In April 2011, we wrote that while the emergence of international discount grocery stores was increasing competition, it was predominately at the expense of the independents, *Ferriers Focus Supermarket Shootout: Will the independents survive?* Three years on and questions about the survival of the independents remain, but the ‘new kids’ in town are making the major players sit up and take notice.

The entry of private label specialist Aldi, US giant Costco and the resurgence of Coles, have all been major turning points for the sector. New benchmarks have been set in the minds of consumers and the value proposition of the major players has been redefined, including: the development and production of more sophisticated private label offerings; the adoption of more competitive pricing strategies (based largely on analytics); and significant investments in the supply chain and store locations to defend market share.

Since 2009, the Australian supermarket and grocery store sector has recorded an average annual growth of 2.4 per cent. IBISWorld expects that revenue will continue to grow at an annual rate of 2.3 per cent over the next five years increasing supermarket and grocery sales by around $6.5bn.
Recent Neilsen research suggests that major retailers are leveraging different strengths, to carve out profitable market niches. IGA appears to be the laggard.

**Brand** | **FY 2013** | **FY 2014**
---|---|---
Coles | Leader on consumer-focused activities | Product innovation on shelf availability
Woolworths | Leader on supply chain | Loyalty, consumer and shopper insights
Aldi | Leader on strategic and manufacturer-focused activities | More branded engagement
IGA | Struggling to hold competitive position | Business model compliance issues

Source: Nielsen Retail Barometer 2013

**ALDI**

Since entering the market in 2001, Aldi has expanded to around 340 stores across New South Wales, Victoria and Queensland. Aldi has grown at a compound annual growth rate of 18 per cent over the past five years.

Significantly, in February 2014 Aldi’s market share surpassed that of Metcash to become the third largest supermarket chain in Australia. With plans to open as many as 120 stores in Western and South Australia, starting in 2016, Aldi sets itself up to be a significant market player.

Aldi’s expansion in the eastern states has benefited from recent changes to planning laws. Under new regulations in Victoria for example, food retailers can open stores in areas that were previously off limits, on the provision that the stores are less than 1,800m² and near main roads. Aldi stores are typically 1,500m², significantly smaller than those of Coles and Woolworths which are around 4,000m².

**COSTCO**

US retailer Costco is also expanding and plans to invest $110m in new stores to further increase its footprint in Australia. Having recently announced plans for a third store in Melbourne, we believe Costco will ultimately have around 25 stores in Australia. With an average turnover of $140m per store, this could divert up to $3.5bn in sales away from the majors.

However, the speed of Costco’s growth may be constrained by the lack of available large-scale retail space. The rapid expansion of Bunnings and Masters, both having similar sized retail space models, has limited the available supply. Coupled with the long waiting time for available land to be rezoned for development, Costco’s impact on the market will be gradual.

**METCASH**

The success of Aldi and Costco are game changers for the Australian grocery sector. While both major players have been adjusting their business models, Metcash’s supermarket business has arguably been the most vulnerable.

Aggressive discounting and a major push towards private label products by competitors have negatively impacted sales and earnings in the food and grocery division (IGA, IGA Express, Franklins, Metcash Food and Grocery, Supa IGA).

**Food and grocery**

![Graph showing sales and EBITA% for Costco](source: Metcash Annual Report 2014)

Political and legislative factors have also provided challenges for Metcash, including the deregulation of trading hours in WA, allowing the major supermarkets to gain market share in this region — and changes to Victoria’s planning laws, which have advanced Aldi’s expansion plans.

In March 2014, Metcash announced ‘Project Diamond’ — a 5–7 year strategy to combat the increased competition and to reinvigorate its brand in an attempt to stay relevant in the marketplace.

Committing $700m in capital for the transformation plan over five years, Project Diamond needs to be successful to halt the erosion of market share of this $9.1bn grocery behemoth. A recent UBS report estimates the negative impact to Metcash of the growth of Aldi in Western and South Australia to be around $236m, equivalent to 1.8 per cent of like-for-like sales.

Like any major initiative, the risk to Metcash may not be in the strategy, but rather the execution.

Metcash’s supermarket business relies, in substantial part, on the purchasing power of the network and its ability to negotiate the best possible deal with its suppliers.

The execution of Project Diamond however, also relies significantly on the confidence of the network partners in the strategy and the ability of the group to deliver on the execution.
The practical reality is that unlike the majors, Aldi or Costco – Metcash’s supermarket model requires a ‘collective’ approach to change management because the success of the model relies on the ‘buy in’ of all members.

This is where the biggest risk lies.

Anecdotal evidence would suggest that the ‘natives are restless’ in the Metcash network as like-for-like sales decline (impacting profitability) and members are asked to fund significant capital expenditure on the promise of improved performance.

LESSONS FROM THE UK — THE GERMANS ARE COMING

In the UK, the major supermarkets have had to cope with the rise of German discount supermarkets, such as Aldi and Lidl severely impacting margins and earnings performance. (Recent rumors suggest that Lidl — a German ‘no frills’ supermarket — is scouting locations in Australia with a view to opening some time in 2016.)

Aldi and Lidl have both experienced strong growth and are taking market share from the majors, as they successfully cater to the UK’s working and middle class. A strong private label offering and ultra-competitive price points have been the key to their growth in this demographic.

Sainsbury supermarkets controls 17.7 per cent of UK market share. Following good results in 2012 and 2013, a press release in March this year showed sales fell by 3.31 per cent, ending a 36 quarter run of gains.

Tesco has long been seen as one of the most efficient retailers in the world and has its own challenges with declining like-for-like sales and recent allegations of financial misstatements in their results.

The major UK supermarkets reacted to the threat of Aldi and Lidl by rolling out more stores rather than decreasing prices, similar to what we have seen here in Australia. While revenue has increased for the major players, gross margins, like-for-like sales and EBITDA has been negatively affected.

METCASH

Metcash Project Diamond initiatives:
- Significant inventory reduction to make way for range optimisation.
- A restructure of the private label offering.
- Focus on local market needs and convenience in an attempt to drive sales.
- $40m investment to reduce prices in order to address the 3 per cent grocery price gap between IGA retailers and the major chains.
- $180m in capex to refurbish 400 ‘tired’ stores over the next four years.
- Implementation of six growth levers to restimulate top line growth.
- Significant investment in supply chain and distribution centres.
- Website redesign and stronger online offering.
- Store buy-back program to purchase 23 ‘Franklins’ branded stores and sell them on to better operators.

THE RISE OF PRIVATE LABEL PRODUCT

Private label products are becoming increasingly prominent in supermarkets, with Coles and Woolworths expected to grow their own private label offerings in response to competition from international entrants. IBISWorld estimates that private label products account for 28 per cent of the grocery market in Australia. By comparison, in Europe and the US private labels account for 53 and 35 per cent respectively.

Products and services segmentation (2013-14)

A decade long rise in private label milk resulted in sales overtaking branded milk in 2000, following the deregulation of the milk industry. Reports suggest that private label milk now represents 71 per cent of the market. Coles and Woolworths have been locked into a head-to-head battle for market share, which has recently expanded to bread and other products.

The increase in selection and quality of home brands offered by retailers appears to have been successful in winning over the hearts and wallets of consumers. In a recent GFK study, 82 per cent of Australian consumers said private label brands were equal to or better quality than the national brands. It is expected that the share of private labels in Australia will increase to 30 per cent by 2016.
For supermarket retailers in Australia, valuable lessons can be learned from the UK market where the German discounter is converting consumers to more cost-effective options and changing their perceived value matrix in the process. The era of high margins is most likely over and supermarket and grocery business models will need to change.

With significant new store rollout plans across Australia, Aldi and Costco will provide fierce competition for market share in the next 5–7 years. And it is not only Metcash who will be challenged — we expect the two major players’ net margins will also come under increasing pressure.

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