

The Battle for Europe's Grocery Shoppers



FULL-LINE GROCERY RETAILERS IN EUROPE ARE approaching a crossroads. As discount grocery stores become increasingly adept at meeting the needs of European consumers—and increasingly acceptable to shoppers at all income levels—full-line retailers are seeing their profits plummet and market shares shrink. Across Europe, consumers are demanding lower prices and greater convenience—and discounters are responding rapidly. (See Exhibit 1, page 2.) Between 1991 and 2005, the number of discount grocery stores in Europe nearly doubled—from 17,300 to more than 34,000. From 2001 to 2005, real food prices in 13 countries of the EU 15 fell an average 1 percent annually. Only Finland and Spain saw real food prices increase.

The future for full-line grocery retailers isn't as bleak as it may seem, however. The Boston Consulting Group surveyed more than 6,000 consumers in six European countries about their attitudes toward spending and saving (in groceries as well as other categories), trading up and trading down, and choosing one retailer over another. We also ventured beyond market surveys, accompanying individual consumers as they shopped in their favorite stores and talking with them in their kitchens as they put away groceries and prepared meals.

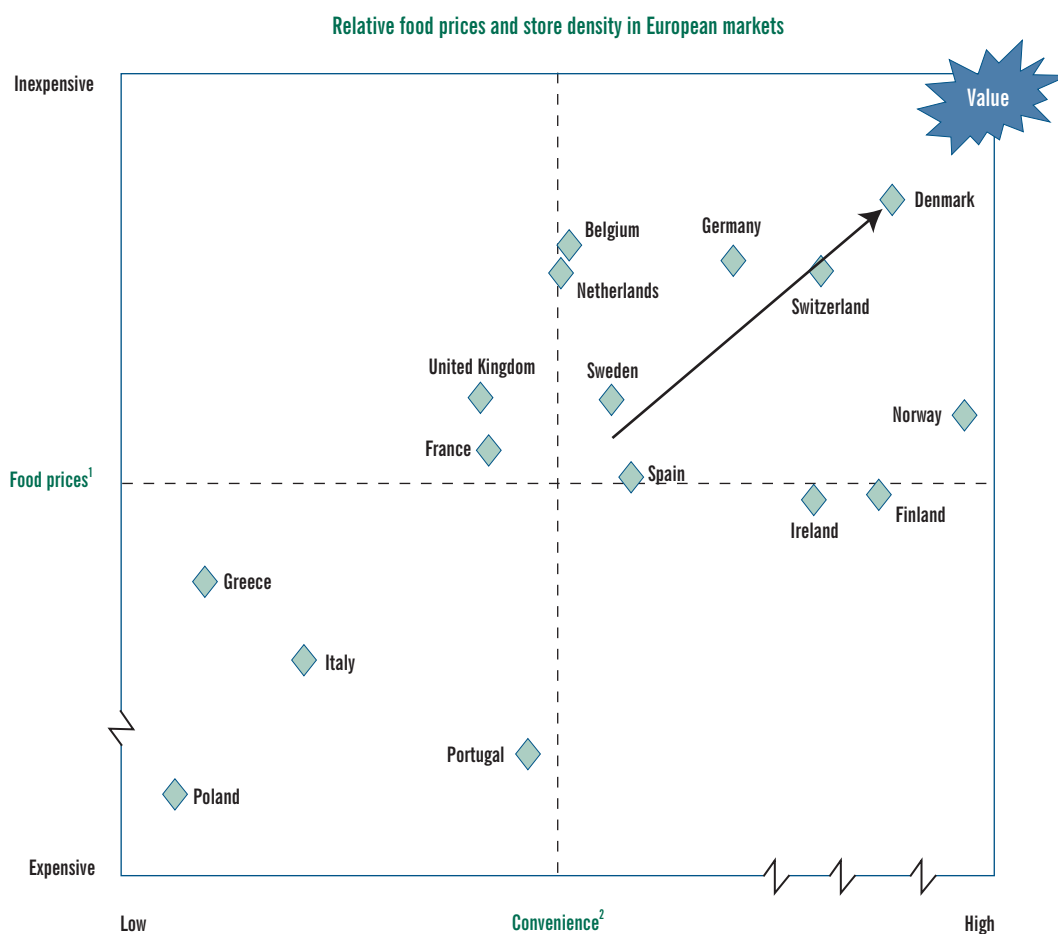
Those surveys and conversations gave us a new perspective on consumers' continuing demand for lower prices and discounters' increasing ability to meet that demand. They also led us to conclude that full-line retailers can still compete successfully in Europe's grocery markets—despite the growth of discounters—if they begin now. For many retailers, that will require a complete rethinking of their business models and strategies in light of consumers' evolving needs and competitors' evolving capabilities. A few retailers will rise to the challenge. Yet many more will underestimate how much they must change or assume that such extensive change is impossible.

Greater Value Exists at Both Ends of the Price Range

Consumers are demanding more because they can get more. Discounters and full-line grocery retailers are supplying products that are both low price and high quality, thereby making trading down a realistic option in almost every category, from meats and fresh vegetables to dairy products and diapers. Scores of shoppers told us that they could save a significant amount of money at discount stores without sacrificing quality, convenience, or speed.

EXHIBIT 1

OPPORTUNITIES ARE PLENTIFUL IN MANY EUROPEAN MARKETS FOR STORES OFFERING MORE VALUE AND GREATER CONVENIENCE



SOURCES: Planet Retail; Euromonitor International; BCG analysis; BCG estimates.

¹Food prices are adjusted for purchasing power in the market.

²Convenience is the ratio of number of stores to population.

Shoppers everywhere are taking advantage of this opportunity. Our research found that nearly 70 percent of European consumers trade down in at least one-quarter of grocery categories. (See Exhibit 2, page 3.) In snack foods and canned goods, for example, 60 percent of European shoppers said that they try to save a little money or spend the bare minimum. But consumers are also trading up. In fresh foods, 40 percent were willing to spend somewhat more or even to pay as much as necessary to get the very best. As a

result, both bargain brands and premium entries are gaining market share, while midprice products are stagnating.

Our surveys found that for home improvement projects, vacations, wine, and baby care, the portion of shoppers who are neither trading up nor trading down was only 25 to 28 percent. Nearly three out of four buyers, then, said that they want either to save money on those purchases or to spend more. Attitudes like these have turned the middle into a no man's land.

Consumers Trade Both Up and Down

Our study confirmed that trading up and trading down have become more prevalent, but it also revealed another trend that retailers have been slow to recognize: the same consumer, regardless of income level or family situation, will trade both up *and* down, sometimes even in the same category at different times. Contrary to the claims of some industry observers, consumers who can be classed solely as *discount shoppers*, *economy shoppers*, or *private-label*

shoppers are rare indeed. All the people we shopped with had at least a few categories in which they wouldn't compromise on quality and a few others in which they would look for basic offerings at the lowest price.

Consider one shopper we spoke with in France, a single mother of three living on welfare. She told us that she goes out of her way to hunt for promotions, buying a special brand of chicken "only when the store runs a two-for-one promotion, and I can freeze the second for later." Nevertheless, in the middle of her basket filled with Auchan's private-label and other economy products were three packs of Barilla pasta (which costs three times more than the unbranded alternatives). She said she had tried the cheaper pastas a couple of times but found that their quality couldn't match Barilla's. "They turned sticky," she claimed.

We heard similar stories in Spain. A working mother with two children bragged about the money she saves using Dia's brand of margarine for cooking. But when it comes to her morning toast, she insists on the more expensive Tulipan brand. A market researcher might tag both women *price-focused discount-store shoppers*—and they are. But they also trade up in a few categories that are especially important to them.

An even more important finding for retailers and their suppliers is that some shoppers will trade up and down within the same category for different occasions. For example, our research indicated that although 46 percent of U.K.

consumers would be willing to shop at a discount store for their weekly and monthly purchases—and 35 percent would shop there for regular evening meals—only 22 percent would purchase food at a discounter to serve guests. They might choose a discounted frozen pizza during the week and then stop at the deli counter for premium-price fresh pizza to have with friends on a weekend. Unlike shopping patterns in the past, this new behavior isn't driven by demographics as much as by occasion and purpose. Retailers, therefore, can no longer assume a single, uniform behavior for a segment of consumers when determining product positioning or assortment. Such an assumption could hurt their business.

In many retail categories, consumers are discovering that trad-

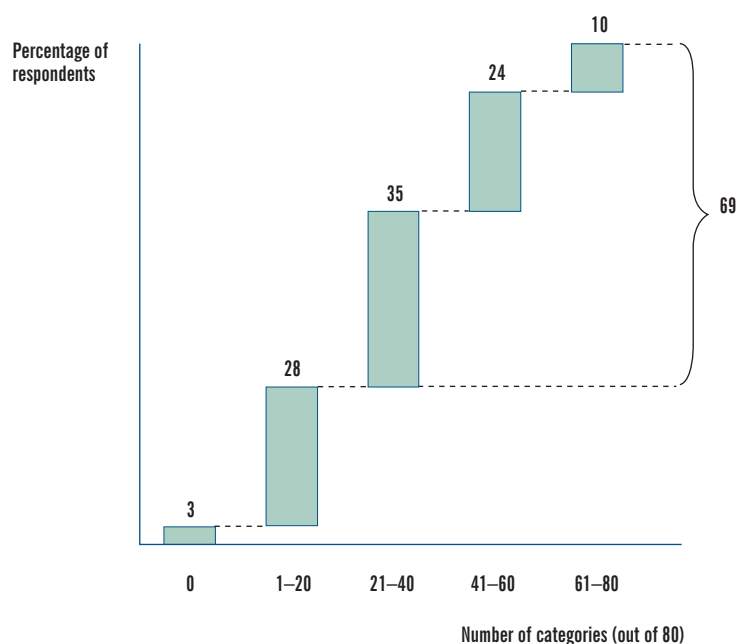
ing both up and down gives them greater freedom, allowing them to use their savings in some categories to spend more in others. A Swedish middle-income family we talked with told us that they love to spend money on travel, art, and furniture. Last year, for example, they stayed in high-end hotels in Beijing, Istanbul, and Tunis. But when they shop at home, they typically go to *hard* and *soft discounters*. "Shopping for groceries is boring," the mother told us. "I might as well save what I can there and have more to spend on pleasures we'll enjoy for a long time."

Consumers Increasingly Seek Value

Consumers in all demographic segments are discovering new options for trading up and down and are shifting their spending as

EXHIBIT 2

MORE THAN TWO-THIRDS OF CONSUMERS ARE TRADING DOWN IN AT LEAST ONE OUT OF FOUR GROCERY CATEGORIES



SOURCES: BCG online survey of 6,035 European adults responsible for grocery shopping in their households, July 2005; BCG analysis.

a result. We asked consumers to predict whether five years from now they will shop more or less at the stores they frequent today. Although their answers differed from market to market, a trend was clear: tomorrow's shoppers will go where they find value. They'll seek out hard discounters and hypermarkets for price and convenience, smart buys, and one-stop shopping. (See Exhibit 3.) As a result, full-line supermarkets and small, independent mom-and-pop stores, as a group, will lose share. However, some players in those segments will adapt to the new competitive environment and reinvent their offering.

We believe that consumers will walk the talk, but not necessarily right away. In regions where discounters have been around for

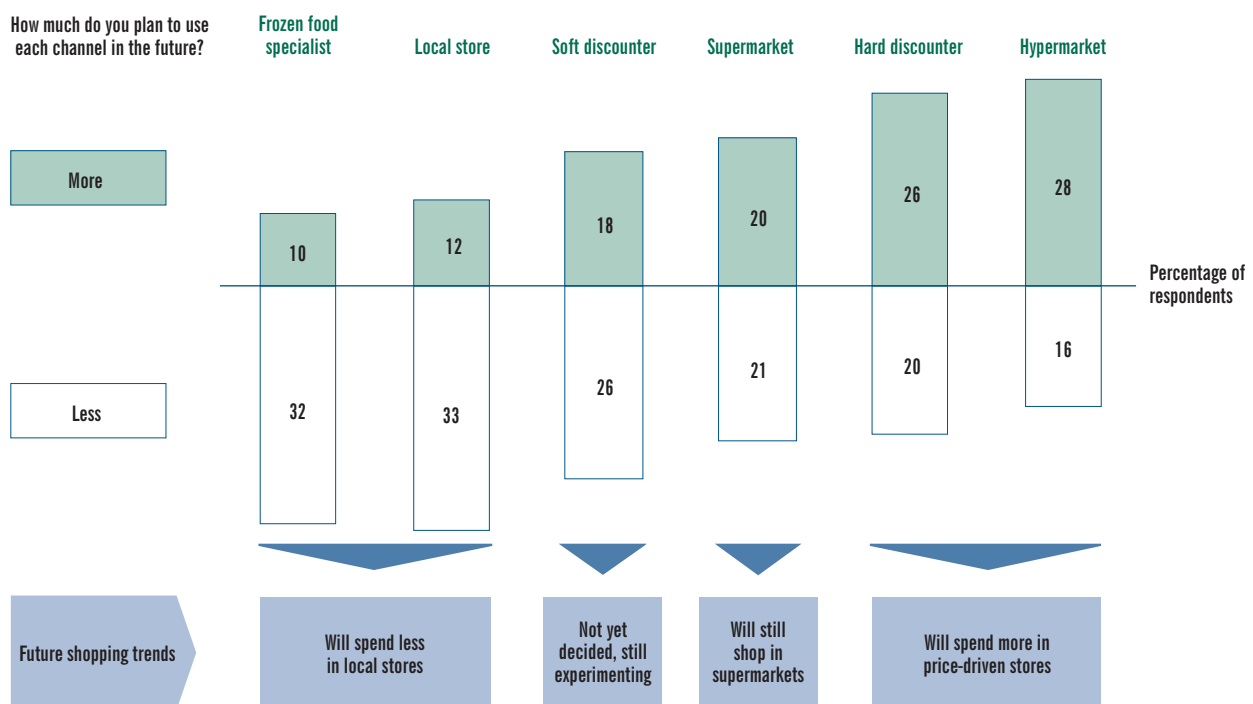
some time, we observed that consumers have grown to appreciate the convenience and quality that discounters provide, although price may have been their initial reason for shopping at these stores. In markets where hard discount stores are relatively new, however—such as France, Spain, and Sweden—consumers clearly like the prices but still rate traditional supermarkets higher in terms of proximity and convenience. In Italy, consumers claim they're not convinced that discounters offer more convenience or value than traditional supermarkets. But considering that the number of discount stores in Italy has increased 10 percent on average per year over the past five years, there's little doubt that discounters are winning over Italian consumers. Consumers' perceptions of discounters in the United

Kingdom are similar to those in Italy, but with a major difference: U.K. consumers' belief that discounters' prices aren't much better than traditional supermarkets' is, in fact, often true. Because U.K. supermarkets have done a particularly good job preparing themselves for competition with discounters, the actual price spread between the two is narrower there than anywhere else in Europe.

Obviously, in countries where discounters are relatively new, the stores won't succeed unless consumers' perception of the value they offer (when it comes to price and convenience) improves. In fact, that is exactly what happens when discounters move into a market. As they open more and more stores, the stores are easier to find and therefore seem more

EXHIBIT 3

SHOPPERS ARE READY TO SHIFT THEIR SPENDING TO CHANNELS THAT PROVIDE BETTER PRICES AND VALUE



SOURCES: BCG online survey of 6,035 European adults responsible for grocery shopping in their households, July 2005; BCG analysis.

convenient. A similar dynamic sets in with consumers' perceptions of how long it takes to shop at a discounter. As more stores open, consumers have more opportunities to shop in them, and that experience helps them navigate the aisles more quickly.

Product quality follows a similar pattern: discounters will continue to win trust, customer by customer, neighborhood by neighborhood, and market by market. Today in the United Kingdom, where discount stores are relatively new, only 40 percent of shoppers perceive the quality of discounters' products as similar to or better than products found at such retailers as Tesco and Asda. In Spain, one customer described a discounter this way: "Lidl is so cheap, something must be wrong." But in Germany, where discounters have been established for decades, 94 percent of customers believe product quality is not a problem. Here's a typical response: "I shop very wisely and economically by going to Aldi, without compromising quality."

Discounters Will Play Hard to Win Big

Discounters aren't merely actors in the trading-down phenomenon; they are driving it, expanding categories and pushing hard to increase the size of shoppers' baskets. In Germany, for example, Aldi and Lidl are now competing successfully with full-line supermarkets by offering fresh meats. In the second quarter of 2005, German discounters sold nearly double the volume of meat they had sold over the same period in 2004. Today they are selling more meat than all of Germany's butch-

ers. Aldi has also launched a range of low-fat children's food products, and Netto has added ecological products. When Lidl opened in Denmark in October 2005, its store offered 1,621 products—nearly 35 percent more than it carries in other Nordic markets.

Discounters are also known for driving traffic by offering nonfood products, such as personal computers, at rock-bottom prices, and services, such as photo processing and cut-rate railroad tickets. Such expansions indicate just how innovative discounters can be. They also point to the core strength of discounters' business model. In such areas as personnel, logistics, and G&A, discounters start with a highly advantageous cost position. And because they build their cost leadership from the bottom up, they avoid adding unnecessary complexity. As a result, their cost of operations is typically around 16 to 18 percent of sales, whereas a supermarket's cost base is usually about 21 to 29 percent of sales. (See Exhibit 4, page 6.)

Such cost advantages allow discounters to operate with much lower gross margins, making it easier to reduce prices and incorporate innovations without adding complexity costs. A discounter will broaden product choice, increase operating hours, or add personnel only after carefully weighing value against cost. A traditional multiformat player, by contrast, may adjust service levels or introduce new products, but its higher costs make it harder to add features without increasing the costs of complexity. A key to reducing costs is to reduce complexity in the system, from factory to consumer.

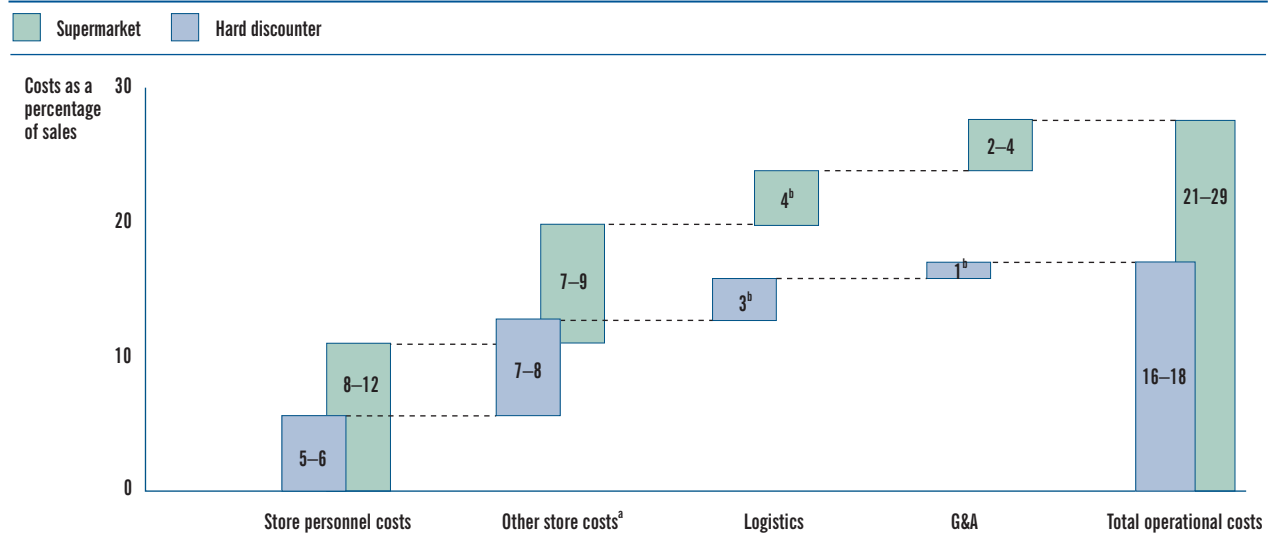
Discounters' focus on avoiding complexity explains why, in addition to lower margin requirements, they also enjoy substantially lower costs of goods per stock-keeping unit (SKU). If full-line retailers were to follow the discounters' example, they might also improve their competitiveness and profitability. By understanding consumers' demands and the fully allocated costs of meeting them, retailers could price products to their benefit. (See Exhibit 5, page 6.)

Discounters' relentless efforts to understand true costs are similar to the tactics of low-cost airlines. In expanding their value propositions, Lidl and Aldi, for example, seem to be taking a page from easyJet's playbook. In going after the business passengers of established airlines, such as British Airways and Lufthansa, easyJet has given these passengers a way to break most of the critical compromises of the traditional no-frills ticket. For as little as €20, the carrier offers access to a lounge and flexibility on changing and refunding tickets online. The company can do this because it starts from a cost advantage and refuses to increase costs more than necessary. And since it understands the true cost of its offerings, easyJet is able to balance that against consumers' perception of value.

Ten years ago, there were no low-cost carriers in Europe. Today they have a 35 percent share of Europe's continental traffic. Value leadership through cost leadership is a powerful strategy. When a discount grocery competitor uses it against a full-line retailer, the blow can be hard to withstand.

EXHIBIT 4

COST LEADERSHIP IS THE ONLY ROAD TO VALUE LEADERSHIP



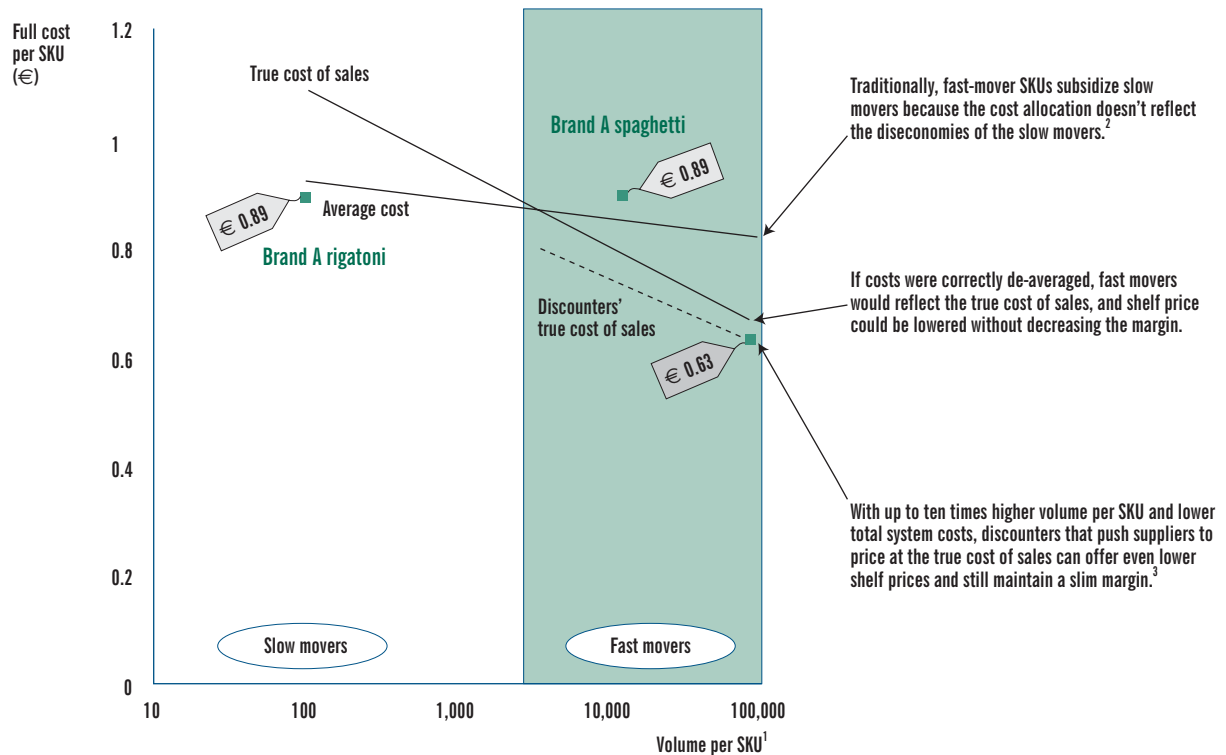
SOURCES: Annual reports; BCG estimates.

^aOther store costs include such costs as rent and utilities.

^bThese percentages are approximations.

EXHIBIT 5

THE SECRET TO GOOD PRICING IS TO REFLECT THE *TRUE* COST OF SALES PER SKU



SOURCES: Store checks; broker reports; BCG experience; BCG analysis; BCG estimates.

NOTE: Actual product prices come from store checks in France and the United Kingdom (2005).

¹The horizontal axis is on a logarithmic scale.

²Fully allocated, high-volume SKUs typically enjoy much lower costs at every step, including raw materials and packaging, manufacturing, distribution, and replenishment.

³In this example, the comparable branded product is 30 percent cheaper at the discount retailer than at the traditional retailer.

How Full-Line Retailers Can Compete for the Future

Grocery retailing is changing rapidly throughout Europe, yet consumers still feel that they are compromising on price and convenience. New players with innovative cost models will continue to be agents for change. Expect to see traditional competitors merge, try new formats, or even go out of business. But as the market adjusts to the new reality, we see plenty of opportunities for today's full-line grocery retailers. Given the number of options, the overriding question for retailers should be how they can reinvent their business to serve future markets. We offer the following advice for answering that question.

If fighting the competition means joining it, understand the rules of the new game. For a full-line retailer, joining the discount segment almost always requires two cost structures and, consequently, two parallel operations. That is what Carrefour has done with its Dia stores, which operate through a separate division, whose head reports directly to Dia's worldwide CEO. The current CEO of Dia is also the worldwide head of food for Groupe Carrefour, where he rolls out best practices from the discount world in private-label strategies and operations. Interestingly, the airline industry is also trying to leverage separate operations. Many airlines, challenged directly by low-cost carriers, have set up new businesses to compete with them, yet even then the airlines have struggled to achieve the separation and independence their new cost structures and customer

offerings require. The goal is to establish a structure that can reduce complexity wherever it exists—one that reflects an understanding of the imperatives of low-cost, low-price operations.

Ensure cost competitiveness with a relentless focus on cost position. A retailer must capture

*A full-line retailer
can always win
on assortment
if it listens
closely to
customers.*

economies of scale at all levels—store, regional, national, and international. Scale advantages drive cost advantages throughout a retailer's cost base—in store operations, marketing, logistics and distribution, and purchasing. When it comes to labor costs, much can be learned from discounters. For example, it is not uncommon for retailers to improve store productivity by as much as 200 to 300 basis points as a result of reducing personnel costs from 12 percent of sales to 9 or 10 percent. Retailers should also make the supply chain as lean as possible. That means working with the most important suppliers on many dimensions, such as eliminating the slow-moving shelf warmers that the most profitable products have been subsidizing and increasing the number of ready-to-sell boxes.

Create an assortment that delivers on price without limiting consumer choice. Retailers should price fast-moving items to reflect the *true* costs of sales, thereby giv-

ing customers the *best* price. One way to do this is to negotiate exclusive contracts with suppliers. Spanish retailer Mercadona, which has both the lowest prices in its market for national brands and opening-price products that are cheaper than those of its competitors, employs this approach diligently. Its strategy is simple: forge deeper relationships with fewer suppliers and market private-label products aggressively. Hence, Mercadona achieves its pricing advantage in two ways: it strives for the best purchasing terms in each category and increases its gross margin through private-label products, which account for more than half of its sales (more than twice the industry average). In addition, Mercadona reduces the number of brands it needs to carry by asking its private-label partners to add features (such as different formats and flavors) that cater to customers' needs. Spanish consumers obviously appreciate Mercadona's formula: the retailer's sales productivity is 75 percent above the average for its sector, a level that has allowed the company to increase sales more than 20 percent annually over the past ten years.

Establish superiority in specific categories to lend power to the assortment. A full-line retailer can always win on assortment if it listens closely to customers. It should know in which categories they are most likely to trade up and trade down and whether selection or price is more important in their decision. For instance, in typical trading-up categories—such as meat, fresh food, and cheese—a retailer should be sure to have the right

destination brands. At the discount end, it needs powerful trading-down categories, such as canned food, bottled water, and snacks, as well as specific products with a strong share of such categories as juices, chocolate bars, and yogurts. Full-line stores might also carry “super-SKUs”—products that have a superior price-to-quality ratio, for example, and attract loyal customers.

Finally, for categories in which consumers trade neither up nor down, a store might expand its assortment to include all price ranges, particularly in high-margin categories, where variety is affordable. Such categories include hair care, bath, and cosmetic products. Every category has its own logic, but the possibilities are almost endless.

Compete against discounters’ weaknesses in service levels and choice. How many retailers know where their discount competitors are vulnerable? Although strong in most key dimensions, discounters can be bested in others. Italian retailer Esselunga competes very successfully with this strategy. Its stores provide high-quality fresh foods, numerous service counters, and an appetizing array of products. The store’s distinctive image is complemented by a highly successful loyalty program (91 percent of sales are purchased with its card) and a private-label strategy that is completely aligned with the store’s overall positioning. It has as many as seven different private labels, most positioned as high-quality products and some manufactured by dedicated factories the retailer owns. The results are astonishing:

Esselunga has sales per square meter of €18,000, whereas the second-best performer has slightly above €10,000 per square meter.

Design the private-label portfolio to support and strengthen the business strategy. A portfolio of private labels and exclusive brands should cover all quality

Every retailer will have its own formula for success, depending on market maturity, competition, and strategy

positions and necessary price points. It should also differentiate the retailer from its competition. Retailers such as Tesco and Esselunga have wide ranges of private-label brands that represent different components of their strategy, such as trading up, health, and ecology. They begin by listening to their customers, gaining insights about needs and tradeoffs that lead them to the right combination of private labels and branded products. Every retailer will have its own formula for success, depending on market maturity, competition, and strategy.

Attack the discounters’ home turf with smart pricing. This strategy requires a retailer to leverage its price architecture to the fullest extent. Tesco did so early on by providing a discount offering within its stores and communicating it clearly. As a result, hard discounters in the United Kingdom find full-line retailers’ prices tough to compete with: branded products in full-line retailers’

U.K. stores are priced at only a 65 to 70 percent premium over products in hard-discount stores. The competition for discounters is much less intense in France, where the premium at a full-line retailer can be as much as 100 to 115 percent. In addition to their attractive pricing, full-line retailers in the United Kingdom also had a well-structured architecture of private labels long before hard discounters entered the scene. That included entry-price alternatives that today are priced about 3 to 5 percent *below* the analogous products of hard discounters. As a result, discounters’ sales in the United Kingdom decreased by 2 percent a year between 2001 and 2005, while their sales in France over the same period grew 8 percent a year.

Practice customer-centered leadership, culture, and systems. Store managers and employees should be trained to be on a constant “customer watch.” The best players hold regular sessions for all levels of staff and customers—in groups or individually—to keep track of changes in attitudes and behavior. All systems and processes are linked and centered around customers. Tesco, for example, is considered to be the leader in customer-focused processes with its sophisticated loyalty systems, mailings with customized offerings, and clubs for targeted segments (such as food, wine, healthy living, and babies and toddlers). The retailer further enhances its credibility with customers by comparing its weekly prices on 10,000 SKUs with Asda’s and Sainsbury’s through its online site. Interestingly, no comparisons are provided for the hard(er) discounters.

* * *

The first thing European full-line grocery retailers must do is face the fact that discounters aren't going to disappear. But that does not mean that full-line retail-

ers can't compete successfully against discounters. To make sure that the most valuable customers spend more time in their stores than in those of their competitors, full-line grocery retailers will need strategies

that are more sophisticated than across-the-board price cuts. Price leadership begins with cost leadership. It's a huge challenge, but a few outstanding full-line retailers are already proving that it can be done.

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