Growing in Retail: win against the new 'barbarians'

By

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Why are Decathlon, Zara and Ikea continuing to gain ground in Europe, despite significant economic headwinds? And why are established and powerful market leaders such as the Carrefour hypermarkets, the Sephora beauty megastores and Tesco in the UK losing market share or at best maintaining them?[1]

Two factors explain these differing trajectories. Firstly the market share still held by 'historic' challengers and independent retailers. This share can still be grabbed by the leaders if these independents and challengers have not managed to catch up in terms of competitiveness. The second factor is the extent of the reach of new competitors, equipped with a different concept, who were of little or no significance on the marketplace ten years ago. A few examples: in less than a decade, the French E-Commerce pure player, CDiscount, has managed to become the top seller of televisions, ahead of the mighty incumbent, Darty/Kesa. Across Southern Europe, large hypermarkets (Carrefour, Auchan …) are losing ground against 'everyday low price' supermarkets such as Mercadona and Essalunga, Fresh specialists like Grand Frais in France, and non-grocery e-tailers such as Amazon and local pure players. In France, Italy and Spain, Sephora is losing market share to Kiko in the 15 to 24 age group and this make-up specialist is building a strong presence also in Germany. In France and Spain, La Plateforme du Bâtiment is challenging Point P-like builders' merchants and is grabbing more and more of the spend of small generalist tradesmen. And today in the UK, 'one pound' stores such as Poundland and discounters such as Lidl and Aldi are challenging the once growing multiples (Tesco, Asda, Sainsbury, Morrisons).

Amazon, Kiko, La Plateforme du Bâtiment, Esselunga, Mercadona are changing the dynamics. Established market leaders are now losing market share rather than winning some. Their traditional competitive edge, based on sourcing power, size of stores, established image, no longer holds up against the newcomers. These new 'invaders' or 'barbarians' are using different weapons and are now aggressively grabbing land.

How best to detect the new 'barbarians' who are not yet at the gates? And how best to react when already under siege?

Detecting disruptive competitors

These new competitors share common characteristics.

They focus on a *consumer aspiration* not currently being met – or only in part – by existing players. This aspiration is often based on one megatrend out of the couple that are now shaping the consumer behaviours in our mature countries; polarization, communitarianism, convenience or well-being … are all trends that are feeding powerful newcomers (see table 1). Kiko, the Italian cosmetics chain, which has opened over 80 stores in France and over 40 stores in Germany in less than three years, focuses on make-up and on young women. Its pricing is very competitive – often half the price of the entry range products at Sephora – and the shops provide an aspirational look and feel. Grand Frais, which sells fruit and vegetables and other fresh products, has gone from 80 stores in France five years ago to more than 140 points of sale today. Consumers can do their everyday fresh shopping in 20 to 30 minutes, whereas they will have to spend 45 minutes or more in a supermarket or hypermarkets. The German online tire seller Delticom offers the same pricing as large out-of-town auto centers

[1] Over a long period.

- Table 1 -

Key consumer trends in mature countries and examples of 'new barbarians'

Convenience

- Increasing desire for rapid purchase and/or delivery (due to digitalization and less structured lifestyles)
- Increasingly competitive convenience shops, which are providing better consumer value and / or experience than large out-of-town big box stores

↓

Amazon, Delticom Germany, Diapers.com, Esselunga Italy, Grand Frais France, Hema France, Mercadona Spain, 1800 Contacts

Low Cost

- Polarization of purchasing towards low cost price offering in certain categories
- Emergence of retailers offering low prices alongside an aspirational experience

↓

Amazon, Esselunga Italy, Hema France, Mercadona Spain, Kiko, Primark

Luxury / premium

- Increased purchasing power among wealthier sections of population
- International brands and concepts
- Access facilitated by the Internet
- Shopping experience and products

↓

Apple Retail, Eataly, L'Occitane, Yoox

Communitarianism

- Products, brands and banners that create a community
- Growth of strong specialized brands (online and in-store)

↓

Asos, Blue Nile, Fressnapf, Karen Miller, Lululemon, Lush, The Kooples, Zooplus.de Germany

Health and well-being

- Ageing population combined with desire for youthfulness and well-being

↓

Alnatura, Eataly, Naturhouse, The Vitamin Shop, Wholefoods but with the convenience of having tires fitted at a garage nearby or the price advantage of customers fitting the tires themselves.

Moreover, these players deliberately focus on *a limited number of competitive levers*, in which they overinvest. Kiko has invested in first-rate store locations and in a very efficient supply chain management in order to combine an extremely deep assortment with small store sizes. On the opposite, it has not invested in above the line advertising, promotions or contracts with models or other brand ambassadors.

Grand Frais favors local and seasonal fruit and vegetables and monitors staff, thus limiting shrinkage, a cost block which on the contrary jeopardizes fresh produce sections in competing supermarkets and hypermarkets. The chain offers top up dairy and grocery products but has not overinvested in those sections' pricing or listing of mass manufacturers' brands.

Fielmann, Germany's leading low cost optician, displays larger stores than competition and offers higher compensation to franchisees.

The combination of these two factors (the focus on an unsatisfied consumer aspiration and on a limited number of competitive levers) is what makes these players game changers and is allowing them to resegment the industry and change the rules of the competitive games. Furthermore, once they have defined their model, they roll their concept out *very quickly*. Whether Walmart (in the 1970s), Amazon (since the turn of the century) or Kiko (over the last five years), the 'invaders' move fast, generate significant cash and find the required financing in order to colonize markets rapidly (see tables 2 and 3).

What to do?

What to do once the new competitor has been detected and the two or three major advantages underpinning its competitiveness have been identified? What response is required?

There are two distinct time horizons: the short and the medium term.

In the short term, three generic strategies are worth considering:

- *Enter into a price war*. This is a viable strategy, as long as its scope is limited and clearly defined. For example, French hypermarkets were able to curtail the rise of hard discount stores by introducing value offerings and developing their economy own-label ranges. This proved a viable strategy as hypermarkets were able to maintain a sustainable overall profit margin because they had a customer base, categories and products that were not under attack. For virtually all national brands up until 2007 and all non dry grocery items, the hard discount stores were not able to win over enough French consumers. The hard discount sector therefore hit a ceiling with low shopping basket averages, in contrast to the grabbing of main shopping baskets achieved by Aldi and Lidl in Germany.

  On the other hand, taking part in a price war across all products, categories and sections is more problematic. The rationales often associated with such a strategy (a return to 'basics', customer focus, a refusal to move 'up market', protecting one's customers' purchasing power and so on) may well help internally but can not be sustained if not based on an actual cost advtantage. Otherwise, what is gained by undermining the brand concept and lowering prices? Price reductions can not be a winning long-term solution. Sooner or later, shareholders and store owners will no longer accept a low return on investment or will no longer have the funds to reinvest. This is one reason why Go Sport abruptly ended its anti-Decathlon strategy in France recently.

- *Bypass the newcomer*. This strategy is based on the idea that, in contrast to the previous strategy, you cannot beat the invader at its own game but you can use its arrival by asserting some of your own strengths to the expense of weaker third-party competitors. Thus when there was a surge in hard discount stores in the west of France in the nineties, Système U invested in the size and convenience of its stores and in its fresh produce and high-end offering. This undermined the Intermarché stores by attracting those consumers most receptive to this offering and to the convenience of the Système U shopping experience. At the same time Intermarché was losing price-sensitive customers and shopping baskets to the hard discount stores. The pincer movement ended up costing

- Table 2 -

Wal-Mart versus Amazon versus Kiko
Speed of growth and cash generation

(in 2013 dollar or euro equivalents and as %)

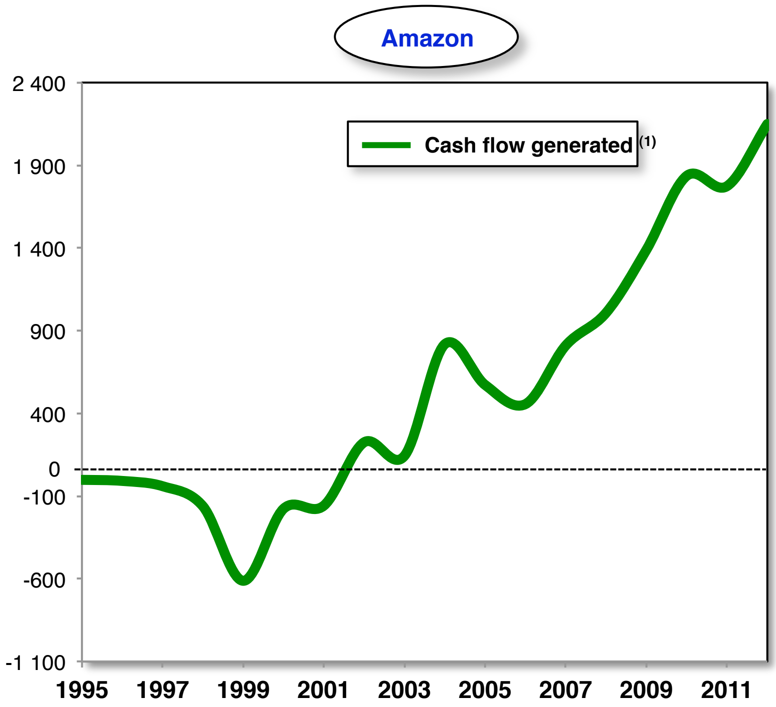
	Wal-Mart		Amazon		Kiko	
	Year 1-9 (1963 to 1971)	**Year 10-19** (1972 to 1981)	**Year 1-9** (1994 to 2002)	**Year 10-19** (2003 to 2012)	**Year 3-9** (1999 to 2005)	**Year 8-16** (2004 to 2012)
Annual sales growth (in \$m or €m; 2013 values)	57	423	636	6 143	0.3	37
	x 7		x 10		x 120	
Annual EBITDA growth (in \$m or €m; 2013 values)	2	31	31	270	-0.3	10
Cash flow generated as % of sales (1)	4%	3%	-6%	4%	n/a	15%
- Cash flow invested as % of sales (2)	-3%	-6%	-9%	-1%	n/a	-12%
= Net cash flow as % of sales	1%	-3%	-15%	3%	n/a	3%
Sources of financing	Stock market and debt		Stock market and WCR		Internal financing	

(1) Includes in particular EBITDA, changes in working capital requirement, tax paid. (2) Includes in particular capex and external growth investment.
n/a = not available. WCR = working capital
Source: annual reports, commercial court registries, Estin & Co estimates and analysis

- Table 3 -

Amazon: cash generation and growth

Cash flow generated (in \$bn)



- **Hit US\$5 billion in 8 years**
- **Internationalization after 3 years and 50% of sales from outside USA after 15 years**
- **New categories of products, excluding books, representing 50% of sales after 15 years**

(1) Cash flow essentially comprises EBITDA, changes in working capital requirement and tax paid.
Sources: Estin & Co estimates and analysis

Intermarché both consumers and store owners, who were won over by Système U, and significantly boosted Système U's market share.

- *Scale down and absorb losses*. Where cost advantages or cash generating engines are not available to finance investments and price-matching and where bypassing is not enough, what else can be done? Here more radical action needs to be taken, which may entail shrinking stores and redefining the store concept to make it competitive again, on a smaller scope and with a different positioning.

  Best Buy in the United States and Tesco in the UK for its Extra hypermarkets have taken this approach. Faced with the exodus of non food spend to Amazon and other e-tailers, Tesco has reduced its non food floor space and redeployed sections to favor categories and concepts which drive long-term store traffic (ready meal food, fruit and vegetables and even bakeries, cafes and delis). Moreover Tesco is planning to take things further and significantly reduce the floor area of its superstores by subletting space (to a Sports Direct style category killer or to a chain of gyms).

In the medium term, although the strategies discussed above are often necessary and prudent, they also often prove unsatisfactory because they rarely solve the fundamental issue of competitiveness. The structural lack of competitiveness will re-emerge later, and will be more acute as the new invader will have grown and strengthened its position in the meantime. Moreover, the short-term strategies will not put companies back on a path of high, sustainable growth. Yet without sustained growth there can be no long-term competitiveness, no funds to invest in a robust defense of the attacked positions, in the development and finally no value creation.

Therefore the challenge in the medium term is to return to long-lasting high growth levels. Above and beyond any short-term action, this comes out of a fundamental reassessment not only of a chain's retail formats but above all of its portfolio of activities, business lines and geographical positioning.

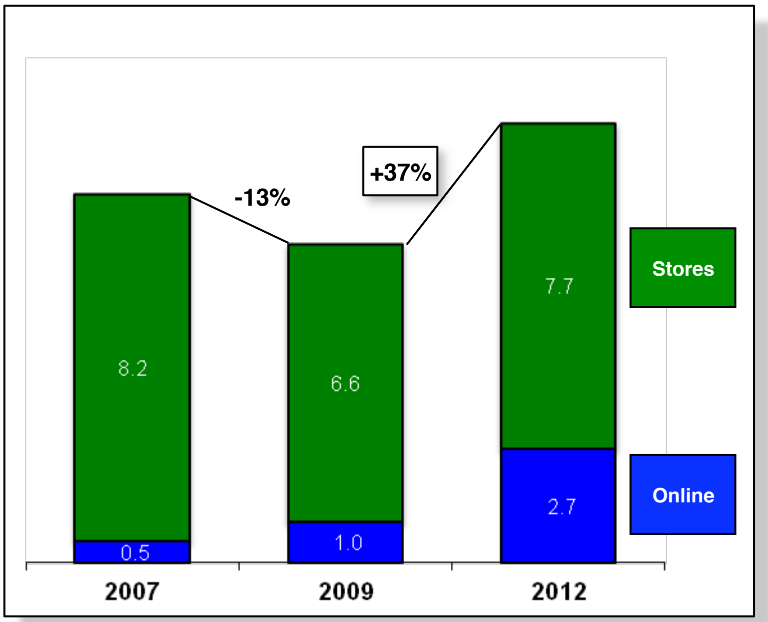
Three main options are worth considering here:

- *Growth through buyouts or alliances* in order to gain renewed competitiveness in core formats or segments. Monoprix (Galeries Lafayette Group, France) for example, came under attack at the beginning of the 1990s from inner suburbs' supermarkets and hypermarkets and from high street clothing chains. It acquired its direct competitor Prisunic and allied itself with the Casino Group. It re-established its competitiveness in both the grocery and apparel sectors: for groceries, by reducing price differential against out-of-town stores and upgrading its Food offering to become a Waitrose-style citymarket; in the case of apparel, by investing in the right style, skills base and management methods. The Monoprix Group eventually turned itself around, returning to profit and successfully reestablishing itself as a stylish convenience destination store. A once declining format managed to reinvent itself and ended up itself integrated into the Paris stronghold of the Casino group.
- *Launch and develop strongly a new retail format* and become its own invader. In the 1990s, the Kingfisher/Castorama Group saw an opening for a discount format focusing on DIY enthusiasts. The decision was taken to launch the discount format, Brico Dépôt, which rapidly moved ahead of Batkor, the first mover, to become the second pillar of the group in France. In order to achieve success in such a strategy, the teams in charge of the new concept must be given autonomy so that they can focus on the development and then the rapid roll-out of the format. The old format has to accept and even embrace the fact that it is essentially financing the new one and that the new format will cannibalize the old. In the case of Brico Dépôt, 32 Castorama stores were transferred to the new banner. On the opposite, trying to launch the new format under the management of teams coming from the existing format will kill any initiative right from the start. A peaceful cohabitation of old and new formats in which synergies are generated is only achievable after 10 or 15 years, once the rapid growth of the new concept is complete and the old has successfully repositioned itself. The success of John Lewis department stores in the UK as an e-tailer with a multi-channel offering is another example of a traditional retailer

- Table 4 -

John Lewis: e-commerce and multi-channel growth

Revenues
(€bn)



	2007	2009	2012
Online share of sales	**6%**	**13%**	**26%**

- **More products available online than in stores**
  - **Continuous growth in online offering**
- **Two additional advantages over pure plays**
  - **Click & Collect service (25% of johnlewis.com sales)**
  - **In-store terminals (15% of johnlewis.com sales)**

Sources: Annual reports, Estin & Co estimates and analysis flourishing in a new channel (e-commerce) and then achieving growth by combining both channels (see table 4).

- *Rapid and focused internationalization*: developing its traditional retail format in several high-potential countries is one good way of returning to growth. If the strategy is put into place at the right time and sufficient resources are put behind it to achieve leadership positions, funds will be generated and enable both to continue aggressive investment in the new countries and to defend the chain's historic markets. Growth and competitiveness has been restored by the Casino Group, mostly through the strong developments and the leading positions in Brazil and Thailand, which has enabled the group to release funds to be used for repositioning itself in France.

What conclusions can we draw?

No business or competitive position is stable in the long term. Markets with large economies of scale such as Retail become concentrated and then resegment when they mature. Dominant formats can no longer increase their competitiveness by becoming larger – or are prevented from doing so by competition authorities – and some newcomers manage to resegment the market and redefine the drivers of competitive advantage. It is therefore to be expected that invaders of one type or another will emerge on a regular basis. Indeed this is happening at an increasing tempo due to the internationalization of concepts, the Internet and the increased fluidity within shopping malls and on the financial markets.

Responding with the right short-term strategy is crucial: the right choice has to be made between counter-attacking, bypassing or scaling back; mistakes or false starts will be costly. But this is not enough: growth has to be resumed, business portfolios need to be reconfigured through targeted consolidations, launch of new formats or internationalization. For established retailers therefore, their portfolio of activities (and countries) is what can make the difference. These players, bolstered by the success of their original concepts in their historic markets, have often diversified and operate internationally; they possess several strong positions, significant local market share and some significant cash generating operations. They can leverage those strengths, invest where profitable growth is accessible and deploy there both human and financial resources. The available funding must be channeled into just a few growth areas (or areas of consolidation), in sufficient amounts and at sufficient speed to achieve leadership positions and levels of profitability able to make up for the decrease in profitability of their core businesses and capable to finance the necessary defensive investments.

After Rome fell to the Barbarians in 476, the imperial insignia passed into the hands of the Byzantine Empire. The reinvented Roman empire then pushed the Germans and the Arabs out and consolidated its position in the Eastern Mediterranean for 500 years.

What about your group? In which segments and which countries do you see yourselves as market leaders over the next 30 years?

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