Growing in Retail: what German retailers can do

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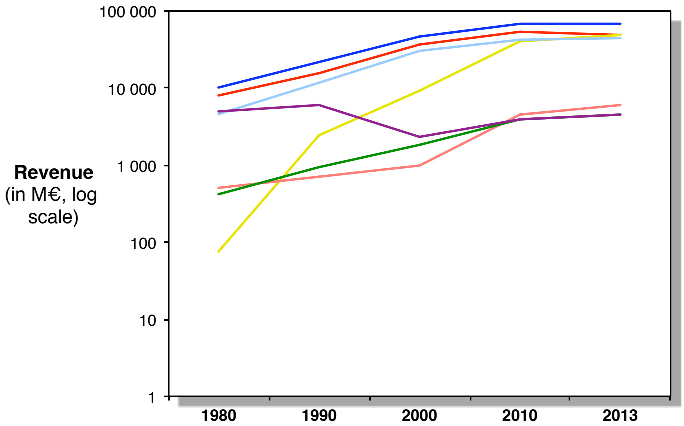
After a long period of strong development, German retail "champions" are currently experiencing low rates of growth. Sector by sector, they are growing more slowly than in the past (see Table 1) and as a result are creating less shareholder value. As a matter of fact, most are more than 80% exposed to the DACH space and its neighboring countries, where market consolidation has been completed, overcapacity is increasing, competition from the Internet and Amazon is unchecked and consumer demand will be depressed for the foreseeable future. Few have succeeded in establishing a strong international presence. Moreover, they often have difficulties breaking down internal, cultural and managerial barriers that stifle growth.

- Table 1 -

Slowdown in growth among German retailers – 1980 to 2011



	CAGR (1)			
	80-90	90-00	00-10	10-13
Metro	8%	8%	4%	0%
Rewe	7%	9%	3%	-3%
Lidl	42%	14%	16%	6%
Edeka	10%	10%	3%	3%
Rossmann	3%	4%	17%	13%
Raab Karcher Group	2%	-9%	5%	9%
Deichmann	9%	6%	8%	6%

(1) Average growth rate in revenue
Sources : Annual reports, press clippings, analyses and estimates Estin & Co

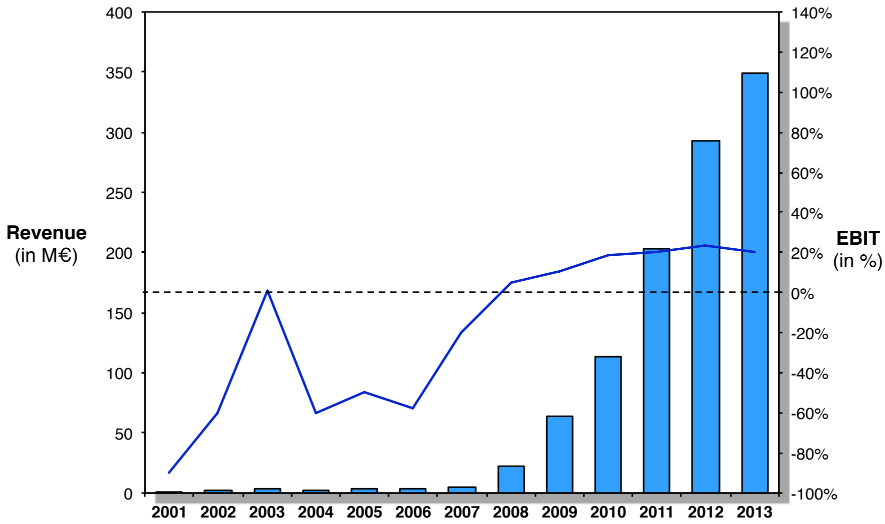
Three sources of steady and long-term non-dilutive growth

Sources of growth do exist, but can only rarely be tapped by the historic concept in Germany. As a result, companies must seek growth "differently":

- By launching *a new concept* on the domestic market, like the Lidl & Schwarz group which developed the hypermarket Kaufland concept and accepted to partially cannibalize its existing Lidl stores;
- By aggressively developing *Internet* sales, as John Lewis (England) and Nordstrom (United States) are doing, despite initial lower profitability on the Internet;
- By seeking leadership positions *internationally*, like Fressnapf (petfood and articles), Rossman (HBC) or the Italian company Kiko (see Table 2) and thus accepting the risk associated with internationalizing a retail concept - a big risk, considering the difficulty of sharing costs or even commercial formats between countries.

- Table 2 -

Kiko – Make-up - Change in revenue and EBIT - 2001 to 2013



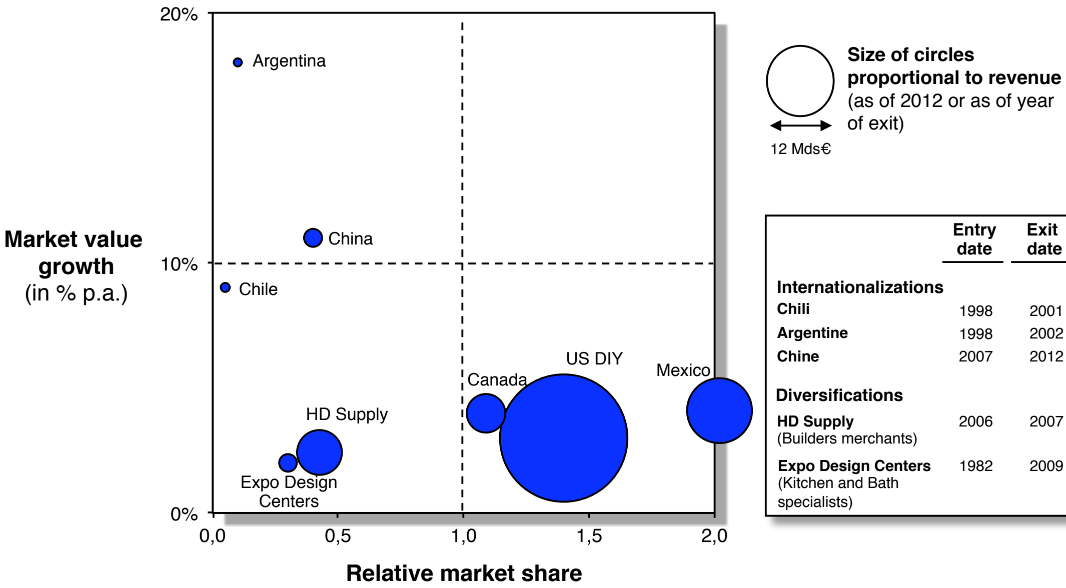
- **Established in Italy in 1997**
- **Mono-brand make-up retailer ; Positioned at low to mid-range (young customers); wide range of products**
- **Stores of approx. 100 m2**
- **~600 points of sale in 2013:**
  - Italy (~300)
  - Spain (>100)
  - France (106)
  - Germany (37)
  - Switzerland (6)
  - UK (5)
  - Austria (3)
  - etc.
- **High investments into stores, supply chain and prices ; no investments in promotions, models and advertising**

Source: Amadeus; analyses and estimates by Estin & Co

These growth initiatives require major investment over a short period of time: whether investing in a new concept, on the Internet or in a new country, a critical size is quickly required. While a 10-15% annual growth rate may look attractive, it will not enable a leadership position to be secured. And without leadership, competitiveness will not follow, and the venture may stay unprofitable. As a result, the company will experience numerous destructive back and forth movements, as seen with Carrefour international operations or Home Depot (see Table 3).

- Table 3 -

Growth that is not focused will not allow to reach market-leading positions and will result in damaging « back and forth » movements
Example of Home Depot



	Entry date	Exit date
Internationalizations		
Chili	1998	2001
Argentine	1998	2002
Chine	2007	2012
Diversifications		
HD Supply (Builders merchants)	2006	2007
Expo Design Centers (Kitchen and Bath specialists)	1982	2009

Note : Relative market share ; > 1 = relation of Home Depot market share on main challenger's market share; less than 1: relationship between Home Depot market share and market leader market share
Note : Market growth for '12-'16 for current activities and for the 5 years following exit for exited activities
Source: Euromonitor, Home Depot, Research, Estin & Co analysis and estimates

Investing money on the scale and at the speed required requires therefore prioritizing: it is hard to invest in numerous growth initiatives without running the risk of taking positions that are too weak and, ultimately, uncompetitive, and without heavily diluting the company's overall short term results. In addition to carrying out the necessary tests of a pilot store, a new website or a flagship store, a thorough assessment of the potential of each growth initiative is necessary. It should include an evaluation of the financial resources required, a comparison of the available funding and financing capacity, and the selection of a cash inflow / cash outflow profile that is strategically and financially sound and consistent with the short term net cash flow to be presented to shareholders.

As far as funding is concerned, a key question is to assess to what extent the historic format can yield cash that will then be invested elsewhere. More broadly, is it better to manage the historic format for cash generation or should it be "reinvented" in order to turn it (once again) into a strong driver of growth? Of course, every situation and every banner is different and must be analyzed on a case-by-case basis. But the analysis must be extremely rigorous and objective, as there have been some successful reinventions (for example: Tesco in the UK over 1995-2005 and the Monoprix / Galeries Lafayette group in France over the same period), but there have been many more failures (for example: the big hypermarkets in France, the mid-range department stores in major American cities, the DIY chains in Germany, etc.). A rigorous and objective assessment of the potential and cost of reinvention must be done, factoring in the market context or "base case" (which is often adverse due to overcapacity and to the need to pass on to consumers all cost savings in order just to maintain sales and market share). The potential and the cost must also be put into perspective with a cash generation strategy that requires less capital, less managerial effort and aims at intelligently optimizing the funding and financing capacity. Such a strategy often includes high return on investment optimization initiatives in prices, space allocations and supplier relationships executed on a greater scale, at a greater speed and with greater professional expertise than those of competitors (see Table 4).

- Table 4 -

Three short-term optimizations to be executed on a greater scale, at a greater speed and with greater professional expertise than competitors and in line with the brand's market positioning

	1- Optimize capex budget and space allocations	2- Review price ladders and prices	3- Improve purchasing terms and supplier partnerships
Objectives	• **Save Capex and increase margins, including through low-cost space reallocations**	• **Improve traffic and encourage trade-up category by category**	• **Make the right bets on suppliers to capture more than fair share of supplier focus and funding**
Total value at stake (in revenue basis points)	• **200 basis points or 20% of the Capex budget**	• **200 basis points**	• **From 100 to 200 basis points, as well as a better alignment with winning suppliers**
Time horizon before the first margin improvements are in the P&L	←	**3 to 6 months**	→

New managerial challenges

It is hard, however, to "resize" opex and capex budgets of the historic concepts at the required pace, due to their weight in revenue, their already lean operations, and the efforts put in over recent years. The retailer faces here a dilemma: it will either lack the resources for its new growth initiatives or it will see managers in its core business lose motivation and, ultimately, it may lose market relevance. Finding a successful solution to this dilemma, generating the savings and funding required while motivating teams may involve: launching several optimizations of the gross margin (as opposed to sheer cost cutting actions, see above); implementing metrics, monitoring systems and incentives on return on capital employed; and anticipating a certain level of managerial turnover.

With the new growth initiative, the challenge is to steer it from the top: give managers a lot of autonomy, empowerment and visibility; budget for significant and anticipated resources – in particular, account in advance for a high turnover among local mid-level managers, such as buyers and store managers, due to differences in language, culture, stamina and the fact that some will be poached by competition; localize certain support functions, even at the cost of possible temporary diseconomies of scale; adapt monitoring, motivation and delegation systems.

The retailer must accept a considerable managerial dichotomy between the historic concept and the new businesses, a dichotomy that is in line with the to be implemented differentiation in market share, growth, profitability and cash flow targets.

Profitable growth is a choice … and a return to the roots

Resuming (accretive) growth therefore involves making difficult choices, making major trade-offs between format/country, prioritizing some growth initiatives and allocating all resources to a few of them. It also requires a clear view on which historic businesses should be reinvented (and to what extent) and which ones intelligently managed for cash generation. Successfully overcoming internal, cultural and managerial obstacles is hard work. But doing so will make it possible to once again create strong shareholder value while reviving the original identity of the "German champions": entrepreneurial companies that are developing a banner with steady, long-term growth prospects, based on one or two favorable concepts, countries or channels.

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Estin & Co is an international strategy consultancy based in Paris, London, Zürich and Shanghai. The firm assists the boards of major European, North American and Asian groups in their growth strategies, and private equity funds in analyzing and improving the value of their investments.

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