoy cooking, but they are unwilling to spend more than a minimal time grocery shopping. They favour streamlined stores that help them find items quickly and to get out, and they are willing to pay extra for that convenience.
- Pure Premium. Pure Premium shoppers want their grocery experience to be enjoyable and the products they buy to be top quality. The most educated and wealthy segment, these shoppers rarely compare prices. Instead, they are willing to pay for premium products and for first-class service.

All seven segments exist across Europe, although the size of each segment varies considerably in different countries (Exhibit 7). Germany contains a disproportionate number of Pure Price and Value Hunter shoppers (a combined 49%), which is undoubtedly linked to the success of discounters in that country. France contains a large proportion of Value Loyalists, who are particularly well-served by the hypermarket format which has succeeded in that market. The UK, meanwhile, has more than its fair share of the Pure Premium shoppers.

Shopper segments define value differently

How does this shopper segmentation translate into knowledge that a retailer can use to tailor its offer? The most important thing to learn from these segments is how they define value. As it turns out, they define value in strikingly different ways.

By correlating the way shoppers rate a store on value with the way they rate that same store on other factors (such as convenience, price, or quality), it is possible to discover how much each factor influences overall value perception.

As Exhibit 8 demonstrates, segments define value very differently. The further out a factor is from the centre of the diagram, the more important it is in that segment's definition of value. Members of the Pure Price segment give stores high marks on value only if those stores demonstrate that they have low prices and are convenient. Range barely contributes to their value perception at all. Pure Premium shoppers, by contrast, do not weight price so heavily. To them, every factor plays an important role.

For Pure Price shoppers, a store will win on value if it provides very cheap goods without a lot of hassle. A Demanding Shopper might judge that same store very poorly, since its bare-bones appearance and overstretched staff make shopping a chore. The same store that appeals to Value Loyalists thanks to its extensive product range might frustrate Quick Quality shoppers who would rather grab the products they need and get out.
This has critical implications for retailers. Exhibit 9 shows how the distribution of these segments varies between three retailers in the UK. Thus we see that shoppers who visit this discounter as their primary store are disproportionately Value Hunters. By contrast, nearly three-quarters of the speciality supermarket's primary shoppers are Pure Premium. The

exhibit 07

Segment sizes
Percent of respondents

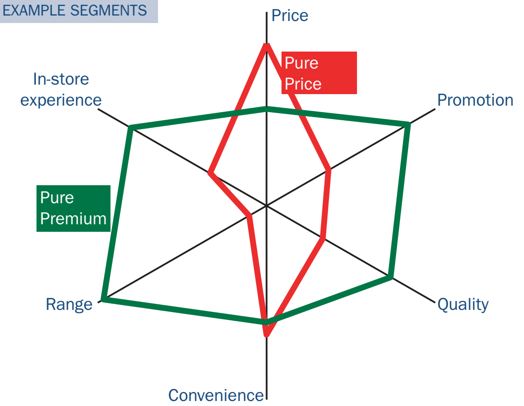
	Pure Price	Value Hunter	Value Loyalist	Uninvolved Shopper	Demanding Shopper	Quick Quality	Pure Premium	Total
UK	4	8	7	23	17	10	31	100
Germany	27	22	8	11	9	14	9	100
France	14	8	23	11	8	27	9	100
Italy	5	17	16	14	21	8	18	100
Poland	9	13	14	6	21	16	21	100
Weighted total	**13**	**14**	**12**	**14**	**14**	**15**	**18**	**100**

Source: McKinsey shopper research

exhibit 08

Segments have very different definitions of value
Deviation from mean on correlation with "provides good value for money"

EXAMPLE SEGMENTS



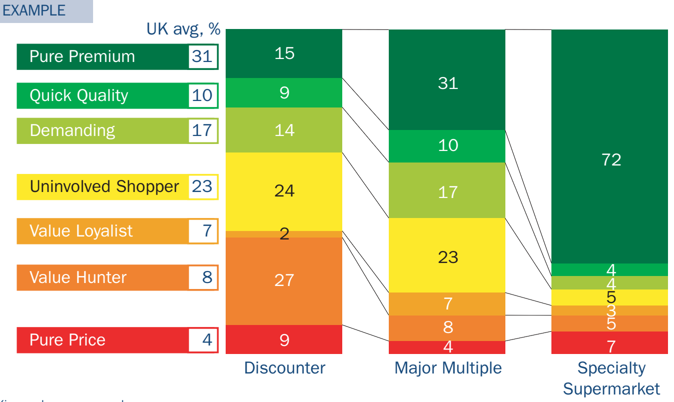
- Price and convenience matter to all segments
- For Pure Price, value is synonymous with low price
- Other segments take into account many other aspects of the store when evaluating value

Source: McKinsey shopper research

exhibit 09

Based on segments' definitions of value, they make very different decisions about where to shop
Percent of respondents who have chosen retailer as their primary store

UK CASE EXAMPLE



Source: McKinsey shopper research

SHOPPER RESEARCH

McKinsey & Company completed a major survey of 10,000 European grocery shoppers in early 2005. The telephone-based survey was conducted in five major European markets (France, Germany, Italy, Poland and the UK). This report has drawn heavily from that survey.

The aim of this research was to understand the performance of discount and non-discount grocery retailers in each of these markets, and to learn about the underlying drivers of their performance. The ultimate goal was to develop insights to help non-discount retailers better serve their shoppers.
This overall objective was broken down into four specific goals:

1. To understand what influences shoppers' store selection
2. To segment shoppers based on their attitudes and shopping behaviours
3. To profile the perceived strengths and weaknesses of major discount and non-discount grocers in each market
4. To identify unmet needs or underserved groups in each market

Respondents were asked to rate stores on a battery of 34 store attributes. For analytic purposes, these attributes were grouped into six categories: price, promotion, convenience, quality, range, and store experience. To ensure more informed evaluations, shoppers were asked to rate only those stores which they had visited within the previous 3 months.

Additionally, respondents were asked to rate how well each of 17 statements matched their attitudes towards grocery shopping. These included statements such as "I shop where I can get the lowest prices even if it means making more trips to different stores" and "I like to have a big choice where there are lots of products offered even if I would probably never buy some of them." Responses to these attitudinal statements formed the basis for segmentation.

Throughout the survey the term "discount" was avoided to prevent possible confusion over the meaning of the term. Only retailer brand names were used. Retailers were later grouped for purposes of analysis and interpretation.

The results of this quantitative research were supplemented with a series of in-home and on the street shopper interviews in all five markets across a broad range of shopper demographics and segments. Additionally, the team drew on existing shopper insights both from McKinsey's other qualitative and quantitative studies and from third-party sources. Where these secondary sources have been used, it has been specifically noted in this report.

This research has yielded a rich understanding of how shoppers view value, their perception of major players in each market, and the reasons that they choose, or do not choose, discounters. While it emphasises the need for non-discount retailers to be increasingly attentive to shoppers, it also provides many opportunities to design a more attractive offer based on an understanding of shoppers' complex preferences.

major multiple's share of each segment exactly mirrors the UK average. This suggests that its delivery of value is varied enough to appeal to all segments. Pure Price shoppers, for example, happily buy its entry level private label products line, while Pure Premium shoppers are satisfied with the customer service and are pleased with its premium product offering.

It is crucial for a retailer to know which segments are shopping in its stores. Such knowledge can reveal the strengths and weaknesses of its offer. Learning the segment composition of the markets it operates in is also critical for future growth strategies.

Who is shopping at discounters?

Armed with a better understanding of what shoppers are looking for when they buy their groceries, what can we now say about Europeans who regularly visit Aldi, Lidl, or one of the soft discounters?

There are a few broad demographic features that distinguish discount shoppers from the rest of the population. As Exhibit 10 demonstrates, they come disproportionately from poorer households. Since poorer people have less money available for buying groceries, they are more likely to seek out retailers that offer them the lowest possible price. Germany is an exception to this rule. There, discount shopping occurs at roughly equal proportions across all income groups.

In every country surveyed, regular discount shoppers are nearly 20% more likely to have large families (i.e., five or more people in the household) than the rest of the population. This might tilt their store selection towards stores that can provide weekly provisions more cheaply. Similarly, the unemployment rate of discount shoppers is between 1 and 3 percentage points higher than for non-discount shoppers.
Nevertheless, these demographic differences shed only a limited light on what differentiates discount shoppers. Despite attracting a higher proportion of the unemployed, for instance, discounters draw the vast majority of their shoppers from the gainfully employed. Income limitations aside, the decision to shop at a discounter is not demographically predetermined. Instead, it is rooted in a person's attitudes towards grocery shopping. To understand this further, we must refer to our shopper segmentation.

It should already be clear that the discount model is the best fit for Pure Price shoppers, who care a lot about price and less about range or in-store experience. It is no surprise, then, that more than one-third of the hard

RESULTS OF RESEARCH ON US SHOPPERS

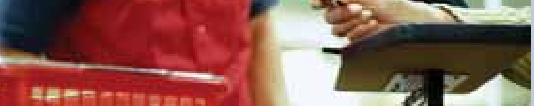
In addition to the European shopper research covered in this report, McKinsey & Company has recently conducted extensive research on US grocery shoppers.
The US retail environment has long been dominated by value-focused supercenters, such as Wal-Mart and Target. Over the past few years alternative value-focused formats - including membership clubs, dollar stores, and limited-assortment retailers (primarily Aldi and Missouri-based Save-A-Lot) - have been gaining share.
Our research reveals several significant parallels between US and European grocery shoppers:

- As in Europe, value is a key driver of store selection.
- A similar, though not identical, set of shopper segments were identified. The most price-focused segments make up roughly 44% of the US market versus 36% in Europe.

The research also highlights areas where the opinions of US shoppers diverge from those of their European counterparts:

- In the US, "value retailers" have broad appeal, capturing nearly 20% of every segment. In Europe, discounters have more narrow appeal, drawing most of their shoppers from the price-focused segments.
- In the US, although limited-assortment retailers such as Aldi and SuperValu are growing, they face many significant rivals. Larger value-focused retail formats, and more space for home storage, means that US shoppers are willing and able to buy in bulk to save money.
- On the other end of the spectrum, premium grocers such as Whole Foods are growing in appeal within the US and beginning to reach the mass market. By contrast, the UK is the only European market we studied where premium grocers (e.g., Waitrose, Marks & Spencer) have achieved a significant presence.

Clearly there are significant differences between these markets. Nonetheless, both geographies are facing a continued shift towards value in which price-focused players are quickly growing market share and challenging those grocers who have failed to recognise and respond to this shift.



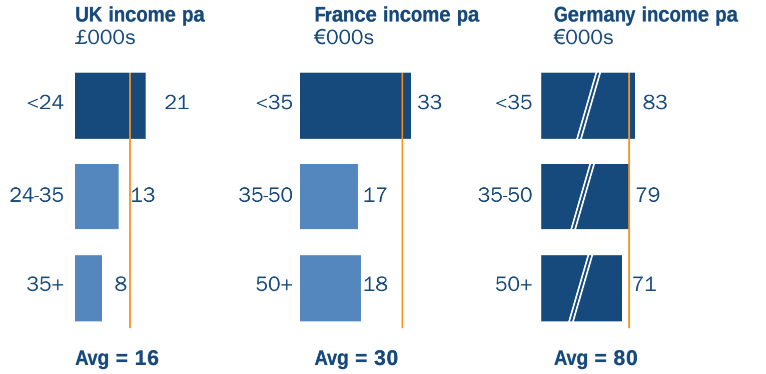
discounters' primary shoppers come from the Pure Price segment. Another quarter of their shoppers are Value Hunters, the other deeply price-focused segment - when these shoppers hunt for the best prices, they will discover them at hard discounters on a significant proportion of occasions.

The remaining 38% of hard discounters' shoppers come from other segments. Moving away from the most price-sensitive segments and towards more complex definitions of value, we might expect shoppers to become less interested in what hard discounters have to offer. This is not entirely the case: the next largest group of discount shoppers are the Uninvolved Shoppers, not the Value Loyalists. This offers several insights into what makes discounters attractive to different shoppers.

exhibit 10

Significantly lower than average

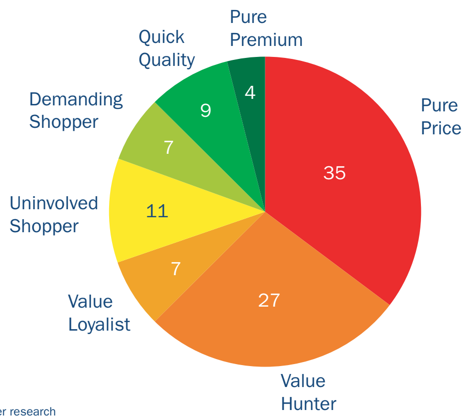
Discounters tend to attract shoppers from poorer segments of the population
Percent of respondents who list a discounter as the store where they shop most often or second most often



Source: McKinsey shopper research

exhibit 11

Hard discount shoppers come largely from the most price-oriented market segments
Percent of respondents who have chosen a hard discounter as their primary store



Source: McKinsey shopper research

Despite their strong interest in low prices, Value Loyalists tend not to shop at hard discounters. We know that hard discounters carry a sharply reduced selection of SKUs. But Value Loyalists prefer to take care of all their shopping needs within one store, and say that they "like to have a big choice where there are lots of products offered even if [they] would probably never buy some of them." Discounters thus make unsatisfactory primary stores for Value Loyalists.
Hard discounters hold a certain appeal, however, for Uninvolved Shoppers, who are put off by the large range at other stores. Because they employ standardised, easy-to-navigate store layouts, Aldi and Lidl make it convenient for members of this segment to find the items they need. Not only will Uninvolved Shoppers value a quicker selection from fewer products. The discounters have long proved themselves adept at managing the checkout process. Some justified their delay in introducing scanning on the basis that it was quicker for a sales associate to recall and enter a price than pass an item over a scanner; more recently, a number have introduced checkouts with longer belts and shorter "landing zones", both reducing the potential for bottlenecks and encouraging swifter packing by their customers. And with the introduction of scanners have come lengthened and multiple bar codes on packs to make first time scanning more certain.

The influence of shopping occasions

Shoppers care about different aspects of grocery shopping depending on the reason for their trip. Grabbing a quick sandwich is very different from stocking up for Christmas dinner. Survey respondents were therefore asked about three grocery shopping occasions to discover how the reason for going shopping influences value perception and store selection:

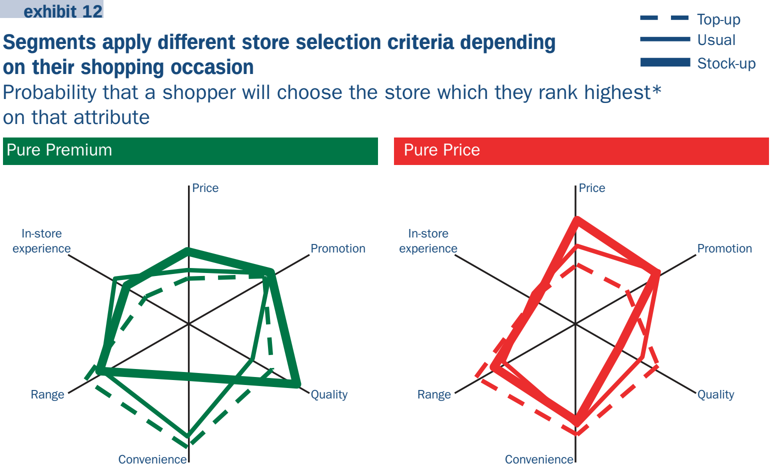
- Usual trip. This is a trip to buy normal food items and everyday supplies. According to the survey, shoppers spend roughly half of their total grocery spend on this type of occasion.
- Top-up trip. This is a trip to purchase just a few items, perhaps for that night's dinner or to replenish fresh goods such as milk or bread. Shoppers spend about 27% of their grocery budget on such occasions. In Poland, top-up trips are much more common - shoppers make such trips 18 times a month on average - and these trips represent 49% of their grocery budgets.
- Stock-up trip. The stock-up trip is used to buy large quantities of goods, usually long shelf-life items. Shoppers go on this type of trip only two or three times a month, but spend around 18% of their budget on those few trips.

The criteria used for store selection change depending on the shopping occasion. When shoppers stock up, for instance, they care more about price. Price and promotion become much less important when shoppers top up; instead, convenience becomes the key driver. As you can see in Exhibit 12, segments retain their basic profiles across these different occasions. The relative importance of different factors, however, does vary.

exhibit 12

Segments apply different store selection criteria depending on their shopping occasion

Probability that a shopper will choose the store which they rank highest* on that attribute



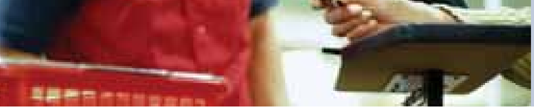
* Or is tied for highest

Source: McKinsey shopper research

The differences among segments are most pronounced during stock-up trips. Quality is a very important determinant in Pure Premium store selection, while it matters relatively little to Pure Price shoppers. And price is much more important to Pure Price than to Pure Premium shoppers. This accentuation of segment differences makes sense: when a shopper plans a major trip, she is more likely to think hard about which retailer will best satisfy her definition of value.

During top-up trips, Pure Premium preferences transform. Range and especially convenience become more important: shoppers want to be sure that they can find all the items they need, and that they can find them quickly and easily. Even in-store experience drops in importance, since specialised service counters and attentive customer service become less important when a shopper is just looking to pick up a few items.

Pure Price shoppers also value different things on top-up trips. In fact, their preferences begin to resemble Pure Premium's top-up preferences. When only a few products are being purchased, the prices of those products become less important to both segments. Convenience, on the other hand, becomes more important to all segments. The differences between segments become much less pronounced during top-up shopping.
Given that shoppers spend over a quarter of their grocery budgets on top-up trips, it is a significant



insight that segments tend to evaluate stores in similar ways when shopping on that occasion. Since convenience - particularly being conveniently located - plays such a large role in top-up trip store selection, a retailer might be able to capture segments otherwise uninterested in its value offer by orienting part of its stores to top-up needs.

Implications

How should this new shopper research affect retailers' strategies, particularly in light of the discount challenge? First, it is worth noting that only two of the seven European segments can be called "natural hard discount shoppers." The hard discount model is well-suited to the preferences of Pure Price shoppers. Given the economic advantages of the hard discounters, other retailers will find it extremely difficult to compete for the Pure Price segment. The same is true of many Value Hunters, who are likely to respond to lower prices by cherry-picking items with the lowest margin. These two segments, making up a combined 22% of total European grocery spending, should not be the primary targets of non-discounter retailers' efforts. Non-discounters can instead concentrate their attention on the remaining 78% of the market. This provides much more room for strategic manoeuvre than many retailers may have believed they had in recent years.

The hard-discount model is least suited to Pure Premium shoppers (19%), for whom name-brands and a pleasant or exciting in-store experience are crucial. Quick Quality shoppers (17% of market spend) can also be drawn to non-discount retailers that are conveniently located for those shoppers. The best strategy for keeping these two groups of shoppers loyal is to develop the most profitable and efficient ways to serve their high and ever-rising standards.

This leaves a battleground made up of Value Loyalists, Uninvolved Shoppers, and Demanding Shoppers - a combined 42% of total European grocery spending. Given the appropriate conditions, shoppers in these segments will turn towards the discounters. This has been the fate of the German grocery market. On the other hand, if non-discount retailers recognise the needs of each of these segments and tailor their offers to suit them, those retailers should be able to meet these shoppers' expectations profitably.
In most cases, it is foolish to target all seven segments (or even all of the five segments which are not naturally drawn to discounters): overambition often results in underdelivery. For most retailers, being selective about whom to serve is critical. Deciding which segments to target and how to target them is the subject of Chapter 7.

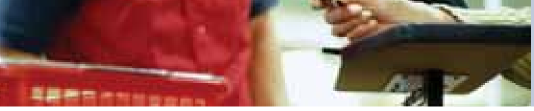
Key Messages

European shoppers can be divided into seven different segments, each with its unique definition of value.

Based on its own definition of value, each segment makes different decisions about where to shop.

Discount shoppers - nearly two-thirds of whom are Pure Price shoppers and Value Hunters - tend to choose discounters based on their attitudes about grocery shopping rather than on demographic characteristics.

Nearly 80% of shoppers can be profitably targeted by non-discount retailers, but a retailer should think carefully about how many segments it chooses to target.



CHAPTER 3

How the Discount Model Works

Discounters deliver very effectively on the price components of value

We have seen that hard discounters are most effective at attracting the price-focused shopper segments. This is largely because the key to the discounter value proposition is a consistently low-price offer. Discounters do not achieve such low prices by abandoning any hope of profit. Instead, virtually every aspect of their business is oriented towards cost reductions. A typical hard discounter has operating costs of 5% of sales, compared with 10-12% of sales at a typical supermarket. Combining these operating cost savings with tremendous purchasing advantages allows discounters to price significantly below the market average and yet maintain attractive returns.

Discounters' cost advantage derives primarily from four aspects of the business model:

- Limited assortment, which yields tremendous buying power and operational simplicity
- Private label, which enables very low price points at acceptable gross margins
- Non-food promotions, which boost margins while also driving footfall and basket size
- End-to-end cost focus, which squeezes cost out by simplifying every aspect.

Underlying all of these aspects, particularly for the hard discounters, is the notion of simplicity. Aldi and Lidl organise for value around a simple theme: the promise of consistently low prices. Constantly articulating such a clear message reminds both shoppers and employees what makes hard discounters distinctive. In this chapter we will discuss how each of these elements contributes to discounters' heightened ability to deliver profitably on the price components of value.

The pervasive benefits of limited assortment

Limited assortment is the cornerstone of the discounter business model. Hard discounters stock only the 600–1,500 top-selling SKUs within a market, which guarantees that none of their products gathers dust on the shopfloor. More importantly, by carrying a significantly reduced number of SKUs, hard discounters achieve a per-SKU buying scale up to 10 times that of a typical non-discount supermarket.

The economies of scale that come from extremely high sales per SKU manifest themselves in lower purchasing costs. It is much cheaper for suppliers to fill hard discount product orders than the orders of non-discount retailers. Because Aldi and Lidl order huge quantities of a limited number of SKUs, suppliers are able to maximise production efficiency with longer, more predictable runs and fewer changeovers. They also save money because order deliveries are much more likely to be full truckloads. Discounters also gain extra negotiating muscle over suppliers. Efficiency gains in production can be siphoned from suppliers into lower purchasing prices for the discounters.

The economic benefits of limited assortment are not restricted to purchasing (see Exhibit 13). The other major benefit of limited assortment is increased simplicity in nearly every aspect of the business model. Carrying a limited number of SKUs makes life simpler for store staff, streamlines head office buying, and helps the distribution centre operate more efficiently.

exhibit 13

Sources of benefit from limited assortment

Area	Benefit
Stocking	Sufficient space per SKU to use the most efficient stocking methods (e.g., pallets, cartons)
Space productivity	Only the fastest moving products are stocked
Head office	Leaner buying organisation
Store real estate	Smaller stores with very little backroom space
Supply chain	Streamlined DC operations, with greater emphasis on cross-docking
Gross margin	Enormous volume achieved with a select number of suppliers and SKUs

Source: McKinsey analysis, Dr Thomas Roeb

When just a few hundred fast-moving items are stocked, most items can sensibly be sold from pallets. This creates tremendous savings in labour costs, since items on pallets can be stocked in a fraction of the time it takes to shelve conventional cartons, with or without shelf-ready outers. As assortment becomes broader, and slower-moving items are added to a retailer's offering, more labour-intensive stocking methods - cartons or even eaches - become increasingly necessary.

Private label

By stocking primarily private label items, hard discounters simplify their supply chain. They avoid paying the higher purchasing prices that name-brands must charge to recover marketing costs. Working with private label suppliers also encourages built-in operational efficiencies, such as easily-scanned large barcodes on products. These advantages allow hard discounters to offer products for 30-50% less than the A-brand equivalents at non-discount retailers.

The risk in offering so many unfamiliar private label brands is that shoppers will think the products are inferior to name-brand products. To increase the acceptance of their products, discounters pitch them as equivalent to A-brands. They do this both by mirroring the packaging of the best-known brands and by emphasising the results of third-party testing (Exhibit 14).

In Germany, hard discounters' products have greatly benefited from the endorsement by independent consumer product testing agencies (particularly Stiftung Warentest). Aldi in the UK has issued flyers touting reviews of their products in popular women's magazines.

exhibit 14

Hard discount products are pitched as equivalent to A-brands

Aldi private label
National brand

Source: McKinsey store visits

These independent endorsements of discounters' quality reflect their refusal to allow suppliers to compromise on quality, for while discounters are demanding on price, they are also stringent on quality standards. As one branded supplier we spoke with described, "We were de-listed because we refused to give them the same quality on PLBs as on the top branded product."

Non-food promotions

Non-food promotions make up some 17-22% of hard discounters' revenue in Germany, and 10-15% outside Germany. Soft discounters' emphasis on non-food varies: while Leader Price, Dia, and Kwik Save have little or no non-food offer, Colruyt and Plus push non-food in stores and online. Employing opportunistic buying, discounters can offer surprisingly low prices while maintaining very favourable margins on weekly "when-it's-gone-it's-gone" offers that range from computers to gardening equipment. Typically, hard discounters will offer two such promotions each week, on Mondays and Thursdays, with 15-25 items per promotion.
Non-food promotions serve multiple purposes for discounters:

- Boosting margin. In Germany, for instance, gross margins of around 40% mean that non-food promotions may provide as much as a quarter of discounters' total gross profit.
- Driving footfall. Many shoppers visit discounters specifically to take advantage of these well-advertised sales. Specials are often placed in the rear centre of the store.

■ Supporting brand. The very low prices on non-food items sustain shopper excitement about discount stores and uphold their image of price leadership.

The profit potential of these promotions is immense. In 1998, Aldi hit the German headlines when it sold 200,000 computers in a matter of days. Selling at €1,000 per computer, Aldi collected €200 million in revenue. With an estimated 5% margin, that meant netting €10 million in gross margin. Given that suppliers are sometimes not paid until six months later, the €200m in revenue could theoretically have accumulated another €8 million in interest profit.[3]

Accordingly, non-food promotions have become a major focus for discounters. In Germany, Aldi has grown non-food from 13% of sales in 1998 to 22% in 2004, increasing the frequency of promotions and focusing on higher-ticket items.

Relentless end-to-end cost focus

From their spartan, fluorescent-lit stores to their negotiations with suppliers, discounters look for every opportunity to take out cost and complexity.

A typical hard discounter operates with labour costs of 2-3% of sales, versus 10% or more at a typical supermarket. As discussed, some of the savings are attributable to much more efficient stocking. This does not, however, entirely explain the gap in labour productivity.

A discount store with an annual volume of €5 million might have as few as two employees at a given time. This is made possible through the impressive multi-skilling of employees. In a typical supermarket, staff are often trained to perform a single task or group of tasks.
In some, cashiers are dedicated to tilling; when customer traffic is slow, cashiers simply become idle. Even in those stores where retailers actively manage to levels of demand, one or more supervisors is employed in monitoring queue lengths and deployment. By contrast, employees at many discounters shift autonomously between tasks in order to avoid downtime.

> Lidl always tries to pass price cuts along to the suppliers. Suppliers that don't agree are de-listed. In negotiations Lidl buyers get very loud and try to mop up suppliers.
> **MM Planet Retail, September 2003**

Recent observation of Lidl employees at a store in Lille-Hellemmes showed that over a 30-minute period just two members of staff juggled the entire operation of the store: they replenished stock, answered customer queries, tilled, and cleaned the store. A more flexible staffing model in which employees are trained to handle any in-store task means that hard discounter employees are almost always busy. Of course, this does come at a cost - queues can be longer, and till points are sometimes unstaffed while employees are working on the floor. Discount shoppers appear willing, however, to accept this trade-off.

Discounters also apply end-to-end thinking in their negotiations with suppliers. In addition to low cost and uncompromised quality, they also demand tight delivery windows and shelf-friendly packaging.

Distribution is another area where discounters squeeze out cost. Aldi, for instance, achieves significant savings in distribution by bucking conventional wisdom.

■ Larger distribution centres. Retailers are usually fearful of the additional capital cost of building large distribution centres. Aldi, however, builds DCs with large floor areas and many loading bays. This simplifies operations. For example, in a larger DC vehicles never have to wait for a loading bay to become available.

[3] AC Neilsen

- No stacked pallets. Although stacking pallets inside DCs is more space-efficient, Aldi keeps them one-storey high and reportedly uses specially-designed forklifts that can accommodate three pallets at a time.
- Field management located at DCs. By locating together the DC manager and store network manager - jobs that require very different skills - Aldi bridges gaps in its organisation and avoids the cost of additional field offices.

A cost-focused mindset pervades almost every aspect of the discounters' operation. This cultural orientation is a significant source of competitive advantage.

Organising for value around a simple theme

Creating a cost-centred culture is fundamental to the hard discounters' ability to deliver value continuously to their shoppers. The structural advantages they achieve through limited assortment, private label, and non-food promotions are necessary. But they are not sufficient. The hard discounters have also aligned personal, collective, and business goals for everyone they employ. In doing so, they encourage everyone to work towards a common goal, from the top to the bottom of the organisation. To make this happen, the key is organising for value around a simple theme. When a retailer is able to articulate a clear message - be it a low-price promise, the guarantee of top-quality goods, or the offer of a fun shopping experience - both shoppers and employees are constantly reminded of what makes that retailer distinctive. The hard discounters have succeeded in organising around the simple idea of absolute lowest prices. To translate that simple idea into behavioural change, they have used several mechanisms:

- Role-modelling. Recognising that behaviours tend to come from the top, discounters' senior managers radiate credible signals that centre on keeping costs low. The role-modelling of top leadership at discounters approaches the stuff of legend. Aldi's Theo Albrecht, for instance, is reported to have dressed down a store manager for ordering too many (4) ballpoint pens for his office.
- Fostering understanding and conviction. Another essential requirement for behavioural change is making sure that every employee understands what is expected of them and why. They also need to want to help make the change happen. Having a simple theme is critical - a message that is over-complicated can be less forceful as well as creating confusion. The hard discounters, of course, have a singular message that emanates clarity and purpose.
- Developing talent and skills. Even if employees understand what is expected and witness their superiors acting consistently, they will need to be capable and skilful enough to meet expectations. To make sure that they attract the most capable employees, the hard discounters typically pay their staff more than the market average wage rates. As one Aldi Nord employee described it, "the pay is attractive, but the job is extremely tough."
- Reinforcing behaviours with formal mechanisms. Behaviours are difficult to sustain unless there are constant reminders of why they are critical to the business's success. Creating structural incentives to exhibit those behaviours can reinforce good habits. The hard discounters do this particularly well.

When structural advantages are supported by the right patterns of behaviour, they become mutually reinforcing. If employees - particularly those on the shopfloor - are motivated enough to keep an ear attuned to any change in shopper preferences, and if channels of communication are kept open, those changing shopper preferences can inform new structural changes. Whether the hard discounters have fully opened the channels of communication is unclear. But, as we discuss in Chapter 5, they have been altering their business model in ways that accurately reflect changing shopper needs.

Taking advantage of regulation

Discounters have grown not only thanks to the strength of their value proposition or their business culture. They have also benefited from governmental regulations that handicap non-discount grocery retailers.

In many markets, national and local planning restrictions constrain the network expansion of larger-format supermarkets and hypermarkets. In some instances, smaller-format discount stores can sidestep such restrictions and open stores in places where non-discount retailers are effectively blocked by the government. This allows discounters to open stores more quickly and with less legal wrangling, and it gives them access to sites with relatively little local competition. As a result, 47% of all new stores in Europe since 1991 have been discount stores. In their core markets, discounters have developed a dense network of smaller stores located near their shoppers. These smaller, simpler stores are easy to reach and help shoppers find what they want quickly.

In eight of the fifteen countries in the EU as of 2003, selling products below cost is outlawed. In France, where such prohibitions apply, this has helped to sustain real food prices that are higher than the European average. Discounters' focus on private label, however, insulates them from such regulation: often, pricing restrictions do not apply to private label products.

Even macroeconomic policies have helped discounters. In much of Europe, economic uncertainty surrounding the introduction of the Euro supported discounter growth. The difficult exchange rate calculations associated with Euro conversion also forced shoppers to anchor the prices of their Known Value Items from scratch. This generated distrust of non-discount retailers, since they were perceived to have rounded-up prices. Similarly, long-term unemployment and slow economic growth have facilitated discounter growth in Germany. While discounters advance most quickly during times of economic uncertainty or hardship, however, the converse is not true. Ratchet-like, discounters tend to hold on to their gains during periods of recovery.

Key Messages

Discounters deliver value to price-oriented shopper segments by radically simplifying their operations and thereby reducing operating costs.

Limited assortment, the cornerstone of the discount business model, generates benefits throughout the entire operation of a store - from increased buying power to more efficient stocking.

Extensive use of private label products means that discounters buy directly from suppliers and are able to offer high-quality goods for radically reduced prices compared to name-brands.

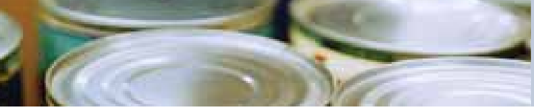
Discounters maintain a relentless end-to-end cost focus when dealing with employees and suppliers.

Non-food promotions supply a significant portion of revenue for discounters, while also driving footfall and reinforcing their low-price image.

Regulations often handicap non-discount grocers while leaving space for discounters to expand their store networks.

CHAPTER 4

Limits of the Discount Model

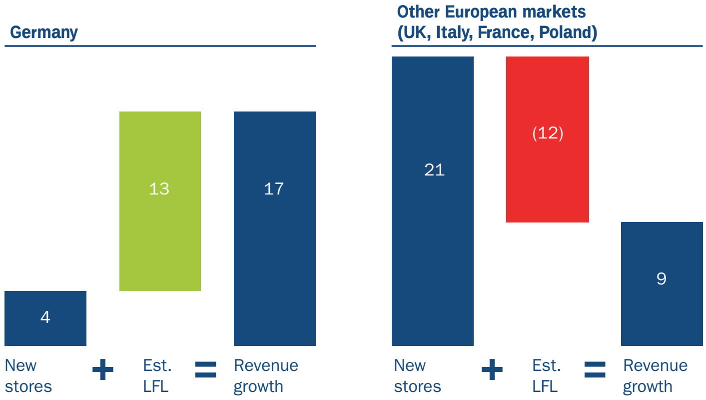


Discounters have grown, but the rapid pace of growth may have masked weakness

The previous chapter highlighted the strengths of the discounters' business model. But highly efficient supply-side organisation is worth nothing unless there is demand to match. All the economic innovations in the world are worthless unless they fit shopper preferences. And, as discussed in Chapter 2, the hard discounter value proposition is particularly attractive to the Pure Price and Value Hunter segments. This helps to explain the surprising finding that, outside of Germany, discounters' rapid growth in market share is actually not due to like-for-like sales growth. Exhibit 15 shows the negative like-for-like performance of hard and soft discounters in the UK, France, Italy, and Poland.

exhibit 15

Leaving Germany aside, discounters' like-for-like sales have been negative
Cumulative percent change, 2001–2004



Source: M&M Planet Retail

Even in Germany, discounters' sales growth has been decelerating. Lidl's growth slowed from 6.5% in 2003 to 4.3% the next year. Aldi's revenue actually shrank by 3% in 2004. Though discounters are able to accumulate market share through store openings, sluggish like-for-like sales abroad and signs of market maturity in Germany may be signs of some of the vulnerabilities of their model.

> After two years of…quite considerable growth, the discounters are now having trouble even matching last year's figures.
>
> **Lebensmittel Zeitung, October 2004**

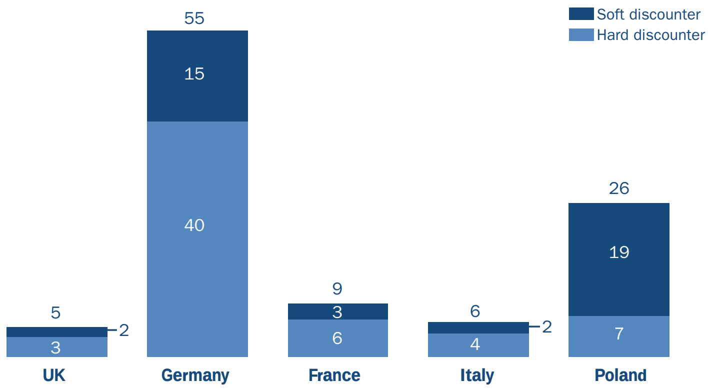
Chinks in the armour

Behind slow like-for-like growth lies discounters' overall difficulty in attracting and retaining "primary" grocery shoppers outside of Germany.

In most markets, shoppers use a discounter as their secondary or occasional store, rather than the store where they do the bulk of their weekly shopping. Only in Germany do a significant number of respondents (55%) list a discounter as their primary store (Exhibit 16).

exhibit 16

One of discounters' greatest challenges has been developing a core group of primary shoppers
% of respondents who list a discounter as their primary store



Source: AC Nielsen, Goldman Sachs, IGD

The primary shoppers that discounters do manage to obtain, furthermore, are not as valuable as other shoppers. They spend an average of 14% less on groceries every week. Of course, part of the reason for this reduced spend is the lower prices at discounters. But that explanation fails to tell the full story. These discount shoppers also allocate a smaller share of their spend to their primary store - the very discounter that is supposed to be giving them the best deals. Whereas primary shoppers at supermarkets and hypermarkets spend, on average, 65% of their grocery budget at their favoured store, discounters' primary shoppers part with only 55% of theirs.

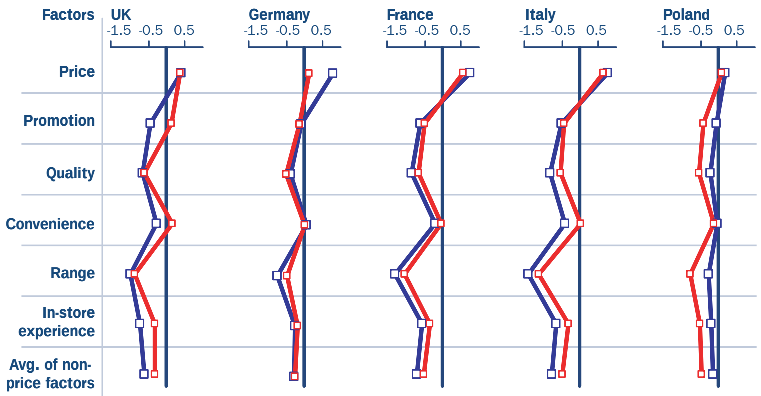
The low loyalty of discount shoppers can be explained partly by looking at the way those shoppers rate discounters against supermarkets and hypermarkets.

As it turns out, even shoppers who choose to visit discounters are dissatisfied with many aspects of those stores. These shoppers see discounters outperforming on price, while achieving parity on convenience. On every other dimension, however, shoppers in all five surveyed markets report that discounters are underperforming. This holds true even for soft discount models, which have tried to broaden appeal by softening some of the more radical characteristics of the hard discount offer (Exhibit 17).

exhibit 17

Even shoppers who choose discount are dissatisfied on many dimensions

Average difference in rating discount shoppers give to discounters versus the rating they give to other stores where they shop (5-point scale)



Source: McKinsey shopper research

Another sign of discounters' demand-side weakness is the relatively low ratings they receive from their occasional shoppers (Exhibit 18). Of course, any store's primary shoppers will hold it in higher esteem than those who shop there only occasionally. What points to trouble for the discounters is the magnitude of the difference in ratings between primary and occasional shoppers.
This suggests that discounters are likely to have a hard time in the future converting their occasional visitors into more loyal shoppers. As an example, Lidl encounters difficulties with conversion: only 20% of shoppers who are aware of a nearby Lidl store wind up as primary or secondary shoppers there. By contrast, other successful retailers surveyed have "conversion rates" of 40% or more.

exhibit 18

Average ratings on value: France

Retailer	Primary shopper rating	Occasional shopper rating	Difference
Soft discounter X	4.4	3.8	0.6
Soft Discounter Y	4.5	3.5	1.0
Hard Discounter Z	4.2	3.7	0.5
Hypermarket X	3.8	3.6	0.2
Hypermarket Y	3.9	3.7	0.2
Hypermarket Z	4.2	3.9	0.3

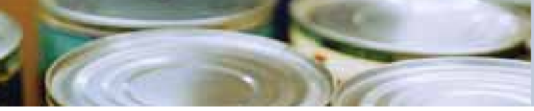
Source: McKinsey shopper research

The double-edged sword

Many of the keys to discounters' success can act as a double-edged sword. The same factors that promote their growth and profitability can also limit their appeal.

Limited assortment

While narrow range both provides cost savings and pleases certain shopper segments, it also leaves many shoppers dissatisfied. Across every market, over 40% of shoppers strongly agreed with the



statement, "I like to have a big choice where there are lots of products offered even if I'd probably never buy some of them."

To satisfy shoppers who prefer choice, discounters are, to a certain extent, dependent on the existence of players with richer assortments. Limited-assortment shopping becomes much more palatable when shoppers know that a full assortment is available to them elsewhere. In this sense, discounters rely on the larger stores' full range of slower-moving items. This isn't necessarily bad news for full-range stores - it means that most discount shoppers are still visiting non-discount stores, and that they might be won back.

Private label

Discounters' emphasis on private label products can also be a disadvantage. Despite discounters' best efforts to highlight the quality of their store brand products, roughly 40% of shoppers still prefer name-brands, even if that means paying more (Exhibit 19). Branded products are particularly important to the Demanding Shopper and Pure Premium segments, which together make up one-third of European grocery spend.

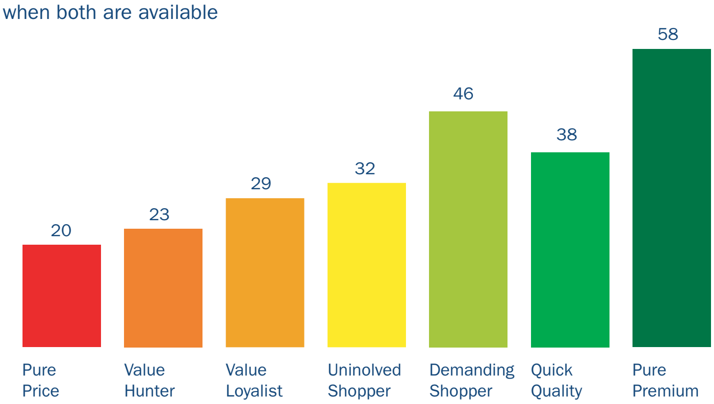
Non-food promotions

Recently, there have been well-publicised signs that discounters' non-food sales are weakening. This is particularly the case in Germany, where non-food sales have historically been the strongest. The German press claims that in 2004 Aldi had a "mountain of stock left over from the previous year" and that inventory levels had increased by a staggering 45%.

In order to cope with the backstock, Aldi opened a non-food store format in April 2005. This store - called 1001 - is "needed so as to make space in the stores," according to a company spokesman quoted in German trade publication Lebensmittel Zeitung.

exhibit 19

Name brands are important to shoppers across all segments
Percent of respondents who prefer buying name-brands to store-brands when both are available



Source: McKinsey shopper research

The need for such non-food outlets might actually be a sign of market super-saturation. Discounters, after all, have not been the only retailers to capitalise on non-food margins. Many German grocers have increased the size and frequency of non-food promotions. A portion of the marketspace has also been filled by Tchibo, a highly successful coffee retailer that sells more non-food merchandise than coffee.

Recent discounter stumbles also highlight the logistical challenges associated with selling non-food. Discounters have made an asset of the simplicity of their model. But a retailer needs highly sophisticated purchasing capabilities to be capable of searching out a steady stream of good deals across a diverse set of categories. Refined forecasting, pricing, and allocation techniques are needed to achieve seamless sell-through at the store level. If these capabilities fall short or if shoppers' responses become more erratic and harder to predict, non-food sales can add significant complexity at the store level: extra management of markdowns and handling shop floor allocation for the residual product, for instance.

Relentless end-to-end cost focus
Discounters' end-to-end focus on cost has run into trouble recently. Suppliers are protesting more vocally about the continuously increasing pressure to lower their prices. Meanwhile, a business culture premised on keeping costs at a minimum risks alienating employees. Hard discounters are increasingly attracting the scrutiny of employee groups. For example, the German trade union Verdi has recently issued a "Black Book" detailing its allegations against Lidl. Whether these objections will boil over into something more serious remains to be seen, but it suggests that clear skies may not lie ahead for hard discounters.
All these shortcomings of the discounter economic model - from limited product offering to troubled labour relations - suggest that while discounters are continuing to gain market share by expanding their networks they nonetheless face some challenges of their own.

It is important to remember, after all, that while the discount model is admirable in its simplicity it is also, by design, relatively inflexible. Successful discounters run a single standard format (or operate autonomously within a multi-format parent). Individual stores have very little power to customise assortment, and the central organisation incorporates new SKUs only after they are proven in other retailers. Additionally, they lack a sufficiently robust field structure to support decentralised decision making or the management of more complex organisational processes.

Nevertheless, discounters have not stood still. The next chapter discusses ways that they have attempted to overcome their limitations, and speculates on some of the strategic decisions discounters have made as they look to the future of the European grocery market.

Key Messages

Discounters' like-for-like performance outside of Germany has been negative in recent years. Even in Germany, growth has slowed.

Outside Germany, few shoppers list discounters as their primary store, and even those who do rate them below other stores on most factors except price.

The sources of discounters' economic strengths can also limit their appeal or create challenges:

- Limited assortment is undesirable to those 40% of shoppers who strongly prefer a larger range
- Despite discounters' emphasis on private label, well-known and trusted name-brands are important to many shoppers
- Discounters' extreme end-to-end cost focus faces challenges from employees and suppliers
- Non-food promotions are generating less predictable sales results and more logistical complications than in years past.

THE IMPORTANCE OF MARKET CONTEXT: DISCOUNTERS' EXPERIENCE IN THE UK

In the early 1990s, both Aldi and Lidl entered the UK. Discount share peaked at 10% in 1996. Since then, they have been in decline. As of 2004, the combined share of the UK's major discounters - Aldi, Lidl, Kwik Save and Netto - was a feeble 4%. Several other discounters have come and gone in the meantime: Penny and Carrefour's ED both abandoned the UK in 1995; Food Giant and ASDA's Dales withdrew in 1999.

Only one British shopper in five visits a discounter regularly. And that one shopper has quite differentiated demographic characteristics. Whereas discount shopping in Germany cuts across all socio-economic categories, the UK's discount shoppers tend to have larger families and are predominately from the lower socio-economic strata.

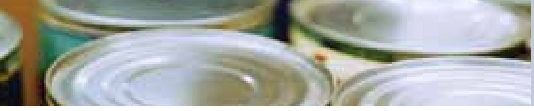
In a typical month, barely a tenth of the British population shops at Lidl; 50% of UK shoppers say they have never visited a discount store. Such unfamiliarity with the discount model does not stem the formation of strong opinions, though. The prevailing winds of public opinion in Britain are surprisingly hostile towards discounters. In fact, in a recent survey of the top ten most hated brands in the UK, Lidl was number 7[1].

Why have discounters failed to thrive in the UK? Many explanations have been offered for discounters' lacklustre performance in the UK. On the surface, the biggest stumbling block has been poor customer acceptance and perceived low quality. Several other factors probably played a role:

- Discounters' market entry in the early 1990s happened to coincide with ASDA's turnaround led by Archie Norman and Tesco's revitalisation under Lord MacLaurin. As a result, discounters faced a particularly competitive environment.
- When discounters entered the UK, the major grocery players already had a strong private label offering - roughly 65% of Sainsbury's sales were from private label. Shortly after discounters' arrival, these retailers launched economy ranges. As a result, discounters faced a strong price-competitive offering on basic goods.
- Though planning permission can be difficult to obtain in the UK, such permission is based on the ability to demonstrate local-market need, not on store size. As a result, discounters in the UK have not been able to outmanoeuvre supermarkets through expansion, as they have elsewhere in Europe.
- The gap in operating costs between discounters and non-discounters is smaller in the UK than it is in Germany. Discounters' ability to run on fewer labour hours is a vital source of strength in Germany's sclerotic labour market. It is less valuable in the UK, where wages are lower relative to other operating costs.
- Discounters failed to adapt their model to the preferences of UK shoppers quickly enough. Up until 1999, neither Aldi nor Lidl accepted credit cards, despite the fact that UK shoppers of all classes rely on credit cards even for small purchases.

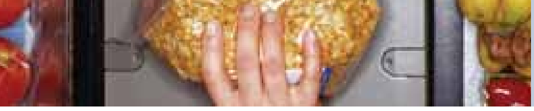
Despite these disadvantages and missteps, it is too early to sound the death knell for discounters in the UK. Aldi and Lidl are both well-funded private companies with a proven willingness to stay for the long haul. To date, neither company has ever exited a market they have entered. And elsewhere in Europe, they are becoming savvier, demonstrating an ability to evolve their offering in ways that make them more appealing to consumers. The road ahead, however, is uphill and steep.

[1] Joshua Consumer Check, 2004



CHAPTER 5

What Does the Future Hold?



So far, we have provided a view of the current retail environment in Europe, concentrating both on shopper insights and on the way that discounters have oriented themselves towards the delivery of price-focused value. But general trends in the retail sector will also play a part. Of course, it is not possible to fully predict how shoppers' preferences will change over time. But it is worth discussing some overarching changes within discounters themselves, shopper opinions, and the broader marketplace.

The hard discounters are expanding and modifying their assortment

Hard discounters seem to be recognising some of the limitations of their model, and are modifying their approach accordingly. Most significantly, given the importance of limited assortment for discounter value delivery, both Aldi and Lidl are gradually expanding their assortment.

New categories

Since 1995, the number of items carried in Aldi and Lidl stores in Germany has nearly doubled.[4] For Aldi, roughly a third of this increase was due to the addition of new categories.

In Germany, the hard discounters have entered an average of one new category every year (taking non-food promotions into account, category expansion is increasing even more dramatically). By augmenting their offering with important categories, particularly in perishables, hard discounters seem to be working to become one-stop-shop grocery stores. This might well be an effort to improve their primary-shopper conversion rates outside Germany.

exhibit 20

Hard discounters are gradually expanding into new categories

Year	Aldi Nord	Aldi Süd	Lidl
1999	Fresh milk	Frozen food Ice cream	—
2000	Prepared salads Incontinence products	Prepared salads and dressing	—
2001	Organic food (milk, potatoes)	Organic food	—
2002	Organic food (tea, cheese, margarine)	Cigarettes	Fresh poultry
2003	Fresh meat	Fresh meat	Fresh meat
2004	—	Cosmetics Wellness products	Wellness products

Source: Press clippings, GfK, Preiseiger

Looking forward, we expect hard discounters to expand their ranges significantly in health and beauty products, a category that Aldi and Lidl entered in 2003. In addition, because much of hard discounters' successful expansion into new categories has happened in Germany only, we expect to see similar category growth in other markets.

Aldi's shift upmarket

Hard discounters seem to be trying to appeal to a broader set of upmarket shoppers by offering a larger selection of upmarket and speciality goods. In 2003, for instance, Aldi UK added speciality goods that mirror the selections available at major UK supermarkets, including hand-cooked crisps and "bhaji bites" snack food. Additionally, Aldi is cultivating a more upmarket image through promotional campaigns that integrate both food and non-food items. For example, a recent Italian food promotion included speciality flavoured oils and bruschetta toppings, as well as grappa glasses and pasta-cooking pots.

> If you haven't been shopping at Aldi for a while, you may be surprised to know that the no-frills chain carries gourmet food. Yes, stacked on packing boxes right there next to the 29-cent cans of dry food and 49-cent bags of egg noodles sit upscale foods from the company's new Grandesse line, products like lime pineapple frozen juice bars, artichoke garlic salsa, oatmeal cranberry cookies and roasted chicken and Portobello mushroom ravioli.
>
> **- Springfield, IL State Journal Register, April 2004**

[4] In some instances, this increase in items does not result in a corresponding increase in SKUs. Sometimes, multiple varieties of discount products come in the same carton, thereby carrying the same SKU number. Source: Markant Handelsmagazin March 1995, Preiszeiger

Some observers also believe that Aldi may have taken away important lessons on quality perception from its re-launch in the UK, and may be considering new convenience-oriented and upmarket offerings. In early 2004, it even experimented with in-store baked bread.

More brands at Lidl

More and more name brand products are being added to Lidl's assortment. As reported by trade magazine Lebensmittel Zeitung, Lidl's expansion of its drugstore lines has included agreements with Procter & Gamble and Nestlé, while negotiations with Beiersdorf and Henkel are well underway.

As Exhibit 21 demonstrates, branded products are increasingly appearing on hard discounters' shelves alongside their store-brand equivalent. There are several drivers:

exhibit 21

Hard discounters are stocking more branded goods

"Necessity is the mother of invention, and there is lots of talk about how brands and hard dis-counters can happily co-exist"

Financial Times, March 2005

Source: Financial Times, McKinsey store visits

- Shopper preference. Across the five markets recently surveyed, roughly 40% of shoppers stated that they favour branded products. Even in Germany, 27% of shoppers say they "always" or "more often" buy branded products when available.
- Category-specific drivers. As Exhibit 22 illustrates, the hard discounters get less than their "fair share" in categories where brand loyalty is particularly high.
- Branded manufacturer willingness to sell to discounters. Even given shopper demand for brands, discounters would find it difficult to offer branded products unless branded manufacturers were willing to work with discounters in the first place.

> Selling to discounters is like a drug. It's profitable, but I know there are long-term consequences. And the more you do it, the harder it is to stop.
>
> **Interview with a leading European supplier**

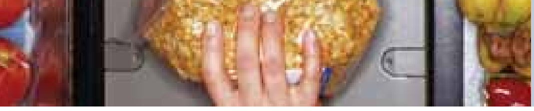
In light of discounters' rapid expansion, relatively predictable item-level sales volumes, and lower costs to serve, branded manufacturers are increasingly willing - even eager - to sell to discounters. According to the Financial Times, there has been a "change in the attitude of food and drink companies to Europe's hard discount chains…As supermarket sales sag, they are selling brands through outlets they used to regard as hostile territory."[5]

The consequences for non-discount retailers are serious. At a recent meeting with suppliers, for instance, one hypermarket executive arrived with a basket of their goods purchased at a local hard discounter for less than those same products cost him wholesale. As branded products are sold at ever lower prices through discounters, shoppers will come to expect lower prices for those goods in other channels as well. Hitherto, non-discount retailers have been able to differentiate themselves from hard discounters through their name brand offer. The growing presence of name-brands at hard discounters, therefore, threatens to undo one of the greatest strengths of non-discounter grocers.

Increasing competition between discounters in Germany

More than 90% of the German public live within 20 minutes of an Aldi store. As a result, the hard

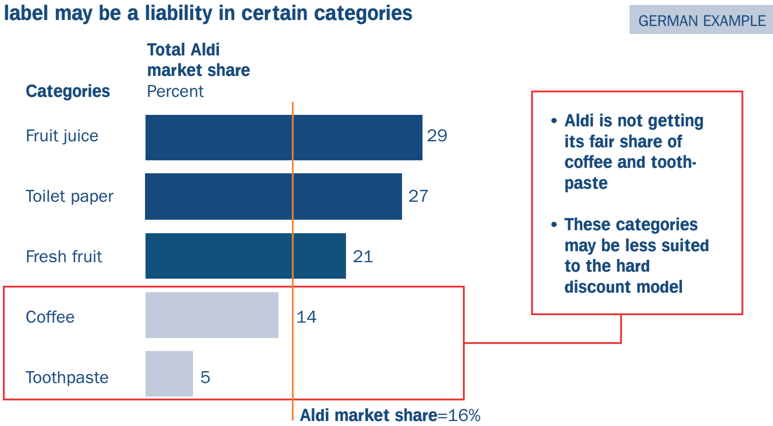
[5] Financial Times, "Brands Get the Worst of a Hard Bargain," Thursday, March 17, 2005



discounters are increasingly battling one another for incremental sales. In October 2004, Aldi Nord heralded a dramatic new round of price reductions to reconfirm its price leadership, most notably slashing its meat prices and broadcasting a new slogan: "Fresh Meat, New Prices. Not just for a few days - as always, forever." Lidl shortly followed with price cuts of its own.

exhibit 22

The combination of limited assortment and exclusively private label may be a liability in certain categories



Source: McKinsey analysis

Hard discounters are also accelerating their marketing spend. In 2003, Lidl's above-the-line marketing spend was €271 million, up from €143 in 2001. That made Lidl the second-largest German marketing spender, just behind Procter & Gamble. Though Aldi spends somewhat less, it has also doubled its marketing efforts since 2001, bringing its 2003 spend to €188 million. These increases suggest that hard discounters need to work harder than in years past to attract and retain shoppers.

How far can the hard discount model be pushed?

Though hard discounters are testing the boundaries of their abilities to support complexity, they are moving cautiously. They tend to test new products by offering them first as non-food promotions and then in a group of pilot stores before adding them as provisional "test" products in all stores. Additionally, they regularly de-list products that do not achieve sales targets. This unrelentingly strict approach is designed to ensure that new items do not dilute hard discounters' purchasing power or significantly impact the stores' overall operating efficiency.
The jury is still out on whether hard discounters will sustain their sales growth through new categories, broader assortment, and the introduction of more branded products. Almost certainly these changes will mean that tomorrow's discounters will increasingly look like small supermarkets, with the additional complexity that that implies. The extent to which they are able to maintain their economic advantage while they do this is a significant unknown. The caution with which they are moving forward suggests that it is an unknown to them as well.

Shopper trends

At the same time that retailers try to tailor their assortment to shopper needs, those needs are constantly transforming. Even though we have identified shopper segments, there is no reason to believe that the characteristics of each segment are static, or that the size of each segment will remain the same in coming years. We have identified several macro shopper trends - including time poverty, obesity, and the ageing population - that might well influence the segments.

One major shopper trend is increasing time poverty. As more and more demands are placed on individuals' lives, shoppers have come to realise that time really is money - and that it is an appreciating currency. Accordingly, shoppers are increasingly seeking offers that save them time. Expectations of convenience are already quite high for Quick Quality and Uninvolved Shoppers, and we expect them to continue to rise. But we witness this trend occurring across the whole population, even to less convenience-oriented segments such as Value Loyalists and Demanding Shoppers. In fact, the trend towards convenience extends to food preparation as well as to grocery shopping. Many people are loath to spend a half hour or longer preparing their evening meals, preferring to buy ready-made meals or eat away from home. As food prices continue to drop, home meal replacement continues to become more frequent. Indeed, in some US cities apartments are now being built without kitchens. This trend represents a threat as well as an opportunity. The most convenience-oriented segments, such as Quick Quality and Uninvolved Shoppers, may abandon more traditional grocery stores altogether in favour of takeaway and prepared food. Other segments, meanwhile, might become increasingly attracted to the convenience section of grocery stores.

Another clear trend is the growing public awareness of the obesity epidemic, which has spread from the US to Europe. Packaged goods companies are offering an ever-growing number of healthy eating alternatives. So far, we have not yet seen this trend result in increased shopper focus on high-quality perishables. But the healthy eating trend has created its own market, as manufacturers and retailers tap into latent demand for nutritional products. This implies that introducing innovative health-oriented products quickly might provide retailers with a first-mover advantage. Since discounters are rigidly centralised and slow to stock new SKUs or categories, the trend towards healthy eating can provide non-discount retailers an advantage.

Another important demographic trend is the ageing of the European population. The effects of this ageing are extraordinarily complex, but several effects seem likely. As health care costs continue to rise, pensioners will find themselves with less disposable income, perhaps discouraging the purchase of premium groceries. Their strong desire to feel younger longer might encourage demand for more nutritional products. If labour becomes scarcer, as seems likely, we would expect wages to rise. This might well confer an extra advantage on labour-saving business models such as the discount format.

Finally, there are signs of a shift in shopper sentiment whereby trust is becoming a competitive differentiator for retailers. Rather than evaluating stores on the collective value of individual products on offer, shoppers are increasingly taking ethics into account. Some shoppers, for instance, attach value to their perception of a store's trading practices (e.g., it offers Fair Trade goods). Still other shoppers come to expect environmentally-friendly, organic, or free-range products. Food safety has become another particularly important dimension of trust since the outbreaks of bird flu in 2003 and the continuing worry over BSE. As shoppers become increasingly attuned to stores' performance on the "triple bottom line" of corporate social responsibility, trust will become even more important.

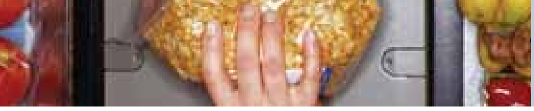
Marketplace trends

Aside from the trends in discounter and shopper behaviour, there are more general changes to the retail landscape that promise to change the nature of competition in the grocery sector.

The nature of competition within the grocery sector is changing. Channels are blurring: at the same time that grocery retailers compete on the non-food category, more and more non-food outlets are selling food. As one major US grocery chain commented, ''we can't just myopically look at [other supermarkets], because we're also in competition with non-supermarkets. We have to consider the Walgreens, the Rite Aids, Costco, Sam's, Target and Wal-Mart and also the dollar stores that sell some of the same things we do.'' Meanwhile, global trade is changing the nature of non-food competition. The blossoming of international sourcing has magnified the availability of very low cost items. This is not without side-effects: consumer durables are becoming so inexpensive - irons for £5, cashmere jumpers for £20 - that shoppers have begun to treat them as disposable goods. As a result, shoppers might begin to become less discerning of quality, instead increasingly demanding ever lower prices.

To keep track of these changing shopper demands, it will continue to be essential to harness the power of IT. Mass marketing becomes less and less effective, since the most successful retailers have developed much more sophisticated and targeted customer insights through the use of loyalty card data. Technology can help create more personalised offers, localised assortment and pricing, and even better performance on convenience through online shopping.

Technology can help on the supply side, too. Radio frequency identification (RFID) has offered a new frontier of supply chain efficiency, for instance. Historically, hard discounters have proved to be slow



adopters of new technology - they introduced scanners only in 2001, and they still fax vendors rather than using EDI. By investing enough attention and resources into the appropriate technology, non-discount retailers can reduce discounters' cost advantage while also making themselves fit shopper segments better.

Conclusion

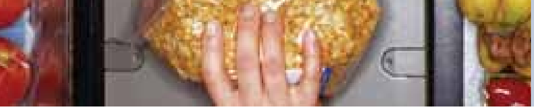
Looking across these trends that are shaping discounting, shopper behaviour and the broader marketplace, we see reinforcement of the broad trend toward value - discounters are refining their models to fit a broader set of value definitions, shoppers are increasingly demanding on many aspects of the value equation, and non-discounters are mobilising to respond to this new environment. Of course, what the future holds is not written in stone. In fact, the choices of non-discount retailers and packaged goods manufacturers are likely to have a significant influence on the outcomes. If they leave space for discounters, by failing to respond to shoppers' demands, the continued growth of discounters will itself influence shoppers. On the other hand, if they develop a compelling benefits-focused offer to serve the 80% of the market that cares about more than just price, the future may hold more loyalty and profitability than many now imagine.

Key Messages

The hard discounters, perhaps cognisant of the limitations to their business model, are expanding into new categories, upmarket private label products, and more name-brands. They have also increased marketing spend as they fight each other for market share both in Germany and beyond.

Convenience is becoming ever more important as an increasing number of demands are placed on shoppers' time. Awareness of the obesity epidemic is prompting demands for healthy eating. Meanwhile, the ageing of the population is certain to create new demands on European retail.

Within the broader marketplace, retailers are aiming to differentiate themselves through global sourcing and information technology.



CHAPTER 6

Meet the Bar on Price

Retailers must learn from discounters

Armed with the knowledge of how different shoppers determine good value as well as an understanding of how discounters are able to deliver on the price components of value, it is now time to look more closely at strategies to go forward. How should a non-discount retailer respond to the rise of discounters? How can it stay competitive?

The best way to respond to the rise of discounters is not to imitate them obsessively. Discounters successfully deliver on value for certain shopper segments, but those segments make up a limited portion of the market. Discounters are the symptom of the larger trend towards value; they are not the cause of that trend. Instead of trying to ameliorate the symptom, retailers are better advised to seek a remedy by concentrating their efforts on responding to the value trend.

In order to win on value, a retailer has to both "meet the bar on price" and "raise the bar on value." Raising the bar on value means deciding which segments to target and serving their rising expectations. Before a retailer can raise the bar on value, however, it must meet the bar on price.

Of course, "meeting the bar on price" does not mean that all grocery retailers should lower prices across the board. Instead, it means first getting credit for the value you already provide to your shoppers. Here, there is much to learn from the efficiencies of the discounter model. Selective application of those efficiencies can go a long way towards improving retailer price positioning.

Ensure that shoppers understand your price position

It is possible to persuade shoppers that non-discounters are not as expensive as they think . But that requires clear and consistent shopper communication every step of the way, from marketing through to in-store signage and value cues.

exhibit 23

Lessons you can learn from discounters

Ensure that shoppers understand your price position	• Provide **clear and consistent shopper communication** every step of the way, from marketing through to in-store and value cues • Ensure **Known Value Items** are competitively priced • Generate **excitement** by selectively providing unbelievable prices • Reinforce message of **no compromises on quality**
Do not invest in activities that shoppers do not value	• Understand **the true costs and benefits of range**, and make thoughtful decisions about where to invest • Minimise supply chain costs by **optimising the ratio of handling units to sales units** and by partnering with suppliers • **Work "shopper back"** to simplify the in-store and head office operation and to eliminate wasted activities

Source: McKinsey analysis

At Lidl-owned Kaufland, for instance, billboard-sized signs reinforce a low-price message the entire time a shopper is in the store. Repeatedly emphasising low prices boldly tells shoppers that a retailer is happy to be compared on prices. (Exhibit 24)

At Colruyt, a Belgian soft discounter, value cues exist throughout the store: from television screens that document price checks at competitors to verify that Colruyt's prices are lowest, to the Spartan, warehouse-like environment of the store.

Meeting the bar on price is not just a matter of marketing. Competitive retailers must demonstrate that they are capable of delivering truly competitive prices. Here again, discounters offer a valuable lesson.

Because they limit their offer to a minimal number of SKUs and take advantage of resultant buying scale and labour savings, discounters often succeed in beating competitors' prices on the 200 or so Known Value Items that are most critical to attracting primary shoppers. By disproportionately investing in those items and categories that reinforce overall value position, a non-discount retailer can harvest the same benefits.

Exhibit 24

Discounters provide clear and consistent communication

Source: McKinsey store visits

Exhibit 25

Discounters reinforce the message that they do not conmpromise on quality

Source: McKinsey store visits

Results of product testing emphasized through large in-store signage

Proof of freshness in fruits and vegetables demonstrated with free samples

In addition to being competitively priced on Known Value Items, a retailer can meet the bar on price by generating excitement through unbelievable prices on certain items. Trader Joe's, an American retailer owned by Aldi, is famous for its "2-Buck Chuck," a rotating selection of high-quality wines sold for $2. Efforts to get credit for low prices can backfire if a shopper thinks quality has been sacrificed. It is crucial, therefore, to reinforce a message of "refusing to compromise on quality." By doing so, a retailer can make sure that it doesn't gain on price perception only to lose out on quality perception.

One of the reasons that discounters have proven so successful in certain markets is that their private label products are not seen as low quality goods. Aldi and Lidl have cultivated a high quality image by demonstrating that its products perform very strongly on taste and nutrition tests. Some discounters employ even more creative ways to demonstrate they care about the quality of their products. In the image of oranges above, for instance, Colruyt not only offers free samples, but explains with signage that those oranges are in season and are at their best that week.

Do not invest in activities that shoppers do not value

The other essential plank of meeting the bar on price is investing only in those activities and products that shoppers care about.

There is no point creating space for a large product range in categories where target shoppers are looking for a carefully-chosen selection. Realising this, Aldi offers only two to five varieties of toilet paper in the UK, Germany, and France; some retailers in those markets offer more than 60. Given the significant incremental cost of having extra SKUs, it is worth learning from discounters' decision to limit product offerings severely.

A retailer must understand the true cost of range and invest wisely in the right balance of SKUs. Here, shopper research becomes key. Too much variety is costly and unnecessary or even damaging, since it makes a store more difficult to navigate. The Uninvolved Shopper and Quick Quality segments, in

Exhibit 26

Mixed SKU cartons, or mixed pallets, where pallets are impractical

Source: McKinsey store visits

particular, react negatively to too much selection. On the other hand, eliminating too many items can have a dramatically negative effect. Rather than implementing a blanket reduction of SKUs across all categories, retailers should understand the true cost of range and make thoughtful decisions about where to invest.

Even when a retailer elects to offer a large choice in certain categories, there are ways to maximise the use of efficient stocking methods. Stocking items on shelves as eaches can cost up to 2.5-3.0% of sales in labour costs. Switching to cartons can halve those costs. Stocking items on pallets can reduce labour costs substantially.

When a retailer cannot achieve the scale to make single-SKU pallets feasible, there are other ways to increase stocking efficiency. Here, working more closely with suppliers is a key opportunity to take cost out of the system. Mixed-SKU pallets and cartons, for instance, offer tremendous labour savings without requiring a sacrifice in product variety.

Understanding shoppers' preferences can offer other ways to cut down on costs. Working "shopper back" to simplify in-store and head office operations and to eliminate wasted activities is absolutely necessary to stay fit enough to compete. If a retailer's shoppers are willing to wait a few extra moments at the checkout, it is worth redirecting employees towards activities that shoppers value more.

As always, the most important way to decide which strategy to pursue depends on the segments a store serves or would like to serve in the future. All of the activities mentioned so far are techniques to deliver on the price aspects of value. Remember, that does not require that a retailer offer the lowest prices around. Price is not the only component of value, and shoppers will weigh a store's price offering against its other characteristics. Getting full credit for the value you offer today while taking extraneous costs out of operations are "no-regrets" moves. By heeding some of the lessons of discounters, supermarkets and hypermarkets can get a leg up on their competitors.

Key Messages

In order to be competitive in today's environment, every European retailer must "meet the bar on price."

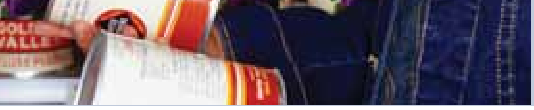
Meeting the bar on price does not require slashing prices to the level of the discounters.

Clear and consistent shopper communication - including signage and value cues - and well-priced Known Value Items are essential to establishing a competitive price position.

The key to removing expense is to work "shopper back," identifying your shoppers' needs and modifying your operations accordingly.

CHAPTER 7

Raise the Bar on Value



The steps described so far - getting credit for the value you provide and eliminating unnecessary costs by working shopper-back - are essential to staying competitive today. But what about tomorrow? Shopper expectations and competitive standards are rising rapidly. Meanwhile, non-discount retailers find themselves competing with one another for a piece of a shrinking market, increasingly eroded by discounters' market share gains and price deflation. Although meeting the bar on price is essential, it is likely to be insufficient to deliver sustained growth. Retailers that survive and thrive will be those who "raise the bar" by becoming famous for something that their shoppers care about.

Decide which shopper segments to serve

Part of the reason discounters have been so successful is that, rather than trying to please all shoppers all of the time, they have oriented their value delivery to satisfy the two most price-oriented segments in the market. The single most important strategic move a grocer can make in today's value-driven environment is to decide which segments it aims to serve.

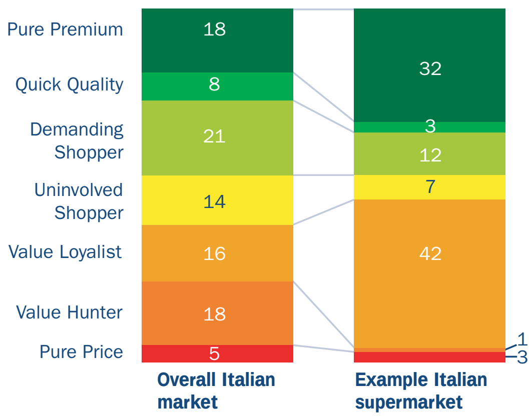
There are three different ways to successfully deliver value to shoppers. Niche players concentrate their efforts on providing outstanding value to just one or two segments. Some large retailers pursue multiformat strategies whereby the preferences of different segments are met by different types of stores. But the vast majority of successful retailers aim for a broad appeal - not for the entire spectrum of shoppers, but for 3 or 4 segments with overlapping needs - within a single format.

Which path a given retailer should choose to pursue depends on its size and its market strength. For most retailers, being selective about whom to serve is crucial: over-ambition often results in underdelivery. It is, therefore, worth taking the time and energy to decide which shopper segments to target.

Who should your target shoppers be? For one thing, you will want to think about how each segment fits with your existing brand and capabilities. Here, learning about the segment composition of your current shopper base is an important guide. Exhibit 27 compares the segment profile of an Italian supermarket to the segment profile of the Italian market overall. This retailer serves a disproportionate proportion of Value Loyalists and Pure Premium shoppers, suggesting that it is successfully providing a large range of products and services. Its weak performance among Quick Quality and Uninvolved Shoppers might reflect a perception that it takes a long time to get in and out of this store.

exhibit 27

Italian segment composition
Percent of segment



Source: McKinsey shopper research

Next, a retailer should evaluate whether it has room for growth within the segments it already attracts. What is the demographic and attitudinal trajectory of the shoppers in its national market? Will all those Value Loyalists being served by the Italian supermarket become Demanding Shoppers in 10 years' time?

Then, a retailer should consider the competitive intensity it will face while battling for each segment. The most price-sensitive segments may already be tapped out in some markets. But over one-fifth of the Italian market is made up of Demanding Shoppers. Might it be worthwhile for the supermarket to try to attract more of them?

If a retailer has a relatively undifferentiated segment profile - if its shoppers' segments closely mirror the market average - it might want to concentrate its efforts on targeting certain types of shoppers. After all, with a few notable exceptions, most retailers cannot effectively grow their share of more than a handful of segments simultaneously.

Finally, if a grocer finds that it needs to look outside the segments it currently serves for growth opportunities, it should evaluate the attractiveness of "adjacent" segments. For example, the Italian supermarket has a value proposition that clearly attracts Value Loyalists. Perhaps it could attract Uninvolved Shoppers or Demanding Shoppers. But to attract other segments, a retailer needs to become well-known for offering something that shoppers in those segments find attractive: to become "famous for" something.

Become "famous for" something

Discounters are well-known for being very inexpensive. To achieve this reputation, it was not enough for them to provide consistent price communication and to work "shopper-back." They also organised around a simple theme - simplicity - and took every possible cost out of their operating model. As a result, they became "famous for" having the absolute lowest prices.

Other grocers have managed to differentiate themselves by adding in extra features or benefits. In the US, for instance, Whole Foods has chosen to be famous for its eye-catching displays and gourmet environment (offering everything from day-long wine tasting events to personalised party menu planning). This has successfully attracted premium shoppers: the retailer has recently grown like-for-like sales by 14%.

Broadly speaking, then, "raising the bar" means either radically taking cost out of the operating model or pushing the envelope on some aspect of benefit to the shopper.

Examples from other industries that have faced a trend toward value can help to demonstrate these two alternatives. In the airline industry, two types of players are successfully responding to value. There are low-cost, no-frills players such as Ryanair. Much like hard discount grocers, these airlines eliminate all but the essential aspects of their offer to provide the lowest possible price points. There are also successful players who make their offering more appealing to customers by adding special benefits to the air travel experience. British Airways, for instance, pioneered a full length-flat bed in business class. They still offer highly competitive prices for business class service, but their competitive advantage comes from being known for comfortable in-flight sleeping.

A similar dynamic is visible within apparel retail. Some players focus almost exclusively on radical cost reduction. TJ Maxx, for instance, features very low price points in relatively disorganised stores that operate at very low cost. On the other hand, retailers like Zara succeed by being famous for its knowledge of fashion trends. By offering highly fashionable merchandise and displaying it attractively, Zara raises the bar through added benefits. And by charging less than you would expect to pay for up-to-date fashion, it meets the bar on price.

It is clearly impossible to be "famous for" everything. Grocery retailers must, therefore, distinguish themselves on one or two of the six elements that make up the value proposition - price, promotion, quality, convenience, range, and in-store experience - while remaining competitive on all the others. Only then can retailers fully reenergise their brands to reflect their revised value positioning.

In fact, the shoppers a grocer chooses to target should determine both which elements of value to emphasise and how to emphasise them. This creates an extra challenge to delivering successfully on value: what makes for good promotions for one segment of shoppers might be very different from the sorts of promotions another segment enjoys, for instance. While value hunters love the thrill of hunting for the best promotional offers across the entire store, demanding shoppers will be impressed only with good deals on name-brand items.

To succeed in raising the bar on value, in other words, a retailer must always remember which shoppers it aims to serve. Recall that in chapter 2 we discussed ways to decide which segments to target. Just as it did in the previous chapter, the decision about which shoppers to target should reverberate throughout the rest of a retailer's strategy.

Raising the bar, one segment at a time

Knowing which segments it would like to target, a retailer should aim to become "famous for" the elements of value that those shoppers care about the most.

The hard discounters, for instance, have tailored their entire offer to suit the Pure Price segment. Rather than adding in benefits, Aldi and Lidl opt to radically take cost out of the system, thereby becoming "famous for" the absolute lowest prices. To maintain their distinctiveness on price, the hard discounters are explicit about how their stores are able to keep prices so reliably low. This builds trust among their Pure Price shoppers.

The hard discounters also remain competitive on the other elements of value as interpreted by their target shoppers. Although their stores may sometimes have long queues, Aldi and Lidl recognise that their shoppers do not evaluate a store's convenience based on this. Instead, Pure Price shoppers find the accessibility of local stores, the wide aisles, and the tailored selections of the discounters very convenient. Their warehouse-like store environment, while unappealing to the premium segments, actually contributes to the in-store experience of Pure Price shoppers, who respond to such value cues. And while some segments might find the lack of many name-brands an indicator of low quality, Pure Price shoppers believe discounters provide private label products of reliably high quality.

As mentioned in Chapter 2, it might be dangerous to compete with the discounters for the Pure Price shoppers. So how might a retailer orient its value offering for other segments?

Let's take Quick Quality shoppers. We know that they like to buy high quality products but that they hate spending too much time in grocery stores. To win over these shoppers, a retailer should become "famous for" high quality items and a streamlined store experience. Since Quick Quality shoppers become frustrated with too large a range, the retailer needs to maintain a narrow assortment. Rather than shrinking food categories and taking out speciality products, however, the retailer should reduce its range by cutting out its low-end products. It might even add more high quality home-meal replacement products.

A grocer aiming to serve Quick Quality shoppers might include high quality service counters, but must be sure to keep them heavily staffed both to ensure short queues and to reinforce shoppers' impressions of attentive customer service. It should stock complementary items near each other - placing salads, dressing, and croutons next to each other, for instance. While the retailer should avoid being too large (Value Loyalists might enjoy the in-store experience of hypermarkets, but Quick Quality shoppers hate it), it should have many more till points than stores of comparable size. It should locate stores near urban centres or within easy reach of public transport and provide plenty of parking.

Every segment, of course, has its own criteria for what makes a store truly distinctive. When deciding what to become "famous for," keep in mind Exhibit 28, which offers a few examples of how the value expectations of each segment might be matched.

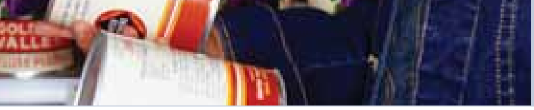
It would be prohibitively expensive to follow every one of these suggestions in the same store. Besides, some of them are actually contradictory: you cannot offer the full range of products that Value Loyalists love while simultaneously providing Quick Quality shoppers with a narrow assortment of high-quality

exhibit 28

Being famous for what segments care about

Pure Price	• Emphasise reliably low prices • Provide value cues throughout the store
Value Hunter	• Provide frequent promotions to generate excitement • Link your best deals to loyalty programmes to staunch their tendency to cherry-pick
Value Loyalist	• Offer a full range and additional in-store promotions • Provide consistent communication and pricing to build trust
Uninvolved Shopper	• Create a no-hassle experience, possibly with a “racetrack” format signposted by familiar brands • Consider developing easy-to-use online shopping
Demanding Shopper	• Offer lower-cost private label as well as higher quality branded items • Make sure to offer good deals on key value items
Quick Quality	• Provide a narrow assortment, focusing on high quality food • Invest heavily in till staff
Pure Premium	• Offer distinctive, high quality private label • Create an upmarket in-store look and feel, with high levels of service

Source: McKinsey analysis



items. To serve multiple segments, a retailer must either maintain a careful balance within its existing stores or develop multiple formats which more closely meet the diverse set of shopper needs. Does this mean that non-discount retailers need to develop a new format? The answer largely depends on how well your current model fits the segments you aim to serve. A relatively upmarket grocer that already has strong leadership within Pure Premium can probably grow its share of Quick Quality shoppers by making its existing offer more streamlined and convenient. That same grocer would struggle to adjust its model to attract Value Hunters. If the retailer decided that Value Hunters were worth pursuing, it would have to seek recourse in a new store format.

This chapter has not, of course, provided an exhaustive list of what retailers might do to serve their shoppers' needs better. This is a good thing - retailers needn't be shackled to a small set of tried and tested strategies; they can innovate and create a truly distinctive offering. Becoming "famous for" something is an area where creativity and differentiation can really set you apart.

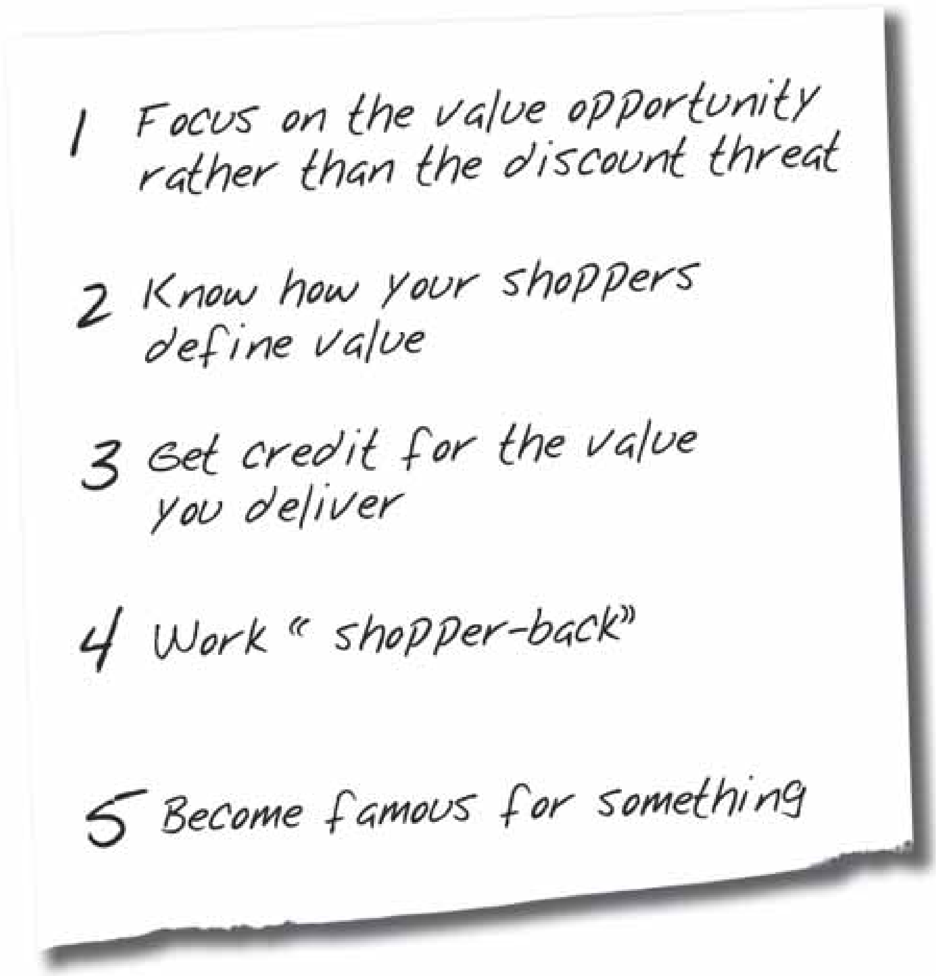
CHAPTER 8

Setting Your Agenda

Success in grocery retail means winning on value. This does not mean having the lowest price, and it certainly does not mean concentrating every effort on beating the discounters. It means discovering what value means for your target shoppers, and delivering on that.

A checklist for success

This report has aimed to provide a detailed study both of discounter retailers and of shopper preferences in a European context. Arming the reader with a better understanding of both, it has then sought to provide retailers with some guidelines for moving forward and succeeding in today's retail environment. To close, we provide a checklist for success that retailers can use to begin guiding strategic decision-making immediately. We believe that, by following this checklist, a retailer can inoculate itself from the discount challenge and ensure that its value proposition continues to attract shoppers into the future.



1. Focus on the value opportunity, rather than the discount challenge
While in some markets discounters are accumulating market share at alarming speed, the real cause for concern is their success in discovering how shoppers in those markets define value and then delivering on that value. In markets where discounters appear to have struggled or stumbled, retailers should save their anxiety for whichever non-discount retailers are most successful at delivering to shoppers' own nuanced definitions of value.

If, instead of concentrating on delivering value to specific shopper segments, retailers opt to obsess over discounters' strategies and behaviours, they will fail. The discounter model is very effective at what it does, and non-discount retailers will find themselves unable to compete successfully on such foreign turf. In the process of failing, these retailers will also abandon those shoppers who were satisfied with the value such stores used to provide.

2. Know how your shoppers define value

Instead of concentrating on winning over discount shoppers, a retailer should focus its immediate attention on coming to understand how its current shoppers define value. This requires an understanding of which segments visit its stores. Knowing this allows retailers to see for which components of value - price, promotion, quality, convenience, range, and in-store experience - shoppers give it credit. Coupling this with knowledge of the segment composition of the markets in which they operate, retailers can decide which segments to target in the future. This allows the retailer to settle upon specific strategies to help it successfully compete in the future.

3. Get credit for the value you deliver

One of those strategies is to meet the bar on price. Despite significant investment in pricing and promotions, however, most retailers are not getting credit for the value they already deliver. To get credit, it is essential to provide clear and consistent shopper communication, to price Known Value Items competitively, to generate excitement by selectively providing unbelievable prices, and by reinforcing a message of not compromising on quality.

4. Work "shopper-back"

Both Aldi and Lidl have homed in on an extremely effective "shopper-back" economic model which offers features only if they are valued by the Pure Price segment. While it is not advisable to try to win Pure Price shoppers for themselves, a non-discount retailer must deliver adequately on price for the shopper segments it seeks to attract.

This requires scrutinising every business cost to make sure that the resultant benefit is valued by the retailer's own shopper segments. Thoughtful decisions about where to invest in range are particularly important. Working with suppliers to take cost out of the system - particularly in stocking - can also go a long way on closing the perceived price gap.

5. Become "famous for" something

Meeting the bar on price is like moving up to the starting line of a race. A grocer cannot effectively compete without being at the starting line. But competing well does not mean winning. In order truly to succeed in grocery retail, it is necessary to raise the bar on value. This means making strategic decisions about how to serve target shopper segments better by becoming "famous for" something.

How to get a copy of the Report

Report XI of the Coca-Cola Retailing Research Council Europe, *Responding to Discount...A New Business Model for Food Retailers?* will be available from September 2005 in English, French, German, Italian and Spanish language versions. You can download a copy in the language of your choice by going to www.ccrrc.org and following the link to Europe.

The Coca-Cola Retailing Research Council, Europe

The Coca-Cola Retailing Research Council Europe (CCRRCE) is dedicated to the development of a better understanding of the food retailing and allied merchandise distribution business in Europe. The focus of its energies is to identify and then to study selected critical issues and problems and to present the findings in a suitable forum, so that full advantage can be taken to further develop the effectiveness of the food retailing distribution business.

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