How Brands Can Prepare for European Retailing's Tectonic Shifts

Europe's food shoppers are favoring smaller stores, everyday value concepts and online shopping, rapidly changing the rules for consumer goods companies.

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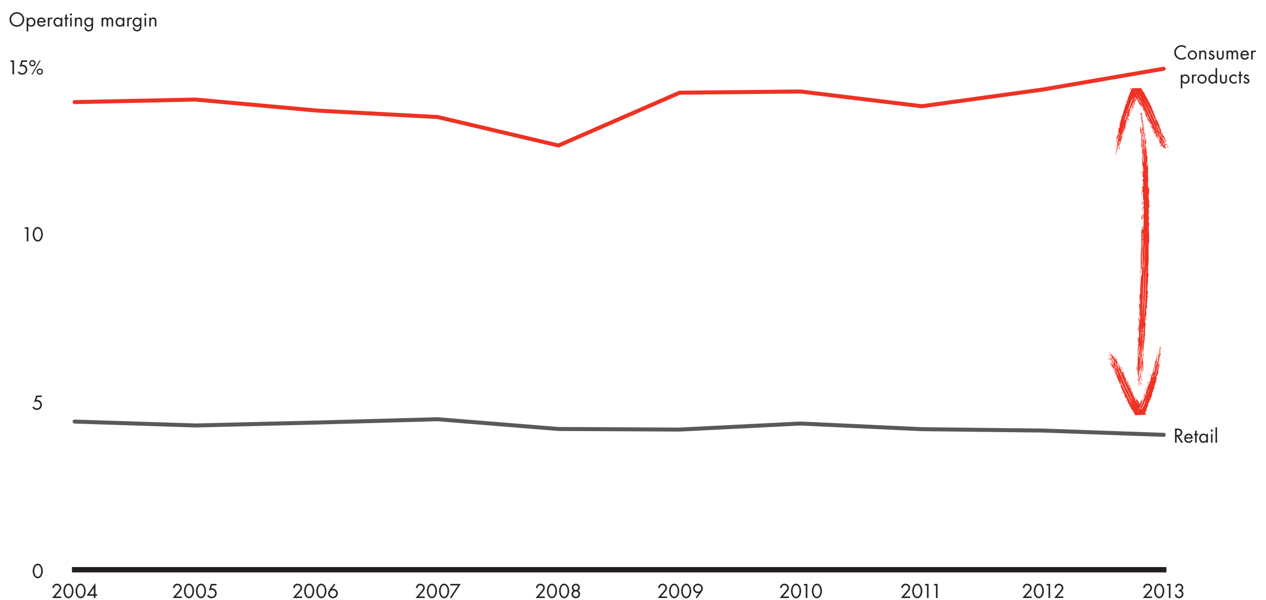
Global consumer goods companies have been on a roll for the past 10 years. Fueled by dynamic expansion in developing markets, an M&A bonanza and relentless discipline in cutting costs, the industry's operating margins have hovered over an impressive 13% for the past decade as consumer goods companies captured greater and greater share of the global retail and consumer products profit pool.

Over the same period, however, global retailers haven't experienced such an enviable fate (see Figure 1). Instead, they have watched their share of the profit pool shrink and their margins erode, as the strategies they implemented weren't as effective as those of consumer goods players. Even the best performers, mostly the largest retailers, have watched their margins tighten over the past decade. Now, retailing is at a major crossroads, and what happens next will have broad implications not only for retailers but also for consumer goods companies, in large part dictating the moves they will need to make if they hope to maintain their stellar performance.

There's no better place to glimpse the future of retailing than in Europe's grocery arena, which embodies many of the challenges faced in other retail sectors and in other geographies. To help us understand the dimensions of those challenges and determine how they will shape the future, we conducted extensive analysis of market data and codified our insights from years of working with grocery and consumer products companies throughout Europe. In association with AIM, the European Brands Association, we also interviewed 30 top leaders at major consumer goods companies that sell to grocers in Europe.

We found that Europe's grocers have grappled with three major trends over the past few years: the weakening performance of big-box stores, the unstoppable rise of everyday value concepts and the acceleration of digital commerce.

Figure 1: Operating margins for global consumer products companies reached a 10-year high while margins for retail companies dipped to a 10-year low



Notes: Based on analysis of 188 consumer products companies and 104 retail companies among the top 500 by revenue; all were public companies with 10 years of data available
Sources: S&P Capital IQ; Bain analysis

Europe's grocers have grappled with three major trends over the past few years: the weakening performance of big-box stores, the unstoppable rise of everyday value concepts and the acceleration of digital commerce.

Challenges to the big-box model

Most major European grocers operate big-box stores. As the name implies, these stores are large, covering a surface area of more than 5,000 square meters (or more than 50,000 square feet). Often called hypermarkets or supercenters, they offer both a comprehensive range of food and a wide choice of nonfood items, historically at low prices due to scale purchasing.

The trouble is, these stores have lost competitive ground in the past decade, with their market share eroding in Western and Southern Europe—from 27%, for both regions, in 2008 to 26% and 22%, respectively, in 2014, according to retail analyst firm Planet Retail. The evolution of consumer demographics and lifestyles has contributed to hypermarkets' decline in performance: The shift to smaller households, aging populations and growing urbanization have reduced the attractiveness of a concept that requires consumers to drive relatively long distances to stock up for a week. These stores have progressively lost ground to more accessible shopping options, such as discount and convenience stores and e-commerce, as well as to specialized and online competition for nonfood products. As a result, the economics of big-box stores are now severely challenged, particularly by negative profits in many nonfood categories, impairing their ability to reinvest in growth.

A doom loop is playing out for most traditional big-box grocers: Reduced foot traffic caused by offline and online competition combine with price pressure generated by growing transparency, compressing the top line. This results in lower sales per square meter and deteriorated economics, leaving stores to deal with a decrease in labor productivity and difficulty adjusting their fixed costs. In response, most grocers cut variable costs, starting with store personnel, resulting in poorer service, unreplenished shelves, stockouts and other challenges that worsen the store experience. This inevitably pushes more shoppers toward the competition, further intensifying the losing cycle.

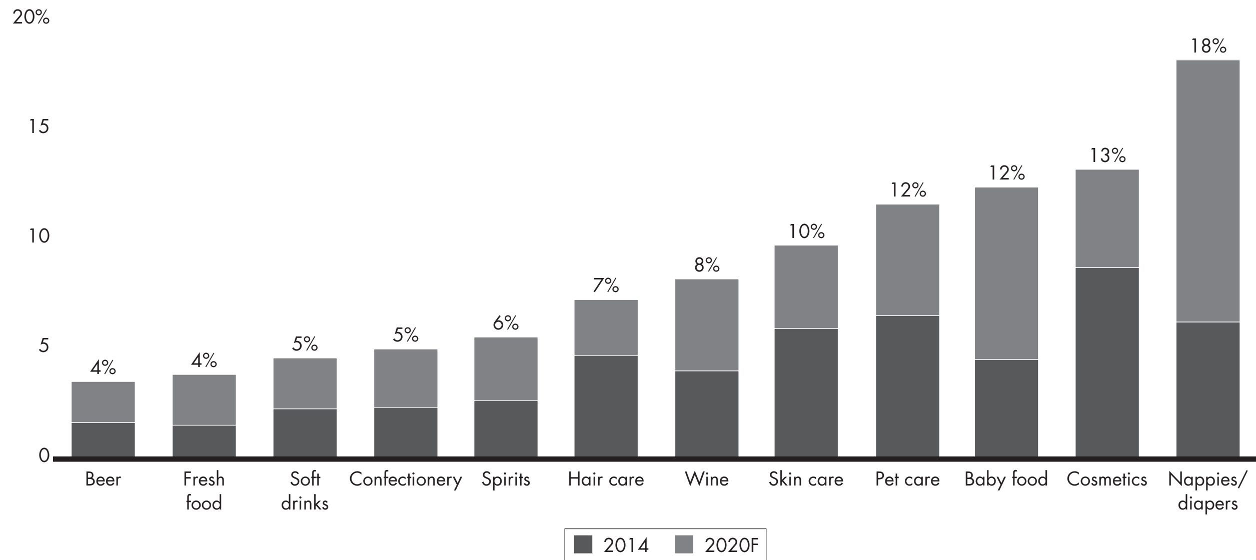
Rise of everyday value

Europe has long been familiar with price-oriented models like "hard" discounters, and these stores have continually gained share over the past decades, for example, capturing more than 35% market share in Germany. Historically, hard discounters focused on providing private-label goods at unbeatable prices in no-frills retail environments. Some value players have also evolved this concept toward "soft discounting," introducing branded goods and offering more-compelling store layouts and customer experiences. And now, some supermarkets are even bridging the supermarket and discount store formats by offering a simplified yet engaging shopping experience and focusing on "value for money" rather than the absolute lowest price, which inspires shoppers' trust. These supermarkets, including Colruyt in Belgium and Mercadona in Spain, have performed extraordinarily well in the past decade, but they have also contributed to reduced average prices in the grocery sector. To make things worse for the sector at large, many traditional grocers across Europe have tried to catch up and reconnect with shoppers by launching price wars, further challenging their own economics and lowering the sector's total profit pool.

Growth of digital commerce

Propelled by the growing penetration of mobile phones and tablets and by consumers' insatiable ap-

Figure 2: By 2020, digital commerce should more significantly penetrate many grocery categories



Note: Only includes the UK, France and Germany
Sources: Euromonitor; Forrester; Bain analysis

petite for convenience and value, the online channel continues to gain momentum. However, many consumer goods companies underestimate the intensity of e-commerce in their categories, partly because the panel data that they rely on to track channel performance seldom covers online sales. Online share is high in nonfood categories that are commonly sold in hypermarkets, but the average online share in the grocery sector remains low. However, some countries, such as the UK and France, and some consumer packaged goods categories—typically the most profitable ones for manufacturers and retailers, such as cosmetics, diapers, pet care and baby food—have already reached online shares exceeding 5%. That's high enough to affect the economics of these categories in stores and, eventually, to influence the grocery sector at large, particularly as many of the online solutions developed by grocers are proving largely unprofitable.

Many consumer products companies also overlook the fact that, across many categories, these levels are projected to double over the next decade (*see Figure 2*). But it is inevitable that online share will accelerate, fueled by a proliferation of online offerings aimed at serving latent shopper demand.

The road ahead

Will these trends continue or even hasten in the future, significantly affecting Europe's grocers in the years ahead and redefining the rules for consumer goods players? Our research and executive interviews helped us formulate a viewpoint, which confirms the weakening performance of big-box stores—for which we are not seeing enough players do what it would take to counter the trend—the continued rise of everyday value, and the rise of digital sales. None of these trends will sound fundamentally new to retail or consumer products executives, but many perceive them to be independent phenomena, which they can handle in silos. But the fact is, they aren't independent. For example, if the discount format accelerates, it reinforces the deceleration

of the big-box format. Similarly, the acceleration of e-commerce hurts the performance of big-box and discount stores. We believe that relatively few executives have fully grasped the mutually reinforcing and cumulative effects of these trends. To assess their impact, we modeled two different scenarios across Western and Southern Europe:

- In the first scenario (our base case), we assumed that the overall grocery market, as well as the convenience and value channels, would continue growing at their current rates; the growth of supermarkets and hypermarkets would slow down by 1 percentage point; and the penetration of online grocery pure plays would nearly triple—essentially, more of the same trends.
- In the second scenario (an accelerated situation), we assumed that the overall market would continue growing at the current rate; convenience and value would grow 2 percentage points faster; the penetration of online pure plays would end up 2 percentage points higher than in the base case; and the growth of supermarkets and hypermarkets would fall nearly 3 percentage points lower than their historical rate.

Our scenario modeling shows that Europe's grocery landscape should be significantly reshaped by 2025 *(see Figure 3)*. In our base case, the market share of supermarkets and hypermarkets will erode to 59%, down from 70% today. In our accelerated case, their market share will shrink to 48% while online pure plays and convenience and value stores will grow to represent the majority of sales.

As a fallout from the shift toward smaller store concepts, we estimate that the average size of grocery stores could decrease by about 10% in our base case. In the accelerated case, in which we assume that hypermarkets will also reduce their network capacity by 30% to address declining traffic and plummeting sales, the average store could shrink by 30% to 35%, resulting in a sizable reduction of available shelf space *(see Figure 4)*.

Consequently, the weighted average assortment size as measured in the number of SKUs by store would meaningfully shrink, dropping by 15% to 25% in our base case. In our accelerated case, we assume that, in addition to hastened channel shifts, hypermarkets and supermarkets will also rationalize their assortments by 30%, in line with the public announcements that some of these stores have made. The effect on assortment size would be even more drastic, with a decline of between 40% and 50% from today's levels *(see Figure 5)*.

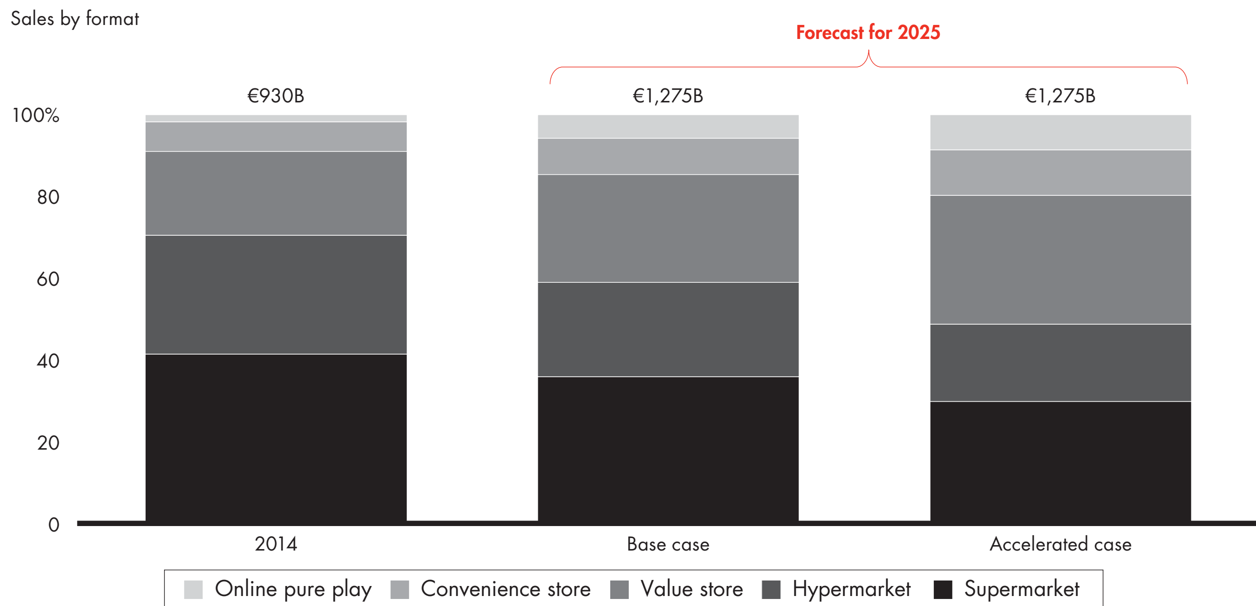
The combined effect of channel trends will take a toll on retail margins, which are likely to fall over the next decade by 20% in our base case and by up to 40% in our accelerated case. Whether the base case or the accelerated case plays out, the future will be less than encouraging for European retailers, with the changing business conditions rewriting the rules for consumer products manufacturers.

What it all means for consumer goods companies

Until now, it has been possible for brands to downplay the major shifts in the grocery sector and still maintain healthy margins. But that will be less and less of an option as growth slows in many developing markets and retailers increasingly face tough times. We've identified five imperatives for thriving in the new grocery world. Let's look at them one by one.

Assess the value—and the risks—at stake. Know where your sales and margins are headed, and shift resources accordingly. Our analysis might be eye-opening, but keep in mind that it's an average across markets and channels in Western and Southern Europe. As such, it doesn't perfectly reflect what the situation will look like for each company as it competes across different categories with diverse market coverage and channel presence. That's why every company needs to conduct an analysis that mirrors its own reality. It's the best

Figure 3: The grocery landscape in Europe should be significantly reshaped by 2025



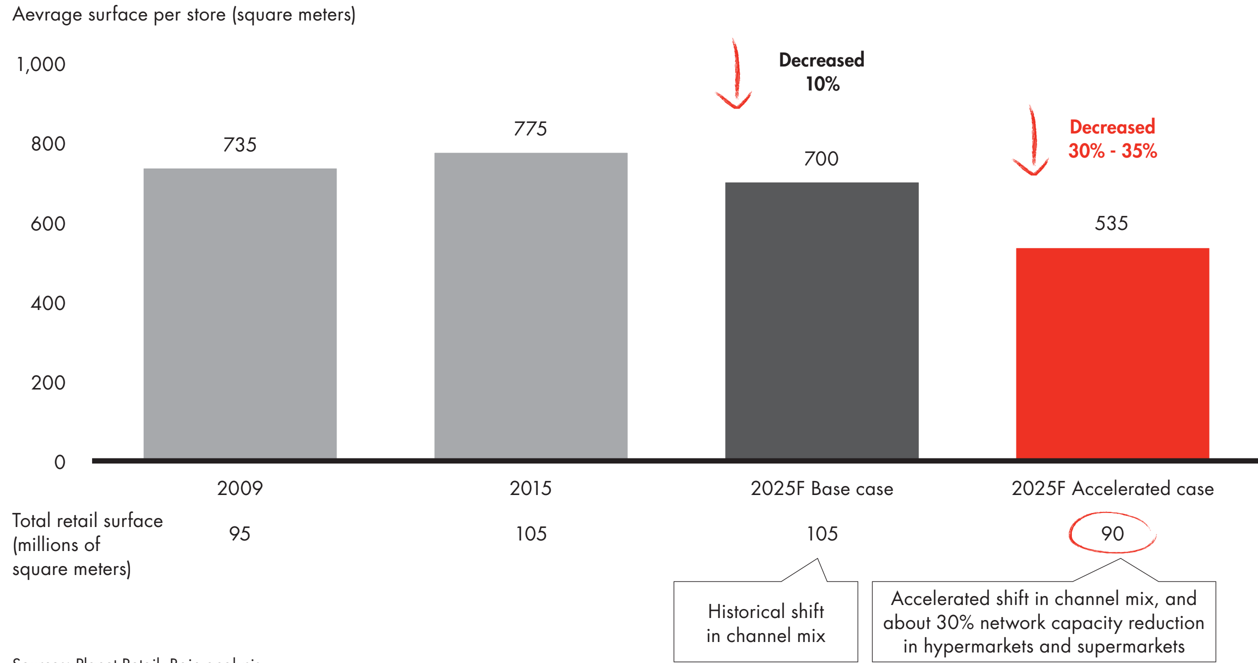
Notes: Western Europe includes Andorra, Austria, Belgium, Denmark, Finland, France, Germany, Iceland, Ireland, Luxembourg, Monaco, Netherlands, Norway, Sweden, Switzerland and the UK; Southern Europe includes Greece, Italy, Portugal and Spain
Sources: Planet Retail, Bain analysis

way to project a company's future channel exposure and the influence this exposure is expected to have on sales and profits. Only after clearly understanding how much of its revenue and margins are at risk or which opportunity it might be missing, can a company lay plans to redirect resources as necessary.

For example, many consumer goods business models in Europe are designed with an emphasis on serving the eroding hypermarket and supermarket channels. Much of the cost base or balance sheet is stranded in expenses or assets that are becoming increasingly obsolete, such as supply chains that are designed to deliver long batches and full pallets to large distribution centers or selling strategies that require companies to deploy armies of merchandisers to replenish hypermarket shelves. However, serving the growing discount and convenience channels requires different supply chain strengths: the ability to prepare multibrand, multi-product pallets and relying on different activation models, for example. But the right decisions can only be made with access to hard facts about the size of the prize for each particular company.

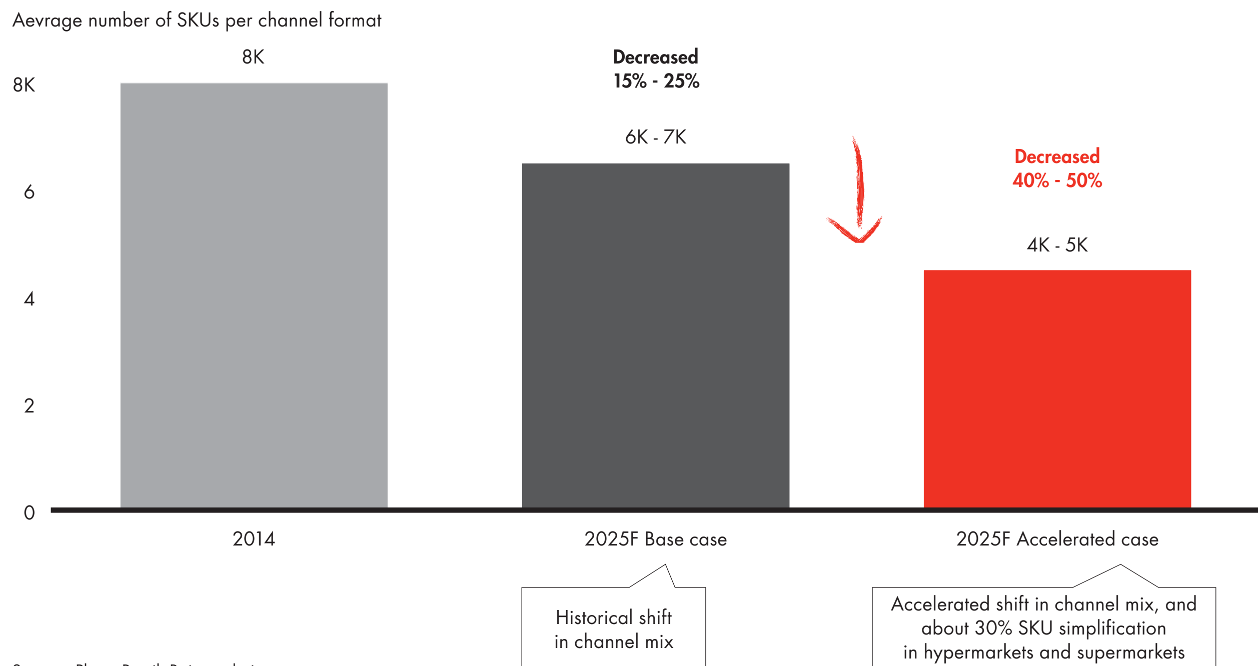
Build simpler but stronger portfolios. There is a big consequence for smaller stores: Shrinking shelf space increases competition among brands, leaving room for only the strongest brands. Looking ahead, this challenge will require consumer goods companies to prune their portfolios, keeping just their best-selling brands. Companies will also have no choice but to drastically simplify their assortments, focusing on their proven hero SKUs to unlock incremental growth and rid themselves of stranded costs (see the Bain Brief "Growth Through Simplicity: How the Best Consumer Goods Players Are Getting Bigger By Getting Smaller"). Winning consumer goods companies will take these measures proactively, before grocers impose them.

Figure 4: Years of increasing store capacity should lead to network capacity rationalization



Sources: Planet Retail, Bain analysis

Figure 5: This channel evolution will result in a reduction of average assortment



Sources: Planet Retail, Bain analysis

We also believe that the need to build stronger portfolios will inevitably lead to continued sector consolidation as consumer goods companies continue turning to acquisitions to reinforce their positions in must-win categories. Finally, companies will need to revise their approaches to innovation, ensuring they deliver fewer and better new products that reinforce hero SKUs and are relevant for shoppers while helping to improve retailers' margins (see the Bain Brief "Innovation in Consumer Goods: Heroes to the Rescue").

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Reinvent how you work with supermarkets and hypermarkets to rejuvenate growth and protect margins. Nobody is suggesting that supermarkets and hypermarkets will disappear from Europe's landscape. In fact, they will continue to represent a significant portion of the retail environment. However, consumer goods companies need to take the formats' predictable erosion and probable consolidation into account, and adjust how they accommodate them to minimize risk. This means redefining commercial and operational strategies in various ways:

- **Focus on the winners.** Collaborate with and invest differentially in those players that are faring well or will know how to reinvent themselves and turn around their declining performance. Deploy differentiated strategies and systems to win at the store and on the shelf (see the Bain Brief "The New Mission for Brands: Winning Shoppers in the Store").
- **Master the art of revenue management and pricing in the context of likely grocer consolidation.** Consolidation will be inevitable for many grocers, if only to rationalize their structural store overcapacity. Consolidation can take different forms. Some European grocers have engaged in virtual consolidation, joining forces to buy together. Some are consolidating their store networks. Either way, grocers are in a position to see one another's prices, terms and conditions—and to demand the best deals. Winning consumer goods companies will prepare for the new reality.
- **Continue looking everywhere for cost savings.** Selling, general and administrative expenses and other operating cost management programs have been key to propping up margins of consumer goods companies over the past decade, successfully helping them offset the higher cost of goods. It's critical to keep hunting for efficiency. A low-cost model will be key for any consumer goods company hoping to control its own destiny. As retailers require brands to share in their margin reductions, cost initiatives will be essential for maintaining enough margins to invest in growth. One way to reduce costs is by leveraging new technology to perform operations better and cheaper. For instance, as consumer goods companies are required to rethink how they deploy their salesforce to emphasize high-potential outlets, they can investigate alternative, lower-cost contact methods. Instead of sending reps to stores to spend hours checking prices, some companies are finding it significantly more efficient for reps to photograph products and transmit the photos to a central location, where the price checking can be conducted at a fraction of the time and cost.

Define winning commercial and operational strategies to gain ground in growing channels. For years, many brands assumed that selling in discount or convenience channels meant losing their shirts. As

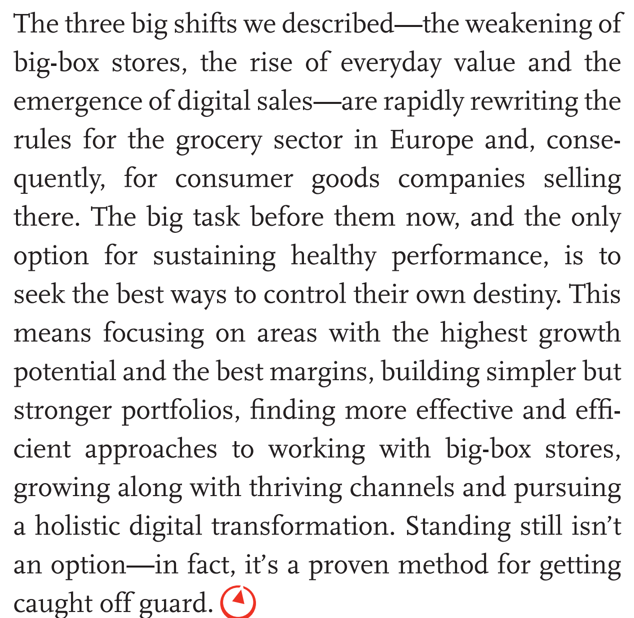
a result, they've dealt with those channels at arm's length or, at best, in an opportunistic fashion. However, as these channels continue to expand, brands will need to develop the right strategies to win there. They'll find they can often reap profits that are higher than in traditional channels. However, it requires careful and proactive attention in such areas as assortment, pricing and supply chain solutions. To reduce dependency on traditional channels that are eroding, consumer goods companies can also explore alternative channels and models, such as specialty stores, drug stores or direct-to-consumer sales.

Engage in a holistic digital transformation. By digital transformation, we mean the ability to use digital technology across as many business areas as possible to help recreate competitive advantage and operate better, faster and cheaper. Companies can typically do this in three areas:

- **Selling through the growing e-commerce channel.** This requires new commercial playbooks to learn how to collaborate with a new host of customers, including online powerhouses like Amazon and Alibaba, which have different needs and requirements than traditional retailers.

- **Revising approaches to consumer engagement** by upping their game in digital media.

- **Investing to build advanced analytical capabilities to learn more about shoppers.** This is an area in which consumer goods players find themselves at a growing disadvantage to retailers—which have greater access to shopper data—and overly dependent on providers of panel data, which typically offer patchy data with critical coverage gaps in fast-growing channels like discount and convenience stores and e-commerce.



The three big shifts we described—the weakening of big-box stores, the rise of everyday value and the emergence of digital sales—are rapidly rewriting the rules for the grocery sector in Europe and, consequently, for consumer goods companies selling there. The big task before them now, and the only option for sustaining healthy performance, is to seek the best ways to control their own destiny. This means focusing on areas with the highest growth potential and the best margins, building simpler but stronger portfolios, finding more effective and efficient approaches to working with big-box stores, growing along with thriving channels and pursuing a holistic digital transformation. Standing still isn't an option—in fact, it's a proven method for getting caught off guard.

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