

Supermarket shootout: Will the independents survive?



You've heard it everywhere: 'Down, Down. Prices are down and staying down.' Coles' promise of everyday low prices has launched a price war that has shaken the foundations of the Australian supermarket sector. Aimed directly at the hip pockets of consumers struggling with higher living costs in uncertain economic times, the 'Down, Down' campaign has struck a nerve with consumers.

The fallout from the everyday low-price guarantee looks likely to be far-reaching. Shoppers are overjoyed, but farmers, growers and producers claim their margins have become so fine that their livelihoods are on the line. The dairy and alcohol industries have responded angrily. But the impact won't end there.

Coles' 'Down, Down' campaign has been so successful it effectively forced Woolworths to respond with its own guarantee: 'Price Knockdown and staying down'. With the two majors going head-to-head on price – and accounting for roughly 80 per cent of the national grocery market – the smaller independent supermarkets are being dragged into the battle.

For years the independents have managed to avoid competing with the majors on price, by focusing on variable price merchandising, product selection, convenience and customer service. But the everyday

low-price guarantee is changing that equation.

Could this new retail landscape force a rationalisation of the independent supermarket sector?

The number of independently owned supermarkets is significant. The independents under the FoodWorks and IGA brands employ 25 per cent of the staff in the industry – over 70,000 people – and turn over \$12 billion in sales: 15 per cent of the estimated \$80 billion spent in supermarkets in 2010.

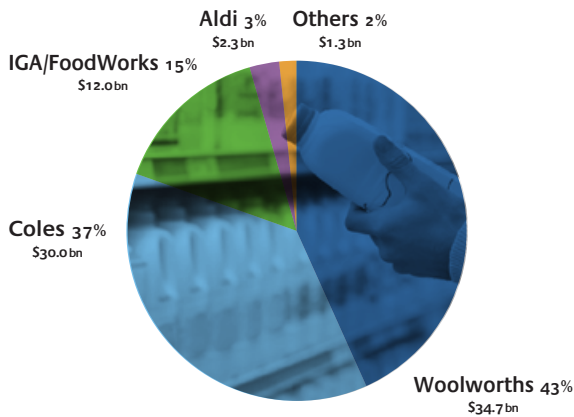
The battle lines are drawn

Competition within the supermarket industry has increased substantially over the past five years due to the impact of rising food costs, increased demand for healthy and organic products, new competitors like ALDI and Costco entering the market, Coles' and Woolworths' greater focus on in-house labels and consumers' changing spending patterns.

What may have appeared to be an overnight strategy from Coles to engage in a public price war is a combination of the improvements made to the business over the past three years of a stated five-year turnaround strategy, which has included refurbishment of stores, sponsoring popular television shows like Master Chef and employing



Market share



Estimated total: \$80 billion

Sources: Wesfarmers and Woolworths annual reports 2010, NARGA November 2010 Report, Master Grocers Australia December 2010 submission to the Senate Economic References Committee

celebrity chef Curtis Stone to front advertising campaigns as a Coles Ambassador.

Coles' strategy was to engage customers to build sales momentum through "non price discounting". Woolworths had no choice but to be reactive and embark on its own store refurbishment plan, launching its "everyday low prices" campaign and introducing its own celebrity chef endorsements with Margaret Fulton. Earlier this year Woolies launched a "Price Knockdown and staying down" campaign, which notably echoes Coles' words: "and staying down."

The last few months have indicated that the price war is likely to be a sustained period of fierce competition. In late January Coles slashed the price of its home brand milk to \$1 per litre, a strategy that forced Woolies to do the same, with ALDI and Franklins joining suit in what is effectively a loss on one product to attract customers away from small independent and convenience retailers.

While larger independent operators may be able to absorb the loss on milk, many smaller independents have less capacity to do so. Coles recognises this and has extended the price war to other staples such as cereals, flour, eggs and nappies. If Coles continues this attack by extending the price war to bread and other key products, staple products will become variable

margin items. This is likely to have greater impact on independent supermarkets than it will for a traditional full-line supermarket.

Traditional full-line supermarkets have the capacity to change the pricing mix across a broader range to manipulate the bottom line, while independents will find it harder to do this within their smaller structures.

Through the price war Coles has effectively set the bar for much of the pricing and product margins around its own home brand and generic products. The other supermarkets – Woolies included – have had to follow suit. We expect this aggressive marketing campaign to continue over the next year rather than subside.

Third-quarter results released this week by Woolworths and Coles show that despite the price war, they are able to manage their margin mix and bottom line. Further, the growth gap in sales on a same-store basis between Coles (7.2 per cent rise) and Woolies (3.3 per cent rise) is tightening as Woolies increases its marketing intensity.

Another invasion

A major impetus for Coles commencing the price war was the impact of German supermarket chain ALDI on the supermarket industry in Australia's eastern states since its arrival in 2001. ALDI now has more than 230 stores in Australia and is well on target to reach its stated goal of 600+ stores, with an estimated turnover of \$2.3 billion.

In 2008, ALDI was named Australia's best-value retailer by the Australian Competition and Consumer Commission (ACCC) following its inquiry into the competitiveness of retail prices for standard grocery items. ALDI's mantra has always been: "keep it simple, keep it cheap." This means smaller stores than your average supermarket, convenient locations, a limited range of basic products, minimal labour costs, limited promotion and a very strong focus on private labels. ALDI's low-cost model is all about sustaining low prices, which is why it poses such a challenge to the major chains and independents with their higher-cost models.

The second foreign invader into the Australian supermarket industry is the US giant Costco, with worldwide turnover of circa US \$77 billion. Costco opened its first Australian store in Melbourne in August 2009.



It was a smash hit, generating sales of \$165.9 million in the first full year of trading, 14 per cent higher than the average US store.

Costco uses a membership model: it keeps product margins low but requires shoppers to pay annual membership of \$60 to shop in its stores. The scale of Costco stores combined with the membership model and the sale of product made overseas specifically for Costco rather than through the normal supply channels of other supermarket operators, make it a real threat to the major retail chains in Australia. Just how much of a threat will become clearer once we see the response to the opening of its second and third stores – in Sydney and Canberra – in July 2011.

The independent supermarkets' response

The market share of independent supermarkets is small relative to the major chains, leaving them at a distinct disadvantage, but they play an important role in the sector and make a substantial contribution to the communities in which they trade.

For decades, the independent sector has relied on drawing patronage from its local area as a competitor to Coles or Woolworths. However, with the emergence of more aggressive promotional activity from the two large chains, consumers have become more prepared to shop around or shop online. Even though the independent sector has the ability to adapt very quickly to its local market, the game-changing impact of the price war has increased the pressure on the independent sector not to get caught in the crossfire between Coles and Woolworths.

Some of the independent operators are better equipped to respond than others: they are flexible, innovative, have critical mass or focus on the convenience market where the price war has less impact. Others benefit from their location (mainly regional) where the lack of local competition allows them to maintain higher margins. It is much harder for the independent operators who are single store owners or only own a couple of stores close to Coles or Woolworths, as they cannot rely on other supermarkets in more lucrative or less sensitive locations to help offset the margin drain of the price war.

Independents such as the IGA network are supported by Metcash Limited. Metcash provides independents

Why are independents at a disadvantage to the majors?

- 1 Don't have the buying power to pass discounts on to customers to compete effectively in this market.
- 2 Smaller range of "home brand" products.
- 3 Lack of vertical integration – wholesale to retail. Coles, Woolworths and ALDI operate their own wholesale supply operations.
- 4 Less capital to invest in store refurbishments, can result in an inferior presentation of supermarkets.
- 5 Lack of scale and capital to invest in loyalty programs, internet orders, home deliveries and petrol discounts.

with the scale necessary to create competitive buying power together with marketing, distribution and financial expertise and support. Metcash assists the IGA network to protect its market share by offering rebates on purchases and using its balance sheet to fund inventory expansion. It also eases credit terms for independents and encourages them to invest more free capital into their stores.

Independents must continue to differentiate themselves from the chains through product range and the promotion of brand leaders. Coles, Woolworths and ALDI are moving towards range rationalisation and driving a shift in consumer spending towards home-brand products. Ultimately, it will be these points of difference and not price matching which will see independents survive the price war.

How we can help

Ferrier Hodgson continues to undertake a number of reviews and assessments of independent supermarket operators throughout the country for financiers concerned with operational performance resulting from a fall in market share in the wake of the price war.



Ferrier Hodgson is able to assist independent supermarket operators and their financiers to:

- Better understand operational issues and the financial requirements of lenders.
- Assess business risk.
- Identify underlying problems and suggest strategies to improve margins and performance.
- Understand the nature and magnitude of all costs related to holding inventory.
- Manage working capital (of which inventory is an important component) to free up cash.
- Manage change.
- Recognise the importance of quality financial information and management information systems.
- Provide a roadmap for responsible management in these times of heightened concern over financial health.

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