THE DISCOUNTER THREAT
A CONVERSATION ON FRONT-LINE RETAIL STRATEGY
“Discounters have a winning combination: a transferable customer value proposition, and an easy-to-implement business model.”
Hard discounters and aggressive e-commerce operators are gaining a foothold in many retail markets globally. With a fundamentally different business model to traditional retailers, their economics support low prices in a way that traditional retailers’ don’t.

We discuss this threat and what retailers can do to resist it in our recent publication, “How To Beat Lower-Priced Competition”, available from oliverwyman.com. Our aim in this paper is to share the perspective from the front line: we interviewed Roland Berner, who was Senior VP of Strategy at REWE Group, a €50 BN trading and tourism group based in Germany and operating in 15 countries.

OLIVER WYMAN: Are you surprised by how fast the discounters are growing internationally?
ROLAND BERNER: No – given the combination of external factors and internal strengths of the discounter business model, I am not surprised by the growth rates we’ve seen in the UK, the US, and many Eastern European countries. In the UK, for example, the recession helped discounters take off, but Aldi and Lidl actually sowed the seeds many years ago – so they were well prepared to benefit from the economic downturn. Because they are not under constant pressure from shareholders, they can afford to pursue a long-term strategy – they aren’t forced to become profitable or grow rapidly in each market in a short time frame.

Why do discount formats seem to be easier to export than other formats?

Discounters have a winning combination: a transferable customer value proposition and an easy-to-implement business model.

Their customer value proposition and brand promise is consistent and clear. They bring something new to a country: they’re not just another traditional grocer. That’s something that many large retailers, who’ve been successful in their home country, seriously underestimate. And the discounters, especially Aldi, are also good at adapting to local markets. For example, in Switzerland there is a big focus on the local provenance of fruit and vegetables – while in the US stores are a bit bigger, with more SKUs, but still fundamentally stick to the core business principles.
The discounters’ business model is low on complexity and is now tried and tested in many markets. Its implementation is further supported by their willingness to pay for really good talent. They pay above the industry average, for both store personnel as well as management, and are creative with their incentives: in Germany, Lidl offers an Audi A4 to each of their 3,200 store managers who achieves his or her targets, representing a potential €100 MM investment in employee satisfaction and retention. Discounters also benefit from their attractiveness to local suppliers. While they are certainly tough negotiators, they have a reputation for fairness and bring with them large and steady volumes, without the complexity of highly promotional retailers.

From your experience of how the discounters evolved in Germany, how do you anticipate things will play out in other markets?

Having seen Aldi and Lidl in multiple countries, I think there is no standardised play. In some countries they are really bold and act quickly; in others they bide their time. What you can be sure of, though, is that they will be well prepared and persistent, and that they will be fast learners. It’s a big risk for any established player to think that discounters will stay small. In fact, the discounters will use their small size to their advantage in the beginning – a price war will hurt them a lot less than the established players while their volumes are small. Then, once discounters become mainstream – once shopping at a discounter is no longer seen as something that’s only for poorer customers but is also for the “smart shopper” – discounter growth becomes very hard to stop. In Germany, discounters now have over 40% of the market. I don’t expect other markets to reach that level but I could see, for example, the UK reach 15–20% in the long run.

And of course, the situation is different for each market. In France, the market share of the discounters is actually decreasing from an all-time high of 16% in 2009. There are strong players, organised in cooperatives (Leclerc, Système-U) and highly focused on their home market, that have had some success fighting back against the discounters. In particular, Leclerc has an excellent price perception, promoting its own price comparison tool “Qui est le moins cher” (“Who has the best price”) on the internet.

So is there such a thing as a “discount shopper”?

Yes and no.

Yes, in that there are people who can’t afford to shop elsewhere, and in many countries this group is growing in number. About half of all German households purchase more than two-thirds of their fast-moving consumer goods at the discounters.¹

No, in that once discounters reach the acceptability “tipping point” almost anyone might be a discount shopper for at least some of their basket. New parents might be attracted by the prices of nappies and other baby essentials; other shoppers may use discounters for their staples and use the savings to go to more premium speciality shops for the rest of their baskets. In Germany, 85% of all households shop at Aldi at least once a year.

What mistakes do established retailers make in competing with the discounters?

The most common mistake I have seen is underestimating the discounter threat, and only reacting when it’s too late. Established retailers often see discounters as small, perhaps niche, competitors; then the discounters become widespread – and widely accepted – and it becomes very hard to stop them growing further.

Often, they also underestimate the performance of discounters in fresh food categories. They interpret a limited range as a poor fresh offering. However, that limited range allows incredibly high turnover, so it can be of very good quality. And it will consist of the core lines that are very important to overall price perception.

Finally, I’ve often seen retailers try to match the discounter prices through their entry price brands, but they fail to match the quality. These days, customers easily become aware of this via social media, forums, press, TV, and consumer protection organisations.

How do you think established retailers can best combat the threat from discounters?

The reality is that once discounters have reached the acceptability tipping point, established retailers will lose share – but those losses can be stemmed and won’t necessarily be equal among all incumbents. It’s important for retailers to recognise discounters’ strengths and not let them build too big a lead on these dimensions, and also to develop or strengthen real points of differentiation that customers value. In general, I would advise retailers to react in two ways by upgrading their value proposition to customers and improving their internal processes.

Developing a more competitive value proposition usually requires several different tactics, which together can make a difference. On price, the most critical thing is matching the discounters on entry price points – and quality, especially on fruit and vegetables. Retailers should also excel at delivering value through their own brands, not just copying discounters’ ranges but developing a unique, high-quality, great-value range of their own. More broadly, retailers need other points of differentiation. This could be niche capabilities and services, speciality ranges that customers love and that discounters can’t easily carry, or really relevant and value-adding loyalty programmes. Wherever possible, grocers should remove barriers and make shopping less difficult. This is something discounters do very well – shopping with them is easy. Established retailers need to focus on making shops easy to navigate, products and prices easy to compare, and check-outs and service counters efficient. Finally, they should play up the human factor where possible, aiming to bring not just efficiency but all-round excellence to customer service.

Internally, traditional retailers should look to reduce complexity. Complexity is a massive threat as it slows decision making and responsiveness while driving up costs. In particular these retailers should take a hard look at processes that involve lots of departments (for example, own brand processes which may involve category managers, buyers, and brand managers) as there is very often misalignment across these processes. Core and supporting processes need to be streamlined, responsibilities and performance measures need to be clarified, and incentives need to be aligned across the different parties involved.
The big difference between the discounter threat and the upcoming e-commerce business and convenience stores is that the latter actually present big opportunities for traditional grocers.

Retailers should think about decentralising some decision-making power to the front line who have direct customer contact. This is a competitive advantage of large cooperatives with independent retailers, such as REWE Group and Edeka in Germany or Leclerc and Système-U in France. Finally, I think many retailers also need to upgrade their key competencies – especially category management, pricing and supply chain management, where intelligent tools can really transform the speed and quality of decision making.

Retailers will naturally turn to their cost base too, but it’s usually very difficult to make a big move on costs. The biggest two cost items for retailers are personnel and rent. It would be very risky to try to change these on a large scale in a short time frame: there’s a good chance that in doing so, traditional retailers would undermine their strengths and points of differentiation. Some of the improvement tactics discussed earlier, such as reducing internal complexity and bringing more efficiency to store operations, are good examples of ways to bring costs down with less risk.

A lot of that might sound obvious, but my experience of the German market would suggest it works not only in the fightback against discounters but also in the fight against other traditional retailers.

Are there any chinks in the discounter armour?

Just as traditional grocers encounter challenges as they try to become more like discounters, discounters also face challenges when they try to apply some of the traditional grocers’ elements to capture more of the market. A few examples that come to mind are breadth of range, city centre locations, and opening hours.

If a discounter tries to increase its range or open smaller city centre locations, it will be deviating from the tried-and-tested formula and result in additional complexity.

Lengthening store opening hours breaks the formula in a slightly less obvious way. In the basic discount model, all fruit and vegetables are ideally sold by the evening and replenished overnight. Therefore extending the opening times make it harder to compete with supermarkets on fresh food in the evening.

Should more traditional grocers be looking to launch their own discounters, especially if Aldi and Lidl aren’t yet major players in their markets?

I think it’s risky for a retailer to launch its own discounter, in particular if it’s planning on running it as part of a large group. Traditional grocers are complex businesses with a broad customer proposition, while discounters are specialised. A good analogy is a decathlete versus a specialist sprinter: the decathlete may be a great all-round athlete but in a head-to-head 100-metre race the specialist will win every time.

In a large retail group, there tend to be so many internal processes that discounters don’t have, adding complexity to what needs to be a very low-complexity business model. The cultural differences between an effective discounter and a large retail group also make it very difficult to copy discounters. So if a traditional retailer were to launch its own discounter, I would strongly recommend they run it as independently as possible.
Even Schwarz Group, which has Lidl as a traditional hard discounter and Kaufland as a larger format (but still applying some of the discount principles very successfully), runs the two as highly independent companies. However, it does not shy away from applying some of the hard discount principles to the Kaufland operating model.

Another interesting example is Carrefour’s spin-off of its discounter Dia in 2011, going public at the Madrid stock exchange. Since the IPO, Dia’s enterprise value has more than doubled and it’s been trading well everywhere except for the French market, where Carrefour recently bought it back.

As well as the discounters, traditional grocers also face ever tougher competition from online retailers and convenience stores. Are these threats similar to the discounter threat?

In one way, the threats are similar: for the traditional grocers, simply trying harder with their current business model is not the right answer. E-commerce and convenience stores both have different business models, and this needs to be recognised.

But I think the big difference between the discounter threat and the upcoming e-commerce business and convenience stores is that the latter actually present big opportunities for traditional grocers. E-commerce can be a good fit for a traditional grocer and in markets such as the UK and France this is showing traction. In food e-commerce, there are two main models: the pure delivery model on one side and “click and collect” on the other. For the first, a trusted retail brand and deep customer knowledge are prerequisite (e.g., Tesco); for the second, the physical store base is an asset, as shown by the French hypermarkets and the growth they have achieved through this approach.

Convenience stores have similar competencies and brand promises to traditional grocers, although of course they face challenges of their own in terms of product range and logistics. So, like e-commerce, it may not be an easy area for traditional grocers to move into, but I think in many cases it’s worth trying.

I suppose one other similarity is that, just as traditional retailers shouldn’t understate discounters, they also should not underestimate the threat of e-commerce giants like Amazon or CPG players on ambient food and “near-food” products. Particularly on bulk items like toilet paper or nappies, you can see a path by which these players could cut out traditional grocers.

Overall, then, what do these changes mean for traditional grocers?

When we consider the different directions in which the market is evolving, we can see that clear format definition is disappearing. This can be tough for retailers who have had a successful formula that has been relatively unchanged over the years. Pretty much every retailer needs to be re-examining their business model and finding a new sweet spot between value proposition, key competencies, and economics.
ABOUT OLIVER WYMAN

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www.oliverwyman.com

CONTACTS

JAMES BACOS
Global Retail Practice Leader
james.bacos@oliverwyman.com
+49 89 939 49 441

NICK HARRISON
UK Retail Practice Leader
nick.harrison@oliverwyman.com
+44 20 7 852 7773

BERNARD DEMEURE
French and Iberian Retail Practice Leader
bernard.demeure@oliverwyman.com
+33 1 45023 209

JOEL RAMPOLDT
North American Retail Practice Co-Leader
joel.rampoldt@oliverwyman.com
+1 212 345 8237

MATTHEW HAMORY
North American Retail Practice Co-Leader
matthew.hamory@oliverwyman.com
+1 617 424 3254

SIRKO SIEMSSEN
Central European Retail Practice Leader
sirko.siemssen@oliverwyman.com
+49 89 939 49 574

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