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Hard discounters: Underestimate at your own peril

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A combination of high quality products and low prices have beaten Walmart twice; hard discounters are coming for Asia

In April this year, Walmart effectively sold off its Asda stores in the U.K. to Sainsbury's. Even though Walmart retains a 42 percent share of what is officially a merged entity, Sainsbury's will gain control of the combined business.

While it is rare to see Walmart withdraw from a market in failure, it is not unprecedented; it failed miserably in South Korea and Russia. What is unusual is the identity of its conquerors, who had earlier forced the retail giant's retreat in Germany in 2006: Aldi and Lidl.

"There were only two retailers that have essentially defeated Walmart not once but twice: that's Aldi and Lidl," explains **Jan-Benedict Steenkamp**, Knox Massey Distinguished Professor of Marketing at the University of North Carolina's Kenan-Flagler Business School. The two German companies are the world's leading hard discounters whose business model of low prices and limited assortment have won major market share in recent years. He continues:

> *"Hard discounters are basically a going-back-basics idea. Those are small stores. They have a small assortment. They tend to have low staffing levels and overwhelmingly private labels. 80 to 90 percent of the assortment are private labels, and these private labels are priced 50 percent lower than national brands. These private labels are also 20 to 30 percent cheaper than those in Tesco (U.K.), Woolworths (Australia) or Kroger (U.S.)."*

Private labels: Low prices, high volumes, big profits

Private label products are manufactured by a contractor or third party manufacturer and sold under a retailer's brand name. In the case of Lidl there is the *Preferred Selection* line of snacks and foodstuff while Aldi promotes *Little Journey* baby products and *SimplyNature* food items. While Aldi and Lidl also carry big brands such as Coca-Cola and the like, their assortment is decidedly narrower than your usual supermarket and hypermarket.

"It starts with the fact that most consumers have a high desire to simplify their purchase process," Steenkamp elaborates, pointing out that hard discounters work on the assumption that consumers "don't need 110 SKUs (stock keeping units) of canned tomatoes and 19 different SKUs of dried pasta".

"Because [hard discounters] sell so much more than [regular grocers] per SKU, they are able to generate irresistible value for money," Steenkamp says. "Why? First, most of these SKUs are private labels. High volumes allows them to ask suppliers for a low price with a long-term contract, and suppliers like that. That gives them the ability to deliver high quality for a very low price.

“Conventional grocers have a much higher gross margin than hard discounters because hard discounters sell at such a low price. But conventional grocers have much higher operating costs – labour, utilities, rent, depreciation etc. Their operating costs are twice as high as a percentage of sales.”

He concludes: “While hard discounters sell at a much lower price, the profitability of hard discounters EBIT (earnings before interest and tax) is about two-thirds higher than that of a conventional grocer.”

Reacting to the competition

Incumbent grocers have responded by creating their own private labels. In the U.K., which Steenkamp describes as being “one of the most, if not the most, sophisticated groceries market in the world [that is] long seen as being invulnerable to hard discounters”, market stalwarts such as Marks & Spencer (M&S), Waitrose, and Tesco have all produced their own private labels to fend off the hard discounters threat.

Steenkamp points to research showing M&S as the only one with higher quality private label products albeit at a much higher price point while most others “are of a significantly lower quality but at a higher price”. The result: “In the last five, six years [in the U.K.] there’s been a virtual explosion in the market share of the hard discounters from less than five percent in 2011 to about 13 percent in 2018.”

Tesco is fighting back with Jack’s, its line of discount stores that promises to be the “cheapest in town”. Its first two shops opened in September this year and initial reports show it has matched or beaten Aldi and Lidl on 18 popular items. While it is unclear whether Tesco is subsidising these low prices with profits from its main business, Steenkamp points out the dangers of a price war with hard discounters.

“Wherever Lidl enters a U.S. location on average the other retailers lower their prices by 10 percent on their private labels,” he reveals. “Food Lion cut by nearly 14 percent, Kroger by 10 percent. It’s the simplest strategy. But they don’t have the efficiency of the hard discounters. If they engage in a price war, it would be fatal.”

Unlike other corporate retailers like Walmart, Tesco and the like, Aldi and Lidl are privately owned by the Albrecht family and Dieter Schwarz, respectively. That frees them from constant shareholder pressure to deliver profits.

“They are privately held, which means they can play the long game,” Steenkamp emphasises. “They don’t have to go every quarter to the market and report their earnings like Woolworths and Tesco have to do. They can essentially incur losses for some time if they see a viable log-term future.”

Aldi and Lidl: Coming to a store near you

Having conquered most of Europe and parts of the U.S., Australia has become “the first victim of the success of the hard discounters” in the Asia-Pacific region, Steenkamp says. Aldi has been in Australia since 2001 and now has over 500 stores down under while Lidl, under the Kaufman brand, is building its first store in Melbourne.

Is the march of the hard discounters unstoppable?

“The vulnerable parts of a hard discounter’s business is when they enter a market in the beginning,” Steenkamp says. “The high volume per SKU is not available in the beginning. You cannot have high volume per SKU if you only have a few stores. You need a certain network of stores for this to work.

“Woolworths’s [in Australia] operating margin actually grew when Aldi entered because they raised prices. They lost market share to Aldi but in the short term it was still pretty good business. Until at some point, the pain that Aldi was generating became too much, around 2013-2014 Woolworths lost not only market share but had to cut prices. Operating margins went down.”

Woolworths, Steenkamp points out, committed the classic error when faced with hard discounters: dismissing them as being irrelevant. And now Aldi and Lidl are making their way into the rest of Asia.

“We know the hard discounters are testing the waters of Hong Kong and China,” Steenkamp elaborates. “We’ll see how that plays out. Why wait for them to enter your market? Why not create your own hard discounters?

“Perhaps you can create your own hard discounter that is better adapted to the Asia Pacific region than Aldi and Lidl. You know the region better than they do. The only thing that would be unwise to do is underestimate them.”

Jan-Benedict Steenkamp was a speaker at the SMU Retail Centre for Excellence (RCOE) Asia Retail Leaders Conference 2018 ‘Leadership in Retail: Navigating Turbulent Waters’ held from 18-19 October.

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