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European new entry into UK grocery retailing

Robert Colin Duke

INTRODUCTION

Until recently, the UK grocery retail market was extremely national in nature, dominated by home-grown incumbents which had developed from regional strongholds (Sainsbury in southern England, Asda in northern England, for example). The lack of any significant presence in the UK market from Europe or the wider world was a remarkable characteristic, particularly when Europe had a number of cross-border grocery retailers.

In the final years of the last decade, this changed, when two European grocery retailers, Germany's Aldi and the Danish Netto, entered the UK market. The entry of these retailers, and the possible entry of others like them, raises a number of significant matters relating to the structure, present and future, of the UK grocery retail market.

The objective of this article is to explain how these new entrants were able to penetrate the market's barriers to entry, to analyse the events which created the market opportunity targeted, and to describe the response of UK incumbents and the long-run effects on the market which are likely to result.

THE UK GROCERY RETAIL MARKET-BARRIERS TO ENTRY

In an analysis of the UK grocery retail market using the framework invented by Porter 1!, Duke 2! concluded that new entry to the market was opposed by three main barriers to entry. These were intense competition and low profitability in the market itself, economics of scale, and the scarcity of new store sites. He observed that a new entrant which could defeat these three barriers would have a good chance of success, and cited convenience store retailing as the prime example at that time.

During the 1970s, intense, price-based competition in UK grocery retailing led to margins as low as 1.7 per cent 3!, a level of profitability unlikely to attract new entrants. During the 1980s, there was a general shift away from price-based competition towards offers differentiated on factors such as quality, service, range, and convenience. Former price competitors, such as Asda and Tesco, abandoned their price-based platform and moved "up-market" towards the quality/value for money position traditionally occupied by Sainsbury. The success of this change in emphasis has shown in steadily widening net margins, now as high as 6 and 7 per cent for major retailers. However, it is precisely this success that has weakened an entry barrier. To European discounters, such as Aldi and Netto, used as they are to net margins of 2 or 3 per cent 4!, UK margins are extremely attractive. Such new entrants will not be deterred by low profitability.

Economies of scale are the second important barrier to entry. In addition to the usual ones, the UK grocery retail market has a special economy of scale effect arising from the substantial bargaining power which retailers enjoy over their suppliers, the manufacturers of food and grocery products. This power allows retailers to force down suppliers' prices, thus reducing their own costs (specifically, their costs of sales) and, since the magnitude of this power increases with increasing market share, it can be regarded as an economy of scale effect. This effect is particularly important since cost of sales form the majority of retailers' costs 5!.

Updating his earlier analysis, Duke 6! observes that the European new entrants, Aldi and Netto, have some ability to defeat this entry barrier. First, they are themselves sizeable operations: Aldi, for example, had turnover of around L6.9 billion in the year ending in 1990 7!, slightly greater than Tesco's. Therefore Aldi also enjoys a buying power-derived economy of scale advantage in the European countries in which it has a large market share, an advantage that its UK operation exploits by sourcing much of its UK merchandise from Europe 8!, thus evading buying power economies of scale entry barriers around the UK market. Duke also observed that Aldi and Netto's UK operations partially evade this same entry barrier through greater use of branded good from smaller manufacturers, rather than major brands and own label.

The third major barrier to entry, the shortage of unexploited store sites, is again one that European discounters may have some ability to penetrate. A preliminary analysis would suggest that the UK market should be difficult prospect for a new entrant. Unexploited superstore sites are running out: Mintel 9! has estimated saturation point for superstores in the UK at about 800, only around 150 more than the present total. Those which are still available are vigorously pursued by skilled and determined incumbents, who, conscious of the imminence of saturation, are investing heavily to acquire and develop the opportunities which remain. The top three operators alone (Sainsbury, Tesco and Argyll) are set to invest about £2 billion during 1991 a sum equal to one-fifth of the total capital expenditure of UK manufacturing industry 10!.

However, Aldi and Netto have the means to defeat this entry barrier too. These retailers operate supermarket-sized outlets, 7,000 to 10,000 square feet of sales floor area 11!, in high streets or on the edges of towns. They are therefore less inclined to compete with incumbents for out-of-town superstore sites. Furthermore, limited line discount supermarkets are less likely to need purpose built stores: they can lease or buy vacant shop units at a fraction of the initial cost of setting up a superstore, and can be trading in as little as ten days, as opposed to a superstore's three years 12!.

THE OPPORTUNITY TARGETED BY EUROPEAN NEW ENTRANTS

The European new entrants Aldi and Netto can be said to have enjoyed a measure of good fortune in that the most vulnerable part of the UK grocery retail market corresponds almost exactly to their own company strengths and marketing assets 13!.

During the 1980s, UK grocery retailing was caught up in the decade's general interest in "going up-market" Retailers, most notably Tesco and Asda, who had previously created offers based on low prices, often coupled with a spartan, "stack it high and sell it cheap" approach to store design, changed tack to fortify the non-price areas of their offers, moving towards the quality/value for money oriented offer employed so effectively by Sainsbury and Marks & Spencer. Ranges were widened, quality improved (particularly in own-label products), stores revamped and provided with offer enhancing facilities such as scanning check-outs, restaurants, cash machines, baby changing facilities, and so on.

Two consequences of this change are significant to this study. First, the reduced emphasis on price-based competition allowed a steady rise in the net margins of most retailers, making the market more attractive to potential new entrants. Second, it left the price-sensitive lower end of the market largely abandoned (defended mainly by KwikSave) and vulnerable. Furthermore, when Aldi and Netto brought their limited line discount approach to the UK, attacking this vulnerable low end, it was an attack that upwardly aspiring former price competitors found difficult to respond to, since a return to price competition to meet the new entrants would contradict their carefully cultivated quality/value for money position.

INCUMBENT RESPONSE AND THE REBIRTH OF THE PRICE-BASED OFFER

A major recent development in UK grocery retailing has been the revitalization of the "no frills" price-based end of the market. As many incumbents abandoned this position during the 1980s, the limited line discount offer was left largely to KwikSave. The recent entry by Aldi and Netto has revived interest in this sector, and the early 1990s have seen a number of indigenous UK retailers experimenting with price-oriented formats or retreating back to their old price-oriented offers. Gateway has created a discount superstore format under the brand name Food Giant 14,15!, while a similar offer has come from the Co-op sector with Pioneer. Budgens has made an experimental entry into discounting 16!, and it has been suggested that Asda may return to its original position as a price-oriented superstore operator as part of a solution to its present troubles 17,18!.

A number of reasons for this renewed interest in discount grocery retailing can be suggested. The present recession is perhaps the most obvious, although other, more subtle but strategically more significant reasons can be identified. First, imminent superstore saturation will encourage retailers to look for new offers and new formats to target in pursuit of growth 19!. To this end, some major superstore operators are investigating convenience store retailing 20! and the revamping of their high street supermarkets, stores hitherto regarded as historical remnants rather than part of future strategy 21,22!. A second, but related, driving force lies in the powerful growth of the three main superstore operators, Sainsbury, Tesco and Argyll. These three are investing heavily, expanding confidently, and raising large sums of money to do so (£1.5 billion in recent rights issues alone). They are now clearly dominant to the other two members of the "Big Five", ailing Asda, and

Isosceles-owned Gateway, which, through the sale of stores to Asda and KwikSave 23,24!, has reduced the size of the Gateway chain, and moderated its aspirations, since its acquisition.

The dominance of the leading group will encourage the rest to utilize more focused strategies to secure defensible positions, rather than engaging in a hopeless pursuit of the "Big Three Gateway is in the vanguard of this development, Isosceles' chief executive David Smith has said "We are not chasing sales at any price. We are chasing margins instead" 25!, underlining the fact that Gateway is now pursuing profitable points of focus rather than market leadership. Discount food retailing is one such point of focus: having disposed of most of its superstores and some small stores to leave a core of sub-15,000 square feet units, now 553 out of its 628 stores, Gateway is targeting two offer types, small supermarkets and discount superstores. Other secondary operators, like Asda and Budgens, may also seek a price-oriented focus.

Another possibility to consider is that the "no frills" price sensitive market segment was not resurrected by recession and emerging competitive forces but, in fact, never really died in the first place. Rather, it was forced to become a partially latent market 26! when so many price-oriented retailers (such as Asda and Tesco) moved "up market" during the 1980s, forcing their customers to move u market with them. The few remaining price-based offers, most notably KwikSave, did not have the territorial coverage to provide most Asda and Tesco shoppers with discount alternatives, and since, as Tables I and II show 27,28!, grocery shoppers usually regard closeness or convenience of store as the prime influence on their choice (which means they are generally reluctant to drive past one store in order to reach another), upwardly aspiring former price competitors carried a captive customer base with them thanks to this local monopoly power (sometimes called spatial monopoly 29!). (Tables I and II omitted)

The remarkable success of KwikSave attests to the profitability of the price-oriented approach that so many others spurned, and raises the possibility that the 1980s vogue for "going up-market" may have enticed some grocery retailers into abandoning profitable price-oriented offers. Despite its down market image, KwikSave grew by 188 per cent during the affluent boom years 1985-1990, outperforming the 58 per cent growth of other large grocery businesses. It doubled its pretax profit between 1986 and 1990, and widened its net margin from 5.3 per cent to 6.0 per cent 8!. In 1990, KwikSave could boast sales growth, added value, return on net assets, return on equity, and price-to-earnings ratio superior to any of the top five retailers 12!.

THE EFFECTS OF EUROPEAN NEW ENTRY ON MARKET STRUCTURE

Until recently, the strategies of major UK operators have been remarkably similar and fairly unobtrusive: the essence of their approach has been based on one type of outlet, the out-of-town superstore, and one basic offer, the quality/value for money approach that most retailers converged on during the 1980s. This homogeneity of strategy, and the lack of intrinsic differentiation between competing superstores, has been cited as one of the main reasons why shoppers tend to use whichever store is closest or most convenient (see Tables I and II), leading to a situation where store location is the only major, defensible competitive advantage. Other forms of offer, such as the high street supermarket, the convenience store and limited line discounting, have been pushed largely to the periphery 2!.

During the 1990s a number of constraints and competitive forces will conspire together to alter the structure of the UK grocery retail market. The onset of superstore saturation will force retailers to seek new ways of competing when massive geographical expansion programmes are no longer possible 19!. The emergence of a dominant "Big Three" group of retailers will force lesser operators to formulate more focused strategies rather than hopelessly emulating the leaders. Of course, new entry from Europe will bring about structural change also.

The effects of European new entry can be examined on two levels. The most obvious of these is to suggest that companies like Aldi and Netto will achieve a significant presence in the UK market and thus alter its structure directly. Since the presence of these companies in the UK is, for the moment, small (although Aldi plans to have 200 UK stores by 1994 8!), their influence on this level should be equally small. The other level on which we can analyse the influence of the new entrants is in terms of the effects that their potential presence will have on the strategies of incumbents. For the moment, this is the more interesting area: because of the potential effects of Aldi and Netto's strikingly different offer, they are having an effect on the market out of proportion to their current market shares.

The reason for this disproportionate influence lies in the fact that Aldi and Netto are very different operators from most UK incumbents: trading from small, austere supermarkets rather than superstores, offering a small range of goods (only 600 lines in the case of Aldi, very limited compared with a superstore range of as many as 20,000, and small even compared with the 2,500 lines of the UK's main indigenous limited line discounter, KwikSave 8!), and emphasizing low prices rather than quality, range and value. Such diversity of entrants is identified by Porter 1! as a source of additional competitive intensity, and, more than anything else, it is this increased diversity brought by European new entrants that will have the greatest effect on market structure.

During the 1990s the present superstore dominated market will develop into a more complex and fragmented system. The present quality/range/value superstore offer and its complementary convenience store niche will be joined by limited line discount supermarkets and discount superstores, as well as new or revamped high street supermarkets. While the "Big Three" retailers continue to dominate superstore retailing, and specialists like Circle K, 7-Eleven and Circle C operate convenience stores, European new entrants and secondary operators may focus on; other market segments, becoming specialists in discount supermarkets (like KwikSave, Netto and Aldi), quality/value for money high street supermarket operations (like Gateway), or discount superstore operations (with offers like Food Giant and Pioneer).

CONCLUSIONS

With hindsight, the entry of Aldi and Netto into UK grocery retailing was almost inevitable. The existing skills and assets of European discounters represent an almost perfect fit with the most vulnerable part of the UK market. Furthermore, these same skills and assets allow these companies to penetrate the three main barriers to entry.

The invasion of European discounters, for the moment more impending than actual, has encouraged some UK incumbents to reassess price-based competition. The retailers showing most interest are, significantly, not members of the dominant "Big Three", suggesting that another reason for this interest may be the pursuit of a market focus that can be defended against the dominant group.

European new entry, and the renaissance of price-oriented competition which it has encouraged, is just one of the forces which will give rise to greater diversity among competitors and offers, and shape a more complex and subtle market structure before the end of the decade.

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