CUTTING PRICES WITHOUT CUTTING PROFITS
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Many retailers have run price-cutting campaigns – but most have failed to produce a dramatic improvement in competitive position, and have simply started price wars and hurt profits. One major US grocery chain is a notable exception, having recently improved its shelf price position by 10% relative to competitors, while at the same time protecting its bottom line. This paper describes how it pulled off one of the boldest value repositionings ever undertaken.

It’s one of the biggest paradoxes in retail: price cuts are unprofitable, but the most aggressive and fastest-growing competitors often have the sharpest prices. Many successful mature retailers see their market share being eaten away by newer players offering seemingly unbeatable value, while their own efforts to lower prices at best produce barely measurable volume gains, and at worst provoke crippling price wars.

In some sectors, after decades of profitable growth, the mature players have reached a stalemate in which they match each other move for move. Respectable financial performance often masks a less certain future: like-for-like sales growth is in many cases driven by inflation, while volumes are flat or declining. Developing a price advantage over key competitors has never been more important – or more difficult.

Despite the challenges, a few retailers have found sustainable, profitable ways to improve price competitiveness. This paper describes one such example: it’s a case study of how a top-ten US grocery chain transformed its value position with a bold program of price moves. In doing so, it broke the cycle of tit-for-tat price adjustments and slow volume decline, and achieved significant market share gains by improving customer perceptions.

CONTEXT

Five years ago, one of the major US supermarket chains had reached a critical point: customers saw it as no better than average in terms of value and quality, sales volumes were slowly declining, and Wal-Mart and other EDLP operators posed a rapidly growing threat. Meanwhile newer, smaller players had carved out a reputation for both value and quality, and were winning customers wherever they opened stores.

In this situation, the natural response would have been to launch a succession of cost-reducing and revenue-boosting initiatives in the hope of shoring up market position. But although making small improvements to the performance of the business might generate better financial performance over the short- to medium-term, the management team
understood that this wouldn’t address the erosion of market share. Only a dramatic improvement in value perception would allow the retailer to regain its place amongst the leaders in the industry and ensure its long-term survival.

However, the management team knew that price cuts would cost money in the short term. In the past, price-cutting initiatives had done little to increase sales volumes, and had quickly been matched by competitors.

The problem is one faced by all retailers: although ‘indirect’, long-term price elasticity may be quite high, ‘direct’, short-term price elasticity is much lower. Any significant price cuts have a serious adverse impact on margin for two years or more, during which time they need to be paid for in some way. Exhibit 1 explains this in more detail. The subtle relationship between price position, price perception, and market share presents two major difficulties. First, how to pay for price cuts in the short term, before there are any big changes in volume to offset the unit margin decrease; and second, how to ensure competitors don’t simply follow suit and remove any chance of building a long-term advantage.

**PAYING FOR THE PRICE CUTS**

The objective was to bring prices close to those of Wal-Mart, requiring reductions unprecedented for a retailer this size. Shelf prices were slashed by an average of 10%: this massive cut was implemented across all categories, affecting over 20,000 products and requiring reductions of 20% or more in some cases. In addition, the business moved from being heavily promotional to being ‘EDLP+’, with sharp everyday prices and lower promotional participation. This bold approach had massive financial implications, as the immediate cost of the cuts – the size of the discount ‘given away’ through price reductions – was between $1 BN and $2 BN, more than the EBIT of the entire company.

Since conjuring up more than $1 BN overnight was obviously out of the question, the price cuts could not all happen at the same time. The management team devised a carefully phased roll-out plan: the price cuts were executed in waves, with those scheduled later paid for in part by extra cash margin brought in by those already carried out. Even with careful sequencing, however, volume would build slowly, and a huge gap would remain in the short term – meaning that other sources of cash needed to be found. With this in mind a set of initiatives aimed at boosting profits was implemented.
The promotions program was cut by half, and through negotiation with suppliers the vast majority of the ‘lost’ promotional funding was channeled into shelf price cuts (despite the buyers’ initial skepticism over whether this would be possible). Significant improvements were made to assortment and space allocation, and a comprehensive SKU rationalization exercise was carried out. Narrowing down the assortment meant the buyers could use the credible threat of de-listing products to carry out a round of aggressive cost renegotiations, generating additional cash. Better monitoring systems and shelf life protocols were established to reduce shrink and improve the freshness and quality of products; and store operations were comprehensively overhauled in search of greater efficiency.

Taken in combination, these initiatives represented a massive push for simplification, with the retailer unwinding much of the complexity that had built up over the previous decade, streamlining its business and refocusing its attention on its customers. Detailed discussion of these programs is not possible in this paper, but each was a major undertaking in its own right.

Another, more subtle source of funding for the price cuts effectively came from competitors. Short-term price elasticity is low, but it isn’t zero: as long as competitors were unable to react to the price cuts, practically all of the short-term volume increase for the grocer would come directly from its competitors’ sales line. This would put them on the back foot and force them to focus on short-term financial performance at the expense of long-term investment. The usual instincts for a retailer in this situation are to run increasing numbers of promotions, raise prices on secondary lines, and cut back on investment in core aspects of the business – all tactics that would work against them in the long run.

MINIMIZING COMPETITOR REACTION

For the price cuts to produce an improvement in value perception, the business needed to open up a significant price gap on its competitors, meaning their reaction needed to be kept to a minimum. This was where the management team realized something absolutely crucial: although the lag between a major price cut and a significant volume gain presented an immediate cash flow problem, it also offered a way of outmaneuvering the competition. The very challenges that the retailer faced could be turned to its advantage.

If the retailer could find a way to fund big price cuts, then, competitors simply wouldn’t be able to react. Caught unawares, each would face the choice between doing nothing and becoming uncompetitive, or slashing prices and becoming unprofitable. It seemed a safe bet they would choose the former and allow a price gap to open up.

The complication was that because price cuts had to be rolled out in waves due to the size of the investment required, this risked giving competitors the chance to react. So in planning the cuts, timing was everything. The most obvious approach might have been to start with the most important, highest-volume products and then work down the list. But although a ‘Top 1000 SKUs’ price cut would have made for a great marketing message, it would also have been relatively easy for the competition to understand and therefore to match; besides, given the scale of the cuts, it would have produced a dysfunctional pricing architecture and unfavorable margin mix within each category.
The price cuts were therefore implemented aisle by aisle, beginning with those aisles identified as key drivers of footfall and moving on to cover the whole store over a period of two years. This approach presented fewer practical, operational difficulties, and meant the price cuts would still be very difficult for competitors to match.

The retailer spent months preparing for each stage of the value repositioning, determining how best to revise the assortment and designing an entirely new pricing architecture from the bottom up. These improvements were then rolled out overnight at the same time as prices were slashed – a set of changes so overwhelming that it would take weeks for competitors even to understand what had happened, and much longer to decide how best to react.

THE RESULTS

As planned, the scale and phasing of the price cuts meant that competitor reaction was very limited – in fact even less than had been expected. At the same time, the management team understood that volume would respond very slowly at first, and had taken care to communicate this message clearly throughout the business. They knew that holding their nerve would be a serious challenge in itself, because the first few months would produce some frightening sales figures.

Ultimately, their boldness was rewarded: over time customers began to take notice of the price cuts. By the halfway mark of the two-year program of price cuts, value perception ratings that had long been declining were showing significant improvements. In addition, volumes were increasing dramatically and comparable store sales growth began to outstrip that of the competitors for the first time in years, as shown in Exhibit 2.

Incredibly, the bottom line held up well through the whole period – despite the radical changes affecting the business. The plan to fund the price cuts succeeded, with sufficient vendor funding reallocations, cost reductions, and volume gains to offset the lower prices introduced.

The overall result was a massive strengthening of the retailer’s long-term strategic position: the business became a leading player again and began gaining market share. As intended, the competitors saw their sales figures decline, found themselves unable to react effectively, and began to pull the usual levers in an attempt to meet their budgets. Running more promotions and afterwards raising shelf prices in an attempt to shore up margins ultimately damaged profits. This in turn limited competitors’ ability to invest in their own businesses, to their long-term disadvantage.

The value repositioning described here was massive in every sense – in terms of its financial impact, the change in customer perceptions it generated, and the amount of hard work and level of commitment required from the buying teams. With the last of these in mind, it’s worth emphasizing the effect it had on the business’s culture.
EXHIBIT 2: BY THE TIME THE VALUE REPOSITIONING WAS COMPLETE, SALES PERFORMANCE BEGAN TO OUTSTRIP THE COMPETITION
DIFFERENCES IN COMPARABLE STORE SALES GROWTH VERSUS AVERAGE OF MAJOR COMPETITORS

Note: E.g., ‘+3%’ denotes comparable store sales growth three percentage points higher than at competitors
Source: Published quarterly financial results, Oliver Wyman analysis.

In the past, the grocer had been heavily influenced by its suppliers, but in planning and executing the overall campaign there was a definite change of emphasis. The value repositioning had a huge impact on the organization’s culture: the focus shifted to customers, to systematically analyzing past customer behavior and identifying the areas where performance improvements would create most value. The way the transformation and change was communicated internally was crucial. Rather than focusing on the ultimate benefits to shareholders, the management team stressed that the goal was that of ‘investing in customers’ – a far more inspiring message for the organization. Today, the value repositioning itself is only part of the reason for the company’s ongoing success, and in the long term, the cultural changes that it brought may ultimately prove an even greater source of competitive advantage.
CONCLUDING REMARKS

If a retailer is a generalist catering to all customer segments, it cannot survive indefinitely without offering sharp prices – because its market share will steadily be eroded by those who do. But there are obvious reasons for retailers to be wary of launching large-scale price-cutting campaigns. The long lag between price cuts and volume increases means such initiatives must be meticulously planned if they are to avoid damaging profitability; and the threat of a price war makes it vital to minimize competitor reaction.

There are many examples of retailers who have implemented half-hearted price-cutting campaigns or who have cut prices and destroyed their bottom lines in the process. In contrast, this grocer’s performance shows what can be achieved through careful planning and bold leadership. The value repositioning ultimately generated significant sales and profit improvements, transforming this retailer from being a player that typically under-performed the competition to one with best-in-class comparable store sales growth. At the same time, it demonstrated that if successful, a campaign of this type can be a powerful way of galvanizing the organization and instilling a new emphasis on serving the customer.
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