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Don't be undersold!

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A new class of European discounters have U.S. retailers squarely in their sights.

When the CEO of Procter & Gamble visited the company's European headquarters a few years ago, Paul Polman, then P&G's president for Europe (and now the CEO of Unilever), took him to visit P&G's most dangerous competitor: not Danone, Nestlé, or Unilever but an Aldi store. Yes, Aldi, a chain of low-budget retail stores with sales in 2008 of $73.5 billion, is the four-letter word that strikes fear in the hearts of brand managers across Europe.

The devastation and poverty that characterized Germany after World War II provided the ideal environment for Aldi, which invented what is commonly referred to as the hard-discount store. The format has been widely imitated - most successfully by Lidl, also based in Germany and the flagship of the Schwarz Group. Other fast-growing European chains include Plus, Penny, Norma, Netto, Ed, and Dia, some of which are owned by huge traditional retailers such as Carrefour, Rewe, and Edeka. These giants have been forced to launch or acquire their own hard-discount formats over the past decade in order to stop hemorrhaging market share to Aldi and Lidl. (See the exhibit "Getting Bigger All the Time.")

A hard-discount store differs from U.S. bargain stores like Wal-Mart and Kmart. It is a minimally decorated outlet that sells a small assortment of foodstuffs and household goods -- typically 1,000 to 1,500 SKUs. (A U.S. supermarket sells 30,000, on average, and a Wal-Mart supercenter sells 100,000.)

Hard-discount stores are about one-tenth the size of a Wal-Mart, with comparably lower staffing levels, and are usually located in low-rent districts. Hard discounters have an extremely efficient supply chain, thanks largely to their limited SKU numbers and private-label focus, which make for a simpler operation. Aldi's costs add 13% or 14% to the procurement price -- 2% each for logistics, rental, overhead, and marketing, plus about 5% for staff. Its efficiency allows Aldi to offer products at startlingly low prices. Indeed, most international comparisons of prices across retail stores have designated Aldi the winner. In Australia, for example, a 60-meter roll of Aldi's Goliath plastic wrap sells for A$1.29, compared with A$3.71 for Glad.

Hard discounters can keep their SKU numbers low, and thus cut supply chain costs, in part because their own brands account for at least half their offerings. In Aldi's case the number exceeds 90% (at Wal-Mart it is 38%). Because these private labels are typically priced at 50% below manufacturers' brands, their success has been disastrous for both traditional supermarkets and brand manufacturers.

To combat market share losses, mainstream retailers have been forced to emphasize their own private labels and develop cheaper versions of them.

Mighty Tesco, the fourth largest retailer in the world (with global sales of $109.1 billion), in September 2008 rolled out a discount private label, Discount Brands at Tesco, and highlighted price comparisons with Aldi in its promotional materials. Following Tesco's lead, France's Carrefour, the world's second largest retailer (with global sales of $160 billion), launched the Carrefour Discount label in June 2009.

Brand manufacturers, also feeling the heat, need to reduce prices, or at least to restrain price increases, in order to ward off competitors. Procter & Gamble was forced to cut the prices of Always sanitary napkins by 17% and Pampers diapers by 11% to remain competitive in Germany against Aldi's private labels.

We estimate that the success of hard discounters -- which now bring in annual revenues of more than $250 billion -- is responsible for destroying between a quarter and a half trillion dollars in mainstream brand sales annually. And no end is in sight.

Sales of the top 10 hard discounters are forecast to increase by roughly 50% over the next five years.

Aldi alone is expected to top $100 billion in sales by 2013, and Lidl to reach that milestone the following year.

Brand executives at major consumer packaged goods companies have mostly been caught off guard by the hard discounters' success. They underestimated the threat to their revenues and market share. In our work with companies and our research into the sales performance of hundreds of brands in Germany, the UK, Spain, and other European countries from 2003 to 2008, we identified four key misconceptions about hard discounters that caused brand managers to ignore them until it was too late. These misconceptions still prevail at many consumer packaged goods companies -- especially those headquartered in the United States. In this article we will address the misconceptions in turn and demonstrate how manufacturers' brands can succeed in hard-discount stores.

Misconception 1: Hard discounters will succeed only in Europe. Although Western Europe is home to the world's fiercest hard discounters, the rest of the world, including the United States, is not immune. Aldi is leading the charge in the U.S., where it has more than 1,000 stores in 29 states. (It also owns more than 300 Trader Joe's stores, but the two chains operate separately and follow a very different strategy. TJ's is known for its eclectic mix of private-label organic, health, and gourmet products.)

Aldi stores are mostly in the Northeast, but the chain entered Florida in September 2008 and will be in Texas in 2010. Its 2009 sales in the U.S. are expected to be about $8 billion. By comparison with mainstream retailers such as Kroger, Supervalu, and Safeway, Aldi is still relatively modest; nevertheless, its growth is astounding. Since 2000 Aldi USA has grown by an average of 12.2% annually.

In 2008 it grew by 21%, and in 2009 by 13.7%. It would no doubt grow even faster but for its strategy of building new stores only as fast as profits allow, so as not to take on debt.

Misconception 2: Hard discounters are for the poor. Executives at brand manufacturers and traditional retailers often comfort themselves by asserting that hard discounters attract only the bottom strata of the market. Never mind that the low-income segment constitutes an important part of the market; the relationship between hard-discount buying and income is weaker than one might think.

In Germany, for example, hard discounters own 43% of the market in the lowest income quartile and 34% in the highest. These wealthy consumers patronize hard-discount stores not because they have to but because they want to. Germans characterize this as "Ich bin doch nicht blöd" ("I am not stupid"). We might call it "smart shopping." Our data demonstrate that smart shopping is more prevalent among better-educated consumers; that's probably why hard discounting is now primarily in rich countries.

Misconception 3: Hard discounters offer inferior quality. Austere stores, sober packaging, and unknown brand names lull competitors into believing that hard discounters' products are no match for their own cherished traditional brands.

Nothing could be further from the truth. Consumer organizations and independent testing agencies have demonstrated time and again that the products of hard discounters hold their own on objective (functional) quality. Aldi's laundry detergent has been rated higher than the brands of Europe's big-three detergent manufacturers: Henkel, P&G, and Unilever. The market research agency GfK analyzed the results of consumer tests in 26 product categories conducted from 2002 to 2006 by Stift ung Warentest, Germany's leading consumer safety group. The tests included 90 premium brands, 45 market-leading brands, 75 other national brands, and 232

Aldi private labels. Seventy-four percent of the national brands -- and 81% of the Aldi private labels -- were rated as excellent or good. In the United States, Aldi offers a "double guarantee": "If for any reason you are not 100% satisfied with any product, we will gladly replace the product AND refund your money." This program sends a message that the price premium charged by national brands is tied to wasteful marketing and advertising rather than to quality.

Misconception 4: Hard discounting is for recessions. Executives at competitors argue -- or perhaps hope -- that the success of hard discounters is a recessionary phenomenon. There is some truth to this. Even rich consumers are more price sensitive in recessions. But research in Europe demonstrates that the truth is more nuanced. Hard times do lure shoppers to hard discounters, but many of these consumers keep coming back for at least some of their purchases even after the economy recovers.

From 2002 to 2003, an economically tough period in Germany, the combined market share of Aldi and Lidl increased from 22% to 26%; but in the more expansive period from 2004 to 2007 it increased even further, to 28%. Why? Because consumers discovered the quality of the discounters' private-label offerings.

Learn to Love Your Enemy

Many brand manufacturers view hard discounters as deadly enemies rather than potential distribution channels. Similarly, hard discounters have tended to see manufacturers' brands simply as competitors.

Hard discounters now understand that an overwhelmingly private-label format can win only so much market share, and in Germany, where hard discounters have 40% of the market, the limit has probably been reached. Some consumers prefer manufacturers' brands in many categories but also love hard discounters for other categories.

A judicious mix of store and manufacturers' brands may enhance sales for a hard discounter, because the latter are known to increase traffic. To enlarge their market share, especially Lidl and even Aldi are carrying more manufacturers' brands in their stores -- but they must be careful not to jeopardize their supply-chain cost efficiencies.

Some 30% to 35% of Lidl's offerings are manufacturers' brands; as a result, the company has grown significantly faster than Aldi over the past few years.

From 2005 to 2008 Lidl doubled its share of the total detergent category by introducing two leading brands from major multinationals. When Lidl stopped carrying Nestlé's Maggi brand mashed potato mix, its market share in the category declined from 12.7% to 11.3% -- but one-third of the Maggi buyers switched to the Lidl brand. Lidl's managing director for the UK explains: "Own-brands are Lidl's future, but we believe branded products complement our range. If a customer comes to us for the first time, they will be more comfortable seeing some brands they know. At some point…customers will swap to our own-brands."

The strategy can pay off for brand manufacturers as well. We looked at sales of the 100 largest packaged-goods brands in Germany from 2003 to 2008 and found that those with a small presence in hard-discount stores saw a decline in sales of 6.7%, on average, whereas brands with a strong hard-discounter presence saw an increase of 0.4%.

For brands owned by U.S. companies, the difference was even larger (-8.8% and +1.0% respectively). The conclusion is clear: To grow, one must be present in the most rapidly growing channel. (Kraft is one U.S. company with strong distribution in hard-discount stores, and its history proved to be an asset: Its top brands at those stores are all formerly brands of the European firm Jacobs Suchard, which Kraft acquired in 1990.)

Of course, selling through hard discounters raises the specter of sales cannibalization -- but this problem is not as severe as one might think. Our research reveals that some 80% of manufacturers' brand sales at hard discounters are to customers who have not previously bought the brand. Furthermore, brand managers can take proactive steps to reduce cannibalization of their sales at the traditional retailers while succeeding with their brands at hard discounters:

Sell unfamiliar sizes at the discounter. This makes price comparisons across stores difficult. Various sizes also cater to different segments. Nestlé designed a two-liter container of Vittel mineral water exclusively for Lidl. Aldi recently added Knoppers chocolate wafers to its stock, but sells them in a special package of 10 wafers rather than the usual eight.

Offer your smaller brands. Brands with a limited market share experience substantially less cannibalization than those with a large market share.

Kraft is a minor player in the German hard-cheese market and has benefited significantly from selling its cheese at Penny: Only 6% of its sales at Penny were to customers who had formerly bought Kraft at a higher price in regular supermarkets.

Carefully manage the price gap. The narrower the price gap between a manufacturer's brand and a hard discounter's private label, the more the hard discounter's label will be cannibalized. This makes hard discounters reluctant to include manufacturers' brands among their offerings. A large price gap signals that the hard discounter's label and the manufacturer's brand are targeting different consumer segments; but if the price gap is too large, the hard-discount customer will turn away from the manufacturer's brand. Of course, the optimal price gap will differ across categories, but in our research it falls somewhere between 75% and 150%.

Present the brand in an attractive outer case. To save costs, hard discounters often don't unpack shipping boxes when displaying products in their stores. In our research, only 6% of manufacturers' brands were packaged in attractively designed outer cases. As a result, almost 95% of brand manufacturers were missing an important merchandising opportunity.

Use dynamic brands. Brands that are regularly updated with new characteristics benefit both the manufacturer and the discounter. Not only do they stand out in a hard discounter's low-innovation assortment, but they can keep the entire category (which may consist of a single manufacturer's brand and a private label) reasonably fresh.

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In the early 1990s Aldi stores were ridiculed by competing retailers and brand manufacturers as being cheap and hawking shoddy products to people who couldn't afford to shop elsewhere. Nevertheless, Aldi's sales, profits, and market share continued to rise. Today Aldi is behind only Siemens and BMW among Germany's most respected corporate brands.

Germany's brand establishment would have done better to make friends with Aldi. But what about the U.S. brand establishment? As competition among hard discounters heats up in Europe, and as mainstream retailers like Tesco and Carrefour get into the game by introducing their own discount brands, the United States looks even more alluring.

Aldi's target demographic in the U.S., more than in Europe, tends to be the lower-income segment.

Under current economic conditions, this segment is poised to grow. Thus it is not surprising that Planet Retail, a provider of global retail analysis and research, projects that Aldi will grow in the U.S. by 10% a year over the next five years, compared with Kroger at 3.7%, Supervalu at 1.9%, and Safeway at 2.1%. The Germans are coming -- and they'll be here to stay.

IDEA IN BRIEF

- The success of hard discounters' own brands is responsible for destroying between a quarter and a half trillion dollars in mainstream brand sales annually.
- Brand executives at major consumer goods companies have been caught off guard, having assumed that hard discounters operate primarily in Europe, supply shoddy goods to poor customers, and flourish mainly in recessionary times.
- The authors' research shows that savvy manufacturers can partner with hard discounters to gain rather than lose brand sales -- by selling differently packaged, smaller, carefully priced, and more dynamic brands through the hard-discount channel.

Getting Bigger All the Time

THE TOP 10 HARD DISCOUNTERS globally account for annual revenues of more than $220 billion -- and their sales are forecast to increase by roughly 50% over the next five years.

	Discount banner	Discount banner sales ($B) 2008	Compound annual growth rate 2003–2008	Number of outlets 2007	Private labels as % of total sales
Aldi Germany	Aldi, Trader Joe's, Hofer	73.5	10.7%	8,693	90%
Schwarz Group Germany	Lidl	62.3	18.6%	8,484	70%
Carrefour France	Ed, Dia, Minipreço	16.0	18.0%	6,259	57%
Rewe Group Germany	Penny	15.9	9.5%	3,149	62%
Tengelmann Germany	Plus[1]	14.0	8.5%	3,132	52%
Dollar General United States	Dollar General	11.0	8.9%	8,362	20%
Edeka[2] Germany	Netto Marken-Discount, NP, (Plus)	8.4	43.1%	2,062	32%
Family Dollar United States	Family Dollar	7.3	7.9%	6,598	54%
Dansk Supermarked Denmark	Netto	7.3	13.4%	1,119	53%
Norma Germany	Norma	4.5	11.6%	1,438	54%

(1) Sales figures are for 2007; in 2008 most Plus stores were sold to Edeka.

(2) In 2005 Edeka acquired Netto Marken-Discount, which accounts for most of its CAGR.

Source: Planet Retail (2008, 2009); GfK (2009); authors' calculations

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