MAY 20, 2015

GLOBAL GROCERY RETAILING

- **Discounters are giving major nondiscount retailers headaches**
- **Opportunities and threats in small-store formats**
- **E-commerce is in its infancy but will prove disruptive**
- **High-growth international markets prove tough to crack**

FUNG BUSINESS INTELLIGENCE CENTRE
GLOBAL RETAIL & TECHNOLOGY

DEBORAH WEINSWIG
EXECUTIVE DIRECTOR – HEAD OF GLOBAL RETAIL & TECHNOLOGY
FUNG BUSINESS INTELLIGENCE CENTRE
DEBORAHWEINSWIG@FUNG1937.COM NEW YORK: 646.839.7017

GLOBAL GROCERY RETAILING

Executive Summary

The simple act of putting dinner on the table grows more complicated by the day—but in very different ways, depending on the exact location of the dinner table.

The groceries that make up the meal might come from a fast-growing discounter or a grab-and-go convenience store, from a pioneering online retailer or a traditional supermarket, from a domestic firm with deep knowledge of the local market or an international behemoth slowly learning that one size does not, in fact, fit all. A customer might stock up at discount store, make a stop at a traditional supermarket, pop into a small neighborhood market for those last few fresh ingredients, or even "click and collect"—shop on the Internet and pick up at the hypermarket drive-through. In the ever-evolving world of grocery retailing, the only constant is change.

This report looks in detail at the shifts affecting five big national grocery sectors—in the US, the UK, France, Germany and China.

Price: Discounters Boom

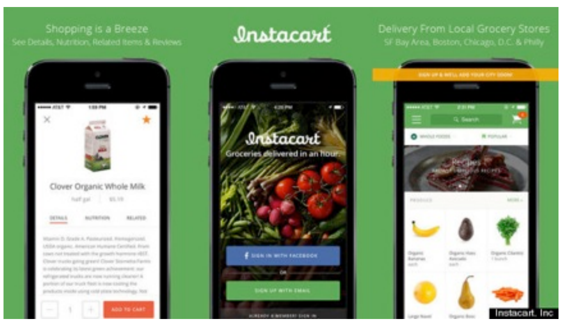
- Discount retailers used the opportunity created by the economic downturn to expand. Led by Aldi and Lidl, discounters have surged ahead, gaining ground in countries such as the UK, Italy, Spain, Poland, the US and Australia.
- Reflecting the discount boom, Schwarz Group, owner of Lidl, jumped from fifth-biggest to fourth-biggest grocery retailer by global revenues in 2014, we estimate.
- But some big operators have also gained by softening their "hard discount" proposition, moving closer to the middle of the market with bigger stores, more branded lines and better fresh foods.
- While these moves can bring in more shoppers, they create risk by adding extra cost to a discount model based on cutting out complexity.

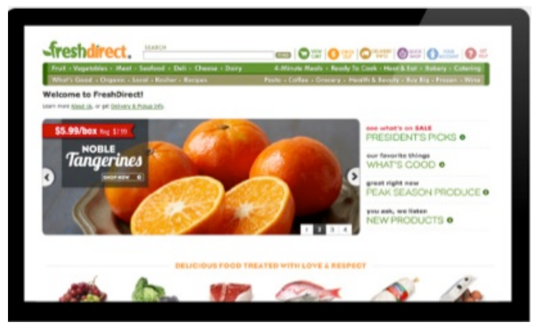
Format: Small Stores Appeal to Shoppers

- Across many countries, big-store grocers are moving into small-store formats in a second space race. Walmart, Carrefour and Tesco are among the names leading the charge, seeking to target urban catchments that a large out-of-town store could not reach.
- Meanwhile, in markets including the UK and China, stores are catering to apparent consumer preferences for more frequent, small-basket shopping, to supplement online purchasing or because of small living space.
- The big-box store isn't dead, but shifts such as the increase in online shopping pose challenges to the superstore format and leave some retailers with redundant real estate.
- Consumers are buying more nonfood merchandise online, affecting in-store demand for merchandise such as electronics and apparel, which hits the big-store footfall on which non-food sales piggyback.

E-Commerce: Remains in Its Infancy but Should Be Watched

- The Internet represents only a tiny proportion of grocery sales in most markets. The UK leads with 6% of grocery spend online, while the US trails far behind, with big retailers like Kroger still only dipping their toes in the water.
- Yet e-commerce will prove disruptive in many markets. Currently, it is much less profitable than in-store shopping, given the costs of picking and delivering orders. It undermines the profitability of big superstores, which lose out the most when shopping moves online. And it loses retailers impulse purchases, including in higher-value general merchandise where cross-category shopping is lost.
- Click and collect is the new battleground. In markets such as the US and the UK, big retailers are pushing this model in an attempt to offer cross-channel convenience to shoppers. Walmart rolled out in-store collection in the US in 2014; Sainsbury's is the latest UK grocer to launch the service.
- Collection is likely to be considerably more profitable than home delivery by costly fleets of temperature-controlled vehicles, so it's to retailers' benefit to push customers toward this option.





High-Growth Markets: Joint Ventures Can Bolster Performance

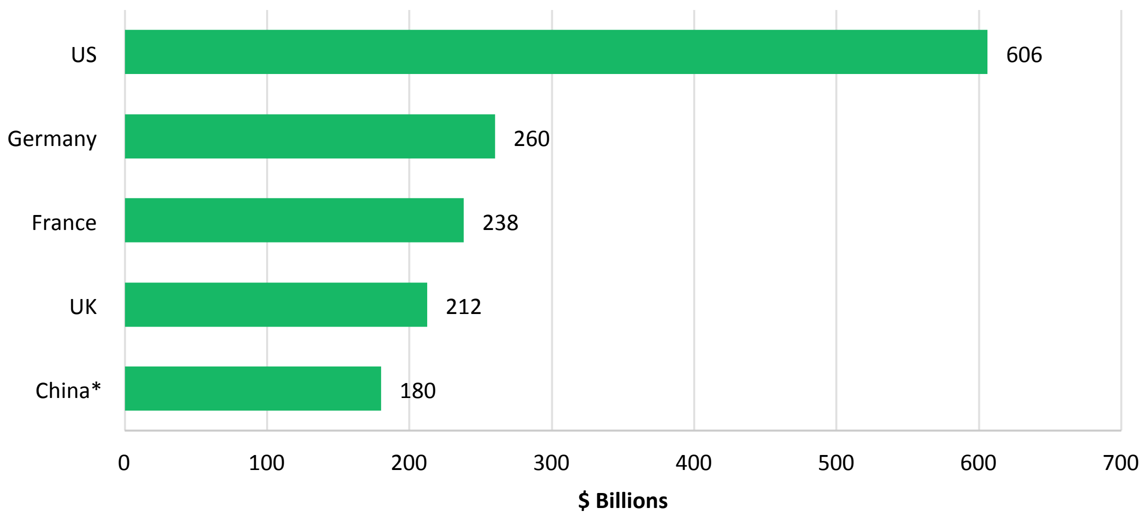
- International retailers have sought to tap fast-growing markets such as China. But domestic retailers and joint ventures, such as the partnership between Auchan and Ruentex, have tended to outperform outsiders.
- Some global retailers made the mistake of expanding into new territories with store formats similar to those they operate in their home markets. Retailers must listen to shoppers' demands and avoid "retail imperialism."

Global Markets Snap Shot

Grocery Sector Sizes and Growth Rates

The US remains home to the world's largest grocery retail sector. China's grocery sector continues to grow at the fastest pace out of the select economies, and there is much progress still to be made.

Figure 1. Grocery Sector Size, by Country, 2015F



**Data is for "supermarkets". Other countries' data is for all non-specialized food retailers.*
Source: Eurostat/Insee/National Bureau of Statistics of China/Office for National Statistics/Statistisches Bundesamt/US Census Bureau/FBIC Global Retail & Technology

The UK and France will see negative sector growth on an annual basis for 2015, we forecast, as supermarket price wars push consumer prices down.

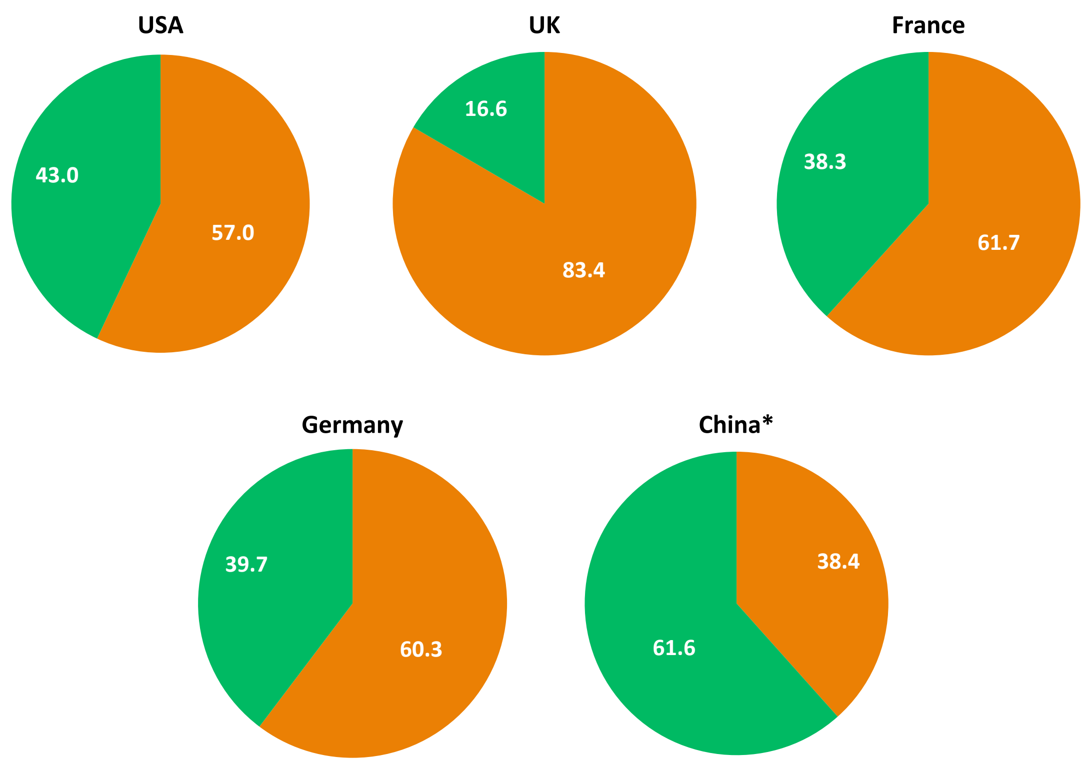
Figure 2. Grocery Sector Growth, by Country, 2014 and 2015F

Source: Eurostat/Insee/National Bureau of Statistics of China/Office for National Statistics/Statistisches Bundesamt/US Census Bureau/FBIC Global Retail & Technology

Levels of Concentration

Chinese grocery retailing is still highly fragmented, relative to the Western markets profiled here. The UK's sector is highly concentrated but that country's biggest four retailers are now starting to see aggregate share slide as British consumers switch to discounters.

Figure 3. Market Share of Top 4 Retailers (%) By Country in 2014



**China market share data is for 2013*
Source: Company reports/S&P Capital IQ/US Census Bureau/FBIC Global Retail & Technology

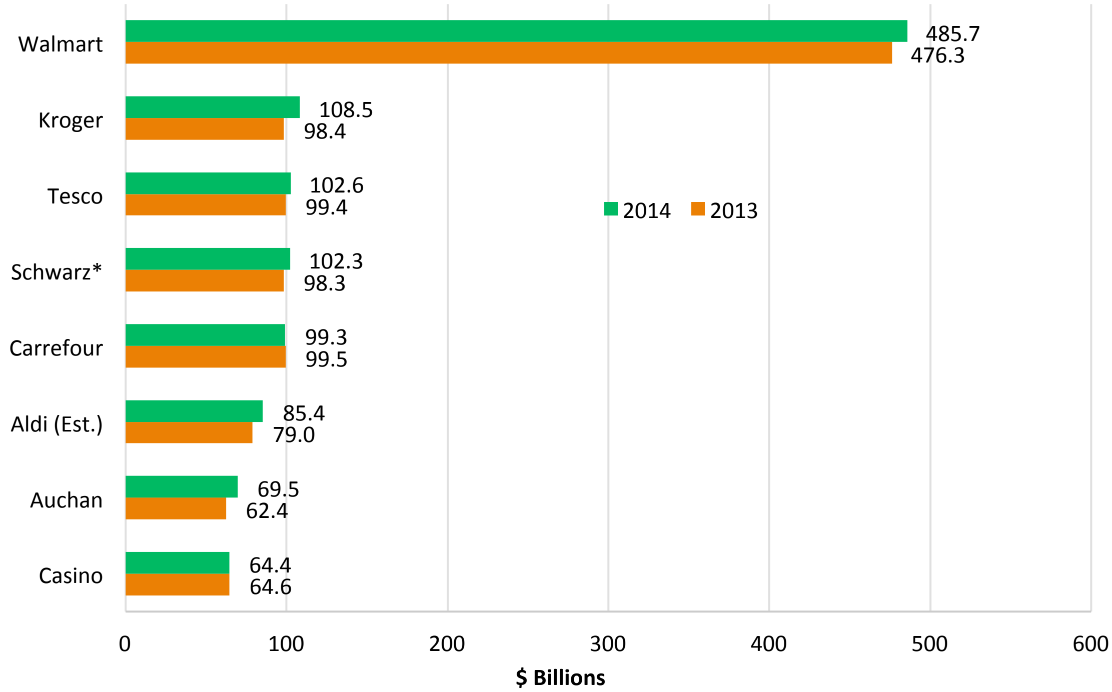
The World's Biggest Grocery Retailers: Schwarz Jumps to #4

Schwarz Group, which owns small-store discounter Lidl and discount hypermarket Kaufland, leapfrogged Carrefour in 2014, we estimate (the latest confirmed sales data for Schwarz is for 2013). It is closing in on third-place Tesco and could well overtake it by annual revenues this year.

Aldi is more reticent about providing operational data, and we believe it still lags these retailers.

Kroger's revenues were boosted in 2014 by a merger with Harris Teeter and by its 2013 acquisition of Vitacost.com.

Figure 4. The World's Biggest Grocery Retailers' Net Revenues



Excludes mixed-goods stores such as Target
**2014 data are estimated.*
Source: Company reports/FBIC Global Retail & Technology

Global Issues

Discounters: Big and Still Growing Fast

Grocery discount stores such as Aldi and Lidl seized the opportunity of the economic downturn to grab share of regional grocery markets. This move was seen across Europe and, to a lesser extent, in the US and Australia:

- In Europe, Aldi and Lidl have gained share fast in the UK, causing major headaches for British supermarket chains, while Aldi saw a resurgence in its heartland of Germany and Lidl gained ground in Italy. Meanwhile, in the US, Aldi jumped from being the 45th largest retailer in 2010 to the 38th largest in 2014, according to the National Retail Federation. And in Australia, Aldi has grown fast, seizing third position from domestic player IGA.
- Looking ahead, Aldi is planning an entry into China and Lidl is expected to launch in the US.
- Although hard sales data for Aldi and Lidl are often scarce, in 2013, Lidl's parent company, Schwarz Group, said it saw a 9.5% jump in sales.
- We've also seen other discounters gain share, such as Biedronka in Poland and DIA in Spain.

It would be a mistake to think of the discounters as small upstarts: Schwarz Group, which also owns discount hypermarket chain Kaufland, jumped ahead of Carrefour to become the world's fourth-biggest grocer in 2014, according to our estimates. And it is their scale that enables the discounters to be so competitive on price.

Market share and profit margins are at risk among established nondiscount retailers. In the UK, for instance, the popularity of Aldi and Lidl has recently prompted a spate of price cutting among the big grocers and, as these companies update their earnings reports, we're likely to see this hitting their margins.

How Have the Discounters Grown So Fast?

Fast expansion and shopper frugality have been important drivers of growth at the biggest discounters, but so too has been a softening of the proposition. Across various countries, grocery discounters have adopted a raft of changes that have moderated their proposition considerably:

- In Germany, Aldi Nord, which is one half of the Aldi empire, has been refitting stores, replacing some existing stores with bigger stores, bringing in more branded lines and introducing in-store bakeries. Lidl and Netto Germany have also launched in-store bakeries.
- In Poland, Biedronka has recently announced plans to upgrade stores and push into urban areas with a smaller format, while Denmark's Netto is opening larger stores to allow more room for fresh foods. Similarly, Lidl plans to open bigger stores to target families undertaking a weekly shop, and the company is already opening larger stores in France.
- In the UK, Aldi and Lidl have introduced high-end own-brand ranges; pushed into ultra-premium categories such as lobster; and boosted fresh foods with in-store bakeries, 100% British-sourced meat and stronger fruit/vegetable ranges.
- Other changes at hard discounters have included longer opening hours in some regions and a reversal of no-credit-card policies.

So, it has not simply been a case of shoppers trading down; retailers have achieved success by moving closer to the middle of the market.

The risk with these changes is that they add extra cost. The discount model is based on cutting out complexity (most notably on ranging), so any move closer to the midmarket threatens to chip away at the everyday-low-cost model.

We think there are other threats, too:

- Limited product choice means discount stores are not so much stealing shoppers from the full-line superstores, but stealing share of basket. Customers tend to buy selectively from the discounters, and they will typically need to do a second shop elsewhere to buy the products and brands they couldn't get at these stores. In many cases, they'll do so from the supermarket where they had previously done all or most of their shopping.
- Looking ahead, the big question is: Will shoppers still go to the trouble of splitting their shopping like this when they feel better off? We think some consumers could switch back to one-stop shopping at full-range supermarkets when convenience once again trumps frugality.

Proximity Shopping: The End of Big Box?

In a number of markets, big-store retailers are moving into small-store formats. Walmart and Target in the US, Carrefour in France and all of the biggest retailers in the UK are opening small supermarkets or convenience stores.

For some chains, these formats offer opportunities to compete in catchments such as urban areas that cannot support large out-of-town superstores. Others are pointing toward consumer shifts away from big-box shopping in favor of more frequent and more local shopping ("proximity shopping"). In some cases, this trend coincides with other changes, such as more online grocery shopping and increased usage of small discount supermarkets.

But we don't think the trend toward proximity shopping should be overstated:

- It is not occurring in all countries.
- Where it is occurring, hypermarket-based retailers, such as Asda in the UK and Leclerc in France, can still perform strongly.
- In markets where there is demand for shopping closer to home, regular town-center supermarkets can fulfil top-up shopping needs - convenience stores are not essential.
- Retailers must also beware the risk of cannibalizing their own supermarket sales if they push aggressively into small-store formats.

So the big-box store isn't dead.

But, looking ahead, small-store shopping is likely to be underpinned by further migration of some grocery and nongrocery shopping online. For online grocery shoppers, bulk Internet purchases typically demand top-up shops for fresh food, a need that small stores can meet well. And online nongrocery shoppers have less need to visit big stores filled with general merchandise such as electronics and clothing.

Moreover, potential long-term changes are indicated by markets such as Japan, where a solid and growing convenience sector is supported by an aging population and more single-person households. As societies elsewhere see similar demographic trends, we could see further growth in demand for proximity shopping.

Sector Shifts Threaten Nonfood Retail

In a number of regions, expansion in nongrocery retail, including clothing, electrical goods and housewares, has underscored the growth and scale of leading grocery retailers. French hypermarkets including Carrefour and UK superstores such as Tesco have built market share by offering ranges that span apparel to entertainment products. In China, big-store operators such as Walmart and Carrefour are likely hoping to grow nonfood sales in big-store formats.

The important point is that grocery retailers build sales in general merchandise primarily from the footfall generated by consumers shopping for groceries, i.e., that general merchandise sales piggyback on grocery shopping.

But there are two threats looming:

- First, in a number of markets, shoppers are buying more groceries online and in smaller shops, including convenience stores or hard-discount stores such as Aldi or Lidl. Online, most grocery retailers operate separate websites and ordering systems for grocery and general merchandise, thereby hitting cross-category purchasing. And in smaller stores, there just isn't the space to offer the major general merchandise ranges found in big-box grocery stores.
- Second, the migration of more general merchandise shopping online, particularly for categories such as electrical/electronic goods, threatens not just the grocers' share in nonfoods, but also the profitability of their bigger stores. As more general merchandise sales go online, superstores are finding they have redundant store space—some of their biggest stores are too big for the e-commerce era.

The trend of shopping at hard discounters or convenience stores may reverse in future, but the migration to shopping online is much more certain. So, even if grocers haven't found themselves confronting these problems yet, they will likely do so in the coming years.

Grocery E-Commerce: Disruptive Beyond Its Scale

Even in the most developed e-commerce markets, online grocery is a very small contributor to total grocery sales. The UK leads the world in online grocery shopping, yet Internet sales there still account for just 6% of grocery spending in 2014 according to retail-measurement service Kantar Worldpanel. The figure is less than half that in other major Western markets, such as the US, France and Germany, we estimate.

Yet the impact of online sales shouldn't be underestimated:

- Even a few percentage points of the grocery sector is still sizable in absolute value terms. For instance, 6% of the UK grocery sector was equivalent to $13.9 billion in 2014, we estimate.
- Grocery e-commerce is growing fast. Customer data firm dunnhumby estimates that year-over-year growth in more established Internet grocery markets such as the UK and France averages 31%, while in emerging markets such as China and the US, it averages a huge 97%.

And Internet retailing can cause serious headaches for grocery retailers:

- Store profitability is hit. Grocery retailing is highly volume sensitive, so even a small downturn in sales can hit profitability disproportionately. As more sales move online, some retailers will find that some of their grocery stores become unprofitable.

- Overall profits are hit. Internet grocery is much less profitable than in-store retailing, because the grocers have to pick, pack and deliver groceries for a relatively small fee.
- Sales are hit. Shoppers make fewer impulse purchases when buying groceries online—not only small-ticket items such as snacks, but bigger-ticket general merchandise, because websites for groceries and general merchandise are usually separate operations. So cross-category shopping is lost.
- Established shopping behavior is disrupted. Large superstores filled with general merchandise see weaker demand, while the need for store-based top-up shopping can boost demand for smaller, local stores such as convenience stores and small supermarkets with a fresh-heavy offer.

From the retailers' perspective, then, the onward creep of Internet shopping is not so much a bright new dawn as a dark cloud looming on the horizon.

Click and Collect: Online Grocery 2.0?

Home delivery was the dominant model of the first wave of grocery e-commerce, but we are now seeing a shift to in-store collection. Click and collect is swiftly gaining share of fulfillment as retailers such as Walmart, Asda, Tesco and Auchan China extend the service.

One exception is France, where click and collect has long been the standard for grocery e-commerce. Making use of their large hypermarket estates, which include big parking lots, the major French grocers offer drive-through collection as the default fulfillment option. Some complement this with home delivery in selected areas.

We're now seeing retailers in other countries rush to offer collection and establish new types of collection points:

- Walmart rolled out in-store collection in 2014 and has been testing same-day collection and stand-alone drive-through click-and-collect points.
- In the UK, Tesco and Asda have launched drive-through collection at their biggest stores, and Asda is now extending this to a handful of newly acquired gas filling stations.
- Also in the UK, Tesco, Asda, Sainsbury's and Waitrose are now offering collection at transit locations, including London Underground stations and railway stations, through a variety of means such as vans in parking lots and automated lockers.

No big grocers currently give concrete indications of their online profitability (many do not even publish their Internet revenues). But it is fair to conclude that collection is substantially more profitable than home delivery, where items are delivered in costly fleets of vehicles to customers' front doors for a fairly nominal fee.

As noted above, Internet retailing is a threat to grocery retailers' margins: pushing shoppers toward the collection option suggests one way to temper this threat.

Joint Ventures Can Bolster Localized Propositions

Global expansion continues apace, with Lidl likely to enter the US and Aldi sizing up the Chinese market. But we have also seen market exits, such as Tesco withdrawing from the US and effectively retreating from China through a joint venture agreement.

One major mistake retailers can make is to transplant the retail offer from their domestic market into other countries with little consideration for local tastes or behavior. Walmart, for instance, has followed the same big-box template in China as in the US. And it appears not to resonate with shoppers as much as offerings from retailers that have tailored their stores toward market tastes. Walmart made the same mistake back in the 1990s when it entered the German market and opened the same big-box stores it operates in its domestic market: in fact, Germans prefer to shop at small, local discount stores and neighborhood supermarkets.

Joint ventures can help reduce risks by building in local knowledge. In China, for example, Auchan (of France) has achieved success through a joint venture with regional firm Ruentex. Its in-store proposition has been much more tailored to conventional Chinese tastes, and the company has been rewarded with strong sales growth.

Tesco, too, finally adopted a joint venture when it decided to throw in the towel in the Chinese market. Its 20% share of a new venture with China Resources Enterprise means it gains from scale and local knowledge, even if only as a minor partner.

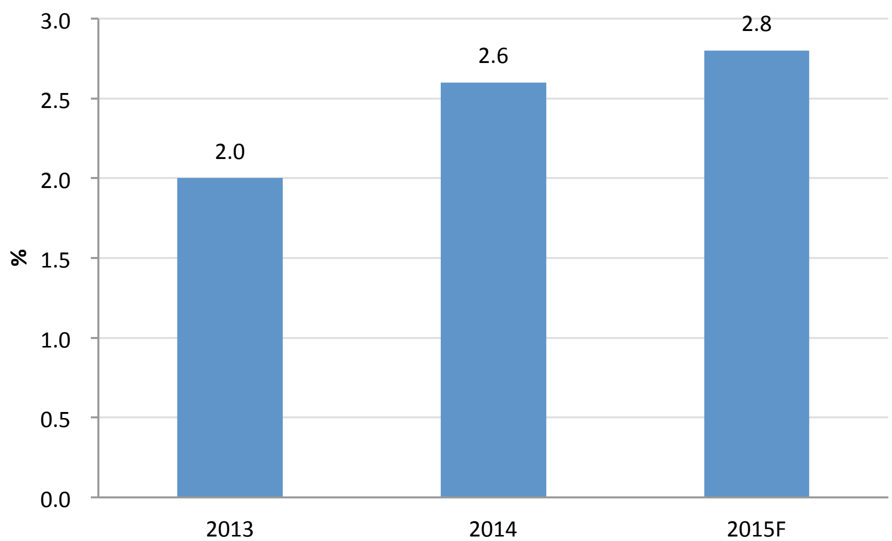
The message is that, even in developing, fast-growing markets, retailers must listen to shoppers' demands: "retail imperialism" rarely works.

The US

Summary

- Grocery retail sales grew by 2.6% in 2014 and we forecast a strengthening to 2.8% for 2015.
- Lower gasoline prices, improving economic growth and the strength of the dollar will boost discretionary spending this year, we expect.
- Market leader Walmart pushed up US sales by 3.1% in 2014 (with comps up 0.4%) while second-place Kroger saw underlying revenue gains of 4.9% as shoppers prioritized quality and freshness.
- Walmart has been ramping up click-and-collect capabilities and Kroger has launched trials of a grocery e-commerce service.

Figure 5. US: YoY Grocery Sector Sales Growth



Source: US Census Bureau/FBIC Global Retail & Technology analysis and forecasts

The Context

Figure 6. US: Country Data

	2014
Population (Millions)	318.9
GDP: Real-Term YoY Growth	+2.4%
Consumer Price Inflation: All Items*	+1.6%
Consumer Price Inflation: Food*	+2.3%

**For urban consumers*
Source: US Census Bureau/US Bureau of Economic Analysis/US Bureau of Labor Statistics

The Sector

Figure 7. US: Retail Sales Data (Including Sales Tax)

	2010	2011	2012	2013	2014	2015F
Grocery Retail ($ Mil.)	523,118	534,283	562,044	578,999	590,832	605,992
Annual % Change	2.1	5.2	3.0	2.0	2.6	2.8
All Retail Excl. Automotive Fuel ($ Mil.)	2,857,200	2,998,470	3,111,335	3,211,999	3,328,595	3,461,739
Grocery as % of All Retail	18.7	18.7	18.6	18.4	18.2	18.0

Source: US Census Bureau/FBIC Global Retail & Technology analysis and forecasts

The Issues

Grocery E-Commerce Remains in its Infancy

US grocery is trailing other major developed markets in terms of online-shopping adoption:

- Just 0.4% of American grocery shoppers buy the majority of their food online, according to a 2014 survey by the National Grocers Association and SupermarketGuru.
- The US is an emerging online grocery market, according to data research firm dunnhumby, with less than 1% of total category sales online in 2014. The firm groups the US with other emerging Internet grocery markets, such as China, Poland and South Africa, which are trailing established markets, such as the UK, France and South Korea.

Moreover, the US is highly unusual in the strength of Internet pure plays in the e-grocery sector. The slowness with which store-based grocers have moved to a multichannel proposition has left the field open for online-only retailers AmazonFresh, Peapod and NetGrocer to establish market niches.

But major grocery chains are starting to play catch-up. Grocery market leader Walmart now sees e-commerce as a growth channel to be tapped. Claiming that it is “the best-positioned retailer to win at the convergence of digital and physical retail,” Walmart rolled out grocery click and collect across 2014 and launched trials of Walmart Pickup, a stand-alone collection point for online orders that offers same-day collection.

Walmart is likely to be taking significant learnings from its UK subsidiary, Asda, which has a long-established home-delivery operation and has more recently pushed into click and collect for groceries, including through automated, temperature-controlled lockers.

Second-place Kroger, by contrast, has been more cautious. It began limited trials of online shopping and collection only in September 2014. This was after acquiring Vitacost.com, an online retailer of healthy-living products, in 2013. The Harris Teeter chain, which merged with Kroger in January 2014, already retails online.

Despite the gap in its offer, Kroger has been turning in strong revenue growth. But given the competitive pressures from Walmart, we think Kroger will likely need to launch a full e-grocery service in the near future.

Smaller-Store Formats Complement Cross-Channel Shopping

Another growth channel for Walmart is smaller store formats, which it's adopting in a bid to tap urban markets where consumers are less likely to be driving to out-of-town stores and where there is increased demand for last-minute, "grab-and-go" shopping.

Walmart is growing its small supermarket format (Neighborhood Market) and convenience store fascia (Walmart Express), and in 2014 it launched a trial gas-station convenience store under the Walmart To Go brand. Across these fascias, Walmart opened 235 small-format stores in 2014, up sharply from 122 openings in the previous year.

At the same time, Target is looking to open more small (20,000 sq. ft.) TargetExpress stores, to reach more affluent urban shoppers.

Smaller stores allow retailers like these, which have mature big-store estates, to tap new areas and target smaller catchment areas that do not justify large outlets. But these store formats also offer a strong complement to Internet shopping for grocery and nongrocery products. Online nongrocery shoppers have less need for big, general-merchandise-filled stores, while online grocery shoppers tend to need to undertake regular, small top-up shops for fresh foods. Smaller formats cater to both groups, so we expect to see further developments in the coming years.

Dollar Stores Chip Away at Grocery Categories

Some established grocery market leaders are likely to have found themselves hit by the growth of variety-store discounters, such as Dollar General, Family Dollar and Dollar Tree. These stores' offerings are typically heavy on core grocery-store categories such as beauty and personal care, household fast-moving consumer goods and ambient, packaged food and beverages.

At the biggest dollar store, Dollar General, the consumables category, which includes food, health and beauty, and household fast-moving consumer goods, made up 76% of sales in 2014—so the overlap with grocery stores can be big.

The dollar store chains are still much smaller than the biggest grocery retailers, when measured by total sales. In 2014, Dollar General, for instance, turned in net sales of just under $19 billion (up 8% year over year), compared to Walmart's US sales of $288 billion.

Yet these stores have chipped away at the sales of some supermarket retailers. So, ongoing expansion by the big dollar store chains is a threat, particularly to those grocery retailers pitched at the lower end of the market.

Flight to Quality and Freshness Among Shoppers

Not only do price-conscious US shoppers have more choice now, they're also fleeing to more natural foods and putting a greater emphasis on quality:

- Kroger performed strongly in 2014, with sales up 4.9% pro forma (stripping out the effects of its Harris Teeter merger and Vitacost acquisition) and 10.3% in total. Kroger has built its performance on a strong private label offering that includes a $1 billion organic brand.
- Whole Foods Market is also posting strong growth rates: sales were up 10% in 2014 and also up 10% in the first quarter of 2015 (latest available).
- Target and Walmart are now looking to add more fresh, natural and organic foods, too.

If this trend becomes entrenched, we expect to see other big retailers bolster their fresh and natural food offerings and invest in their store environments.

Lidl Likely to Join Aldi in the US

Lidl, the German hard discounter, may enter the US market as soon as 2016, according to reports. The company had signaled that it planned to launch in the US in 2018, but it has reportedly been contacting its suppliers already to see which of them can serve US stores and has been advertising US-based jobs.

We think Lidl could do well in the US, for several reasons:

- There looks to be some consumer shift toward smaller-store grocery shopping at the expense of big superstores, which plays into the hands of small-store discounters.
- Lidl, like Aldi, has shown that it's willing to tailor its offering to regional markets. And in recent years, it has softened its hard discount offering considerably in other markets by developing premium own brand ranges and by boosting its offer in fresh foods.
- The development of Aldi in the US provides evidence that shoppers there are increasingly happy to buy from hard discount formats.

Aldi has been growing fast: In 2014, it was the 38th biggest retailer in the US, up from 45th place in 2010, according to the National Retail Federation. Its latest move was to reopen a tranche of Bottom Dollar stores acquired from Delhaize (albeit less than half of the 66 stores it acquired) as part of its plan to add 650 more US stores by 2018. This is on top of the approximately 1,400 stores it currently has in the US, giving it a big head start on Lidl.

Prospects for 2015

The outlook for retail growth in 2015 is generally positive. Improving economic growth, lower gas prices and the strength of the dollar will underpin greater discretionary consumer spending. The National Retail Federation forecast 4.1% total retail growth for the year, although given that issues such as the standoff with Russia and clouds over the eurozone have lingered following that February forecast, we think total growth may come in a fraction below this for the year. Discretionary retail sectors are likely to gain more than grocery will.

The Retailers

Kroger completed its merger with 227-store Harris Teeter in January 2014, bolstering Kroger's sales for 2014. In 2013, Harris Teeter generated sales of $4.7 billion.

Safeway completed its merger with privately owned Albertsons in 2015, which resulted in Safeway being delisted. Albertsons generated sales of $21 billion in 2013, meaning the new group should see annual sales in the region of $57 billion.

Figure 8. US: Top Four Grocery Retailers' Sales and Market Shares

	Net Revenue		Market Share*	
	2013	**2014**	**2013**	**2014**
	$ Bil.	**$ Bil.**	**%**	**%**
Walmart US	279.4	288.0	48.5	48.7
Walmart US Grocery-Only Sales (Est.)	156.5	161.3	27.1	27.3
Kroger	98.4	108.5	17.1	18.4
Safeway	35.1	36.3	6.1	6.1
Publix	28.9	30.6	5.0	5.2

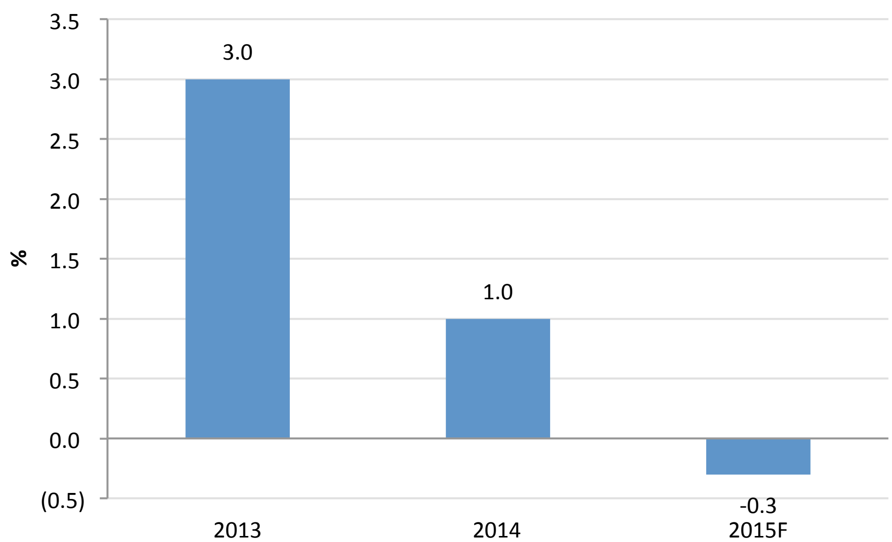
Excludes mixed-goods stores such as Target
**Share of grocery retail sector sales. No adjustment was made for grocery retailers' revenues from products or services not included in the grocery sector size, e.g., automotive fuel, so market shares may be overstated.*
Source: Company reports/S&P Capital IQ/US Census Bureau/FBIC Global Retail & Technology analysis and forecasts

The UK

Summary

- Grocer sector sales were up just 1.0% in 2014 and we forecast a slight decline, of around 0.3%, for 2015.
- Strong price competition is the principal driver behind the sector's softening growth rates, although lower commodity costs and currency effects have also had an impact.
- Tesco is still the UK market leader, though its market share is being chipped away, not least by fast-growing discounters Aldi and Lidl.
- Aldi's and Lidl's rapid growth in the UK is causing headaches for all four of the big established grocers. After years of consolidating the grocery market, the big four's aggregate market share is now in decline.

Figure 9. UK: YoY Grocery Sector Sales Growth



Source: Office for National Statistics/FBIC Global Retail & Technology analysis and forecasts

The Context

Figure 10. UK: Country Data

	2014
Population (Millions)	64.3
GDP: Real-Term YoY Growth	+2.8%
Consumer Price Inflation: All Items*	+1.5%
Consumer Price Inflation: Food and Nonalcoholic Beverages*	-0.2%

**Harmonized indices of consumer prices*
Source: Eurostat/Office for National Statistics

The Sector

Figure 11. UK: Retail Sales Data (Including Sales Tax)

	2010	2011	2012	2013	2014	2015F
Grocery Sector (£ Mil.)	125,338	130,833	135,020	139,075	140,515	140,093
Annual % Change	2.6	4.4	3.2	3.0	1.0	-0.3
All Retail Excl. Automotive Fuel (£ Mil.)	292,390	302,771	310,705	320,991	332,912	341,467
Grocery Sector as % of All Retail	42.9	43.2	43.5	43.3	42.2	41.0
Grocery Sector ($ Mil.)*	193,747	209,843	213,966	217,555	231,513	212,311

**2015 conversion to USD at rates for January 1–March 31, 2015*
Source: Office for National Statistics/FBIC Global Retail & Technology analysis and forecasts

The Issues

Discounters Stealing Share of Basket

Discounters Aldi and Lidl have experienced storming sales growth in recent years, hitting the established players in the market. At Christmas 2014, for instance, Aldi posted a 23% surge in sales while Lidl grew sales by an impressive 15%, according to market-share measurement service Kantar Worldpanel (12 weeks to 4 January 2015).

All of the big four domestic supermarkets—Tesco, Sainsbury's, Asda and Morrisons—have been posting negative comps as a result. And after years of consolidating the grocery market, the aggregate share of sector sales taken by the big four is falling. Renewed price competition has been the result, with food price deflation deepening into early 2015.

Aldi and Lidl are hard discounters, operating smaller supermarkets selling limited lines, which are almost entirely private label. This limited choice means Aldi and Lidl are not so much stealing shoppers from the big four; they're stealing share of basket. Customers buying from Aldi and Lidl will typically need to do a second shop elsewhere to buy the products and brands they couldn't get at the discounters and, in many cases, they'll do so at the store where they used to buy all or most of their groceries.

So, looking ahead, the big question is: Will shoppers still go to the trouble of splitting their shopping like this when they start to feel better off? The British grocery shopper is accustomed to convenience, so a reversion to one-stop shopping at a full-range supermarket is the biggest threat to Aldi's and Lidl's future growth in the UK.

Premium Players Outperform, Too

But it's about much more than price. The growth of the discounters shouldn't be interpreted as British shoppers simply trading down to the cheapest option. As we showed in the Global Overview section of this report, the discounters have achieved success in large part due to a softening of their offering.

And shopper demand for quality is shown elsewhere with the robust performance of two big premium players, M&S and Waitrose. Both have continued to post positive comps in spite of the torrid market conditions. Their growth has been helped by ongoing expansion (comps tend to be flattered by the maturing of recently opened space). But it's also indicative of a further shift of spending away from the middle ground, as consumers break up their purchases into smaller basket sizes split between different retailers.

As with the discounters, M&S and Waitrose are not main-shop destinations. These stores are primarily used for smaller top-up shops, which means that their growth further reflects a splintering of spending rather than a simple transfer of customers from the biggest grocers.

UK Leads the World in Online Grocery

The UK is the most developed market for Internet grocery retailing, when measured as share of sector sales. Yet Internet sales still accounted for only around 6% of grocery spend in 2014, according to Kantar Worldpanel.

Moreover, the online channel is dominated by the established supermarket groups. Ocado is the only Internet pure play of note, but it trails Tesco, Asda and Sainsbury's in online market share, says Kantar Worldpanel. (Morrisons was late to the party and launched online only in early 2014.)

So it is not so much about the Internet providing new opportunities for grocery retailers, but about the established market leaders having to offer this service simply to maintain their overall market share: they're running in order to stand still.

And despite accounting for a small share of sector sales, the online channel is giving the major grocers some headaches. We noted the following impacts in the Global Overview section of this report, but it's worth restating them, given the UK's leadership in e-grocery:

- Online is much less profitable than in-store retailing. Grocers have to pick, pack and deliver groceries for a relatively small fee (and these fees have generally been declining in the face of competition). In mid-2014, HSBC analyst Dave McCarthy estimated the major supermarkets to be losing around £100 million in profit annually, because it can cost around £20 to pick and deliver an order, but retailers only charge the customer around £3 or £4. So far, Tesco is the only major grocer to claim profitability on Internet orders and Ocado has only recently moved to into the black at operating profit level.

- Impulse purchases are lost online. This applies both to small-ticket items (think chocolate bars at the checkout) and to general merchandise, because products such as clothing and electrical goods are usually offered on separate subsites and cannot be ordered with groceries online.

- Larger superstores/hypermarkets tend to be hit. Online grocery captures big weekly or occasional shops, not least due to minimum-order requirements (for example, £40 at Morrisons.com). So the channel hardest hit is the large superstores, which are filled with general merchandise and generate the bulk of profits for the big grocers. Some retailers are finding their biggest stores overspaced as shopping for both general merchandise and groceries migrates to online.

- Occasional, bulk online purchases boost demand for top-up shopping, which can benefit convenience stores and small local supermarkets.

It is tempting to say that the lesson for retailers in other markets is to not let the genie out of the bottle by moving into the online channel. Yet in most Western markets, some migration to online is inevitable, and the major store-based retailers need to cater to what shopper demand there is for online.

The keys, perhaps, are to not promote the channel so hard that it hits a retailer's own interests and to adopt e-commerce models that impact profitability the least.

Click and Collect Is Catching Up

One means of limiting the cost disadvantages of selling groceries online is to push customers toward click and collect.

Tesco and Asda have rolled out this service only in recent years, initially to stores (including drive-throughs) and more recently to transit locations. Sainsbury's is the latest to offer in-store collection and it has also joined Tesco and Asda in offering collection in London Underground station car parking lots. Also at Tube stations, upmarket Waitrose has been trialing automated, temperature-controlled lockers. Morrisons has yet to offer any form of collection.

Click-and-collect demand now appears to be gaining traction. In August 2014, Asda said that collection already accounted for 10% of its online grocery orders and that it expects click and collect to treble in scale, to 30% of Internet orders, over the next five years.

As we show elsewhere in this global report, French grocers have established collection as the default fulfillment method on the other side of the English Channel. Though we have no indications of online profitability from those retailers, click and collect is likely to be more profitable than home delivery, so it is perhaps a model for other markets to follow as they move online.

Convenience Growing but Threatens Spiral of Cannibalization

Citing trends of consumers shopping more often and locally, the UK's big grocery retailers are opening higher-growth convenience stores in city centers, suburban neighborhoods and transit locations. At the same time, several of them are pulling back on building new supermarkets, and some are closing handfuls of unprofitable stores.

Convenience store sales are undoubtedly growing faster than sales through supermarkets. Some retailers, including Sainsbury's, point toward greater local shopping and smaller average basket sizes to justify opening greater numbers of convenience stores. There are other justifications, too:

- Convenience stores offer a strong complement to online grocery shopping.
- The convenience store segment is the last major grocery segment to be consolidated by the major grocers, so there is scope to gain share at the expense of independents.

But we believe a problem for the grocers is that their convenience stores could cannibalize sales from their own supermarkets: if a small Tesco Express store opens close to home, then there is less reason for a shopper to drive to the large Tesco superstore further away. In turn, those consumer shifts to local shopping can then be used to justify more convenience store openings, creating a spiral of cannibalization.

The dilemma for the retailers is that if they pull back on convenience store openings to temper this cannibalization, then they leave the field open for their rivals to take that space.

Overcapacity Hits Hypermarkets Hardest

An underlying problem for UK grocery is overcapacity: it looks to be served by too much space (and with the growth of the discounters and convenience stores, total space is still growing).

The changes in shopper behavior and new convenience store openings noted above are impacting demand for big grocery stores. Some large out-of-town superstores are seeing footfall decline as large-basket shops migrate online or consumers opt to break up their traditional weekly shop between different retailers (e.g., discounters) or into smaller-basket shopping trips (i.e., buying for today).

Another issue is that as more nongrocery shopping moves online, ever-larger stores filled with general merchandise are beginning to look outdated: the store space devoted to categories such as electrical goods is starting to become redundant.

The hit to large superstores should not be overstated, though (for now, at least):

- When delivering his first interim results, Tesco's new CEO, Dave Lewis, told analysts that two-thirds of that retailer's hypermarket estate "you would die for."
- Asda has until recently been the strongest performer among the big four grocers, and it is predominantly a hypermarket retailer.
- Sainsbury's was until very recently planning to open more large superstores.

Nevertheless, some retailers have confirmed that certain of their big stores are struggling. Following Christmas 2013, Tesco revealed that comps in its biggest stores were typically down 3.1% over the holiday period. More recently, Sainsbury's new CEO, Mike Coupe, announced plans to dramatically scale back big-store openings and stated that 25% of the company's large stores are, or will be, overspaced.

And because grocery retailing is highly volume sensitive, a small dip in sales can hit store profitability disproportionately.

The challenge is to make profitable use of the now-excess space. Accordingly, Tesco launched its "store of the future" format in 2014, with food-service brands and a greatly improved fresh-food offering designed to make its hypermarkets shopping-trip destinations (though costly store conversions to this format have been halted under the company's new back-to-basics approach). This year, Sainsbury's announced a tie-up with general merchandiser Argos to install Argos order-and-collection zones in 10 stores, and Asda has launched a trial with sportswear retailer Decathlon to pilot a shop-in-shop format.

As hypermarkets continue to be hit, we expect to see more stores carved up and, in some cases, sales areas sublet as grocers find they have too much space for the Internet age.

Real Estate and Writedowns

One major consequence of these structural changes is the diminishing value of some grocery real estate. The "space race," which saw major retailers rush for land to build big stores on in the 1990s and 2000s, has come back to haunt the grocers. The biggest three listed grocers have booked fully £7.5 billion of property writedowns since April 2013:

- In April 2015, Tesco took a huge impairment charge of £3.8 billion against stores that are trading (including some outside the UK) as well as £925 million of writedowns for pipeline property that will not now be developed.
- This came after Tesco booked a writedown of £804 million on UK projects that it would no longer pursue, in April 2013.

- Tesco has also closed 43 UK stores, while Morrisons is planning to close 10 loss-making stores this year.
- Tesco's latest writedowns dwarf the substantial £1.3 billion impairment on properties that Morrisons booked in March 2015, "due to market conditions."
- In November 2014, Sainsbury's wrote down £628 million for sites that it had decided not to develop and for unprofitable or marginally profitable stores. This was on top of a writedown of £92 million booked in November 2013 for schemes that were no longer economically viable to develop.

At the same time, there is clear demand for property elsewhere for convenience stores and for edge-of-town sites that can be developed for Aldi or Lidl. Aldi wants to get to 1,000 UK stores by 2022, while Lidl's UK managing director has said he sees the possibility of 1,500 Lidl stores in the UK.

The issue, particularly for major chains pushing into the convenience format, is to not repeat the mistakes of the space race by piling into formats that, while growing now, will ultimately compound the problem of overcapacity.

Prospects for 2015

We expect the UK grocery sector to be deflationary for much, if not all of 2015. Tesco started the year with a price campaign on selected branded goods and Asda, Morrisons and Sainsbury's have already pledged to cut prices further.

We've already seen grocery sector sales turn negative for selected months in 2014 and into 2015, and our current forecast is for annual sector sales to be down very slightly year over year. That said, changes in external cost pressures, such as oil or food commodities, could push sector growth in either direction.

The Retailers

Morrisons, traditionally pitched toward the lower end of the market and with a bias toward northern England, has been hardest hit by the discounters, with fiscal year 2014 comps down 5.9% (excluding automotive fuel).

Tesco's 2014 results were flattered by it being a 53-week year. On a 52-week basis, Tesco's UK sales fell 1.8% in 2014.

Figure 12. UK: Top Four Grocery Retailers' Sales and Market Shares

	Net Revenues		Market Shares*	
	2013	**2014**	**2013**	**2014**
	£ Mil.	**£ Mil**	**%**	**%**
Tesco**	43,570	43,573	34.1	33.8
Sainsbury's	23,949	23,775	18.8	18.4
Asda***	23,325	23,442	18.3	18.2
Morrisons	17,680	16,816	13.9	13.0

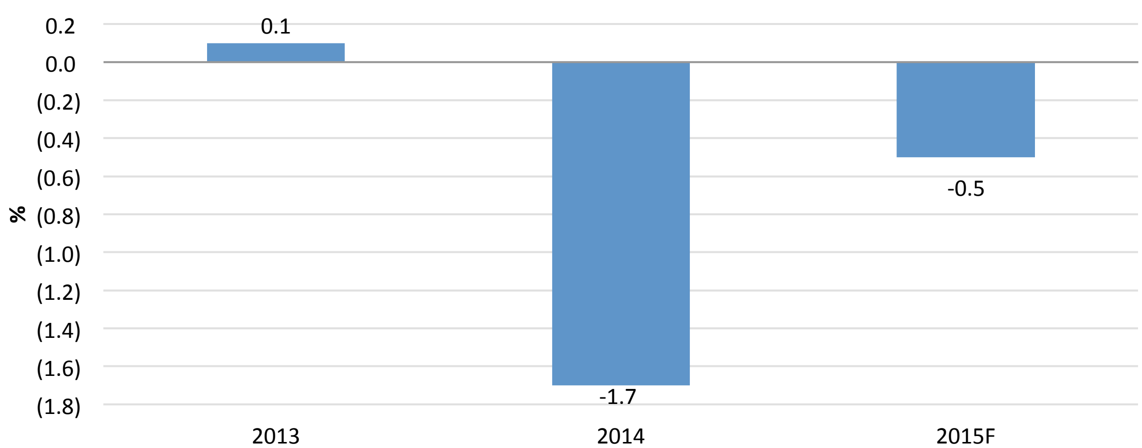
**Share of grocery sector sales. The grocery retailers' sales data exclude sales tax, so we used tax-adjusted sector sales to calculate market shares. No adjustment was made for grocery retailers' revenues from products or services not included in the grocery sector size, e.g., automotive fuel, so market shares may be overstated.*
***2014 was a 53-week year.*
****Estimated for 2014. Full-year results are due shortly after we publish.*
Source: Company reports/Office for National Statistics/FBIC Global Retail & Technology analysis and forecasts

France

Summary

- Grocery retail sales slumped 1.7% in 2014 and we forecast very slight negative growth of -0.5% for 2015.
- Supermarket price wars coupled with lower commodity costs and France's weak economy have depressed sector sales.
- Carrefour has long since lost market leadership to value-positioned Leclerc. But Carrefour's growth rates have improved as it has refocused on price.
- The hard discounters have not been successful in France: a preference for hypermarket shopping and price competition from the big grocers have stifled the growth of Aldi and Lidl.

Figure 13. France: YoY Grocery Sector Sales Growth



Source: Eurostat/Insee/FBIC Global Retail & Technology analysis and forecasts

The Context

Figure 14. France: Country Data

	2014
Population (Millions)	63.9
GDP: Real-Term YoY Growth	+0.4%
Consumer Price Inflation: All Items*	+0.6%
Consumer Price Inflation: Food and Nonalcoholic Beverages*	-0.8%

**Harmonized indices of consumer prices*
Source: Eurostat/Insee

The Sector

Figure 15. France: Retail Sales Data (Including Sales Tax)

	2010	2011	2012	2013	2014	2015F
Grocery Sector (€ Mil.)	205,558	211,456	215,340	215,628	211,987	210,927
Annual % Change	1.6	2.9	1.8	0.1	-1.7	-0.5
All Retail Excl. Automotive Fuel (€ Mil.)	466,261	480,155	487,707	488,733	487,377	491,208
Grocery Sector as % of All Retail	44.1	44.0	44.2	44.1	43.5	42.9
Grocery Sector ($ Mil.)*	272,878	294,432	276,885	286,354	281,730	237,989

**2015 conversion to USD at rates for January 1–March 31, 2015*
Source: Eurostat/Insee/FBIC Global Retail & Technology analysis and forecasts

The Issues

Hypermarkets Continue to Dominate

France and Germany are polar opposites in terms of dominant grocery retail formats. In Germany, small-store, neighborhood discounters and smaller supermarket formats dominate the market, but in France, out-of-town hypermarkets have long been the leading grocery format.

Yet there are some signs that the French hypermarket format may be starting to face struggles similar to those seen among superstore players in the UK:

- Hypermarket retailer Carrefour is pushing into proximity formats, notably convenience stores, and is turning in weaker growth (sporadically negative) in its hypermarket formats.
- As in the UK, general merchandise shopping for categories such as electrical goods is moving online, reducing demand for nonfood space in superstores.

At the same time, online grocery shopping and the progress of discounters is much less developed in France than in the UK. So, there are currently fewer pressures on the hypermarket format in France, and the threats must not be overstated.

Price Wars and the Discounters

French consumers' attachment to the hypermarket format has been one depressing force on the growth of hard discounters. The small-store, limited-range, mainly private label proposition of Aldi and Lidl has appeared to resonate less with consumers in France than in some other markets. Indeed, shopper ambivalence has led Lidl to soften its proposition considerably, with more fresh foods and much bigger stores.

At the same time, a price war between the major domestic grocers has provided shoppers with fewer reasons to switch to the discounters. Carrefour has sought to turn around performance with a renewed emphasis on sharpening prices, prompting a full-on price war between the leading groups, Leclerc, Carrefour, Auchan and Casino.

These price wars have, in turn, contributed to the deflationary environment and the substantial decline in sector sales recorded in 2014. So, the major supermarkets have succeeded in muting the threat from the discounters, yet they have trapped themselves in a cycle of deflation with the consequent risk of margin attrition.

Carrefour on the Front Foot Again

The renewed emphasis on price competitiveness has helped prompt something of a turnaround at Carrefour, although it has long since rescinded market leadership to value-positioned Leclerc. The company's turnaround offers a model to similarly struggling retailers in other markets, notably Tesco.

Until its recent refocusing, Carrefour had been seeing sales fall in its core hypermarket format. The company's previous CEO, a marketer who had joined from Nestlé, sought to revive the hypermarkets with the Carrefour Planet format, an aspirational, zoned store model that brought in services such as hairdressers. An admirable attempt at longer-term thinking, the glossy look of the stores nevertheless appeared only to convince shoppers that Carrefour was more expensive than its rivals. The CEO was ousted, and Georges Plassat, the former Carrefour chief, parachuted in to rethink strategy.

In France, this consisted largely of halting store conversions to the Planet format; a renewed emphasis on everyday low prices, with a price-match guarantee on 500 top-selling lines; and allowing store managers to tailor product ranges to their local catchments. (Internationally, it's also included a retreat from a number of countries in order to focus on core regions.)

And it appears to be paying off. In 2014, positive growth was seen in all store formats in France for the second year in a row.

This Carrefour model isn't especially complex: cutting prices and tailoring ranges to market are basic retailing. Yet it's a model certain retailers can take some time to adopt when they are losing share in price-sensitive markets. In the UK, Tesco, for instance, also embarked on fancy superstore conversions to halt a fall in traffic. But having sacked the CEO who came up with that strategy, Tesco, too, is now concentrating on sharpening prices and it has shifted closer to an everyday-low-price position.

In European grocery, there are clear shopper trends toward prioritizing price over frivolities such as flashy stores. The message from Carrefour and other retailers like it is: don't be too slow to react to this consumer demand.

A Drive-Dominated Online Model

All the major grocers in France have pushed into the online channel, with the exception of the no-frills discount stores. The French model for fulfilling online orders is predominantly drive-through collection rather than home delivery.

For the retailers, shoppers collecting orders cuts out the costly labor hours and temperature-controlled delivery fleets that are necessary to bring an order to a customer's front door. Collection also reflects the preponderance of hypermarkets in France: these stores have the outside space needed to offer collection services.

The online grocery market is still small. Just 11% of all French individuals bought food or groceries online in 2014, Eurostat data show. This is the same proportion as seen in Germany, where discounters are very strong and few nondiscounters offer a full online service. But it is well behind the 25% participation rate recorded for the UK.

None of the major players gives concrete indications of their online grocery sales, providing a further hint that e-commerce is a tiny contributor to sector sales. We think e-commerce is likely to have contributed only around 2% to 3% of total sector sales in 2014, with online sales of general merchandise by grocery retailers accounting for some of this.

At the same time, the online channel must not be ignored. The underlying demand for convenient, one-stop shopping ingrained by the hypermarket format suggests that French shoppers are much more likely than their German counterparts to migrate to Internet grocery in the long term. And, as we've already noted, the shift of nongrocery categories online is a potential longer-term threat to the large out-of-town superstores that have dominated the French sector for so long.

Prospects for 2015

2014 was a very weak year for the sector. France's dismal economic performance coupled with the grocery price wars to depress retail growth. We expect 2015 to be weak, too, though perhaps not quite so bad as 2014:

- Last year provides some very weak comparatives.
- Eurozone quantitative easing will make imports into the eurozone more expensive.
- Food deflation has been softening in 2015.

So, the short-term outlook is not bright, not least because the French economy is still weak and in need of liberalization. But we expect 2015 to be slightly better.

The Retailers

Auchan (with €20 billion in estimated 2014 sales) and Casino (with €19 billion in 2014 sales) are just outside the group of the top four grocers.

Figure 16. France: Top Four Grocery Retailers' Sales and Market Shares

	Net Revenues		Market Shares*	
	2013	**2014**	**2013**	**2014**
	€ Bil.	**€ Bil.**	**%**	**%**
Leclerc	37.55	37.68	19.5	19.9
Carrefour	35.44	35.34	18.4	18.7
ITM (Incl. Intermarché and Netto)**	22.3	22.7	11.6	12.0
Système U	21.0	21.0	11.0	11.1

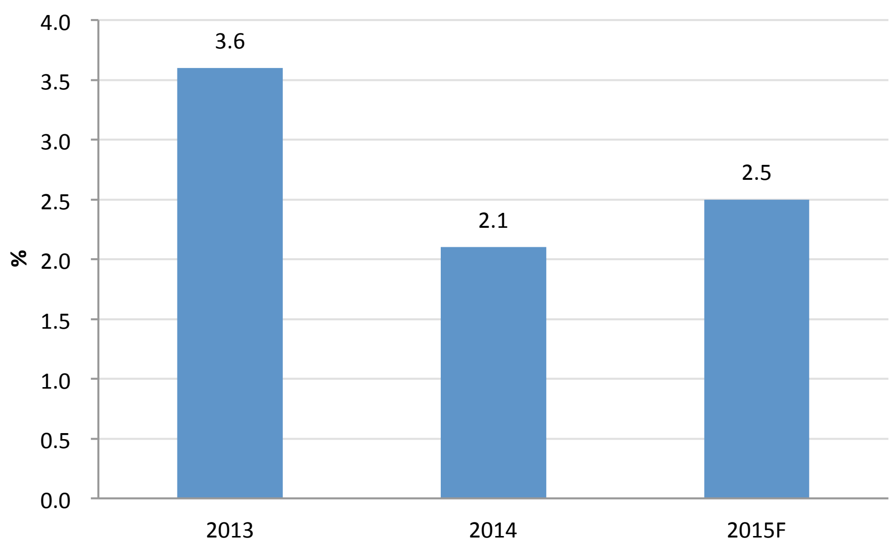
**Share of grocery sector sales. The grocery retailers' sales data exclude sales tax, so we used tax-adjusted sector sales to calculate market shares. No adjustment was made for grocery retailers' revenues from products or services not included in the grocery sector size, e.g., automotive fuel, so market shares may be overstated.*
***Figures exclude automotive fuel, unlike those for other retailers listed above.*
Source: Company reports/Eurostat/Insee/FBIC Global Retail & Technology analysis and forecasts

Germany

Summary

- German grocery retail sales grew by just 2.1% in 2014 and we expect modest growth of around 2.5% for 2015.
- Lower inflation impacted sector sales in 2014, with food prices turning deflationary in some months.
- Discounters such as Aldi and Lidl are very strong in Germany. But the sector is led by a nondiscount retailer, Edeka, whose predominantly small-supermarket formats offer a good complement to discount formats.
- Online retailing has barely taken off in Germany, although some retailers, including supermarket chain REWE and (surprisingly) hard discounter Lidl, are pushing into this channel.

Figure 17. Germany: YoY Grocery Sector Sales Growth



Source: Eurostat/Statistisches Bundesamt/FBIC Global Retail & Technology analysis and forecasts

The Context

Figure 18. Germany: Country Data

	2014
Population (Millions)	80.8
GDP: Real-Term YoY Growth	1.6%
Consumer Price Inflation: All Items*	0.8%
Consumer Price Inflation: Food and Nonalcoholic Beverages*	0.9%

**Harmonized indices of consumer prices*
Source: Eurostat/Statistisches Bundesamt

The Sector

Figure 19. Germany: Retail Sales Data (Including Sales Tax)

	2010	2011	2012	2013	2014	2015F
Grocery Sector (€ Mil.)	200,931	205,813	212,523	220,258	224,779	230,400
Annual % Change	0.7	2.4	3.3	3.6	2.1	2.5
All Retail Excl. Automotive Fuel (€ Mil.)	534,830	548,147	559,058	566,866	578,632	591,073
Grocery Sector as % of All Retail	37.6	37.5	38.0	38.9	38.8	39.0
Grocery Sector ($ Mil.)*	266,736	286,574	273,263	292,503	298,731	259,961

**2015 conversion to USD at rates for January 1–March 31, 2015*
Source: Eurostat/Statistisches Bundesamt/FBIC Global Retail & Technology analysis and forecasts

The Issues

A Stable, Discounter-Led Sector

German grocery is a sector of exceptional stability and continuity. It is the home ground of some of the Continent's biggest hard discounters, including Aldi and Lidl; these types of stores account for almost half of the entire sector's annual sales. And there's no sign that shoppers are really interested in moving away from the hard discounters. German shoppers tend toward frugality on day-to-day purchases.

- There is little apparent demand for trading up to hypermarkets. Metro Group's Real is the only major (nondiscount) hypermarket chain, and it perpetually reports low sales growth.
- The online grocery market is tiny and few players have pushed into it convincingly.
- In Germany, we haven't seen the migration to convenience stores that we've observed in France and the UK (probably because shopping at discounters is already local, smaller-store shopping).

Discounters Softening

The solid growth at some of the major discounters has been partly the result of them providing shoppers with more reasons not to switch: there has been a distinct softening of the proposition from a number of players in recent years.

At the softer end of the discount spectrum, Penny has undertaken store refits and own-label overhauls that bring its proposition even closer to that of a regular supermarket.

And Aldi Nord, which is one half of the Aldi empire and was traditionally at the hardest end of discounting, has been softening a little. Since 2013, it has been refitting stores, closing some outlets and replacing some others with bigger stores, bringing it more in line with sister chain Aldi Süd, which has long offered larger, more attractive stores. Aldi Nord has also brought in more branded lines, a strategy that rival Lidl began a number of years ago, and introduced in-store bakeries, which Lidl and Netto have done, too.

The conclusion may be that, while German shoppers continue to expect low prices, it's no longer enough for retailers simply to offer the hardest-of-hard proposition.

But the Sector Is Led by a Nondiscounter

The overall grocery market leader is not a discounter, though. It's Edeka, a retailer that operates smaller supermarkets and neighborhood stores as well as a handful of hypermarkets. And this retailer's success stems largely from its counterbalance to the discounters: it serves consumers' top-up shopping needs, including branded lines, that inevitably arise when they shop at limited-line, own-brand-dominated discount stores.

For a similar reason, the REWE supermarket chain takes fourth place in the market, bookending Aldi and the Schwarz Group, the owner of small-store discounter Lidl and discount hypermarket chain Kaufland.

It is the complementary nature of these supermarket formats and the discounters that has stifled growth at Metro Group's Real fascia, the only major nondiscount hypermarket chain. Although Real is now reporting very modestly positive comps, it has consistently failed to gain any real traction in top-line growth. And that is fundamentally a result of the conservative, discount-dominated nature of the market.

Online? Maybe, but Not Yet

The conservatism and price consciousness that mark the sector mean the online grocery market is tiny. The hard discounters will not sell a full range of groceries online, as the cost of transporting deliveries, especially fresh foods, does not fit with their low-overhead business model. And even some of the major nondiscount supermarket retailers do not have a full online offering yet. As a consequence, e-commerce accounted for only 1% or less of sector sales in 2014, we estimate.

Yet there are hints of potential, if grocers focus on those consumers who are not primarily shopping at discounters. Some 11% of all Germans bought food or groceries online in 2014, Eurostat data show. This is the same level recorded for France, where most of the major grocers have pushed into e-commerce. (In Germany, this number may have been boosted by occasional online food purchases such as gifts.) And German consumers are avid online shoppers for nonfoods: some 70% made an online purchase of some kind in 2014, according to Eurostat.

At the same time, retailer activity is increasing online. REWE has been expanding its coverage for online shopping, as part of parent company REWE Group's somewhat belated push into e-commerce. And in a surprise move, Lidl launched a grocery e-commerce service in 2014, offering a selection of ambient products such as beauty and coffee. While this was an unusual move for a hard discounter, the absence of fresh products means there is no need for costly delivery fleets. All orders are mailed, with a rather hefty €4.95 shipping fee.

In March 2015, rumors circulated that Aldi was planning an e-commerce launch, beginning in the UK, though the company denied any launch was imminent, saying it was "not an immediate" priority.

Further activity from major grocers could prompt some German shoppers to take another look at online shopping. But it is likely to be a slow, incremental process.

Prospects for 2015

Although food-price deflation emerged in some months in 2014, data from the statistics offices show decent year-over-year sector growth of 2.1% in 2014.

Some of the big, price-led retailers underperformed relative to this sector growth. Citing GfK data, trade press declared that REWE performed strongly and that Lidl and Aldi had seen sales declines in the first half of 2014. Aldi Nord revealed that sales inched up just 0.4% for 2014 and Lidl said only that it had experienced "some" positive growth. This came after a strong 2013: at total group level, Schwarz (Lidl and Kaufland) increased sales by 9.5% in 2013, while Aldi Süd reportedly grew domestic revenues by 3.1% in the same year.

We expect 2015 to be another year of relatively muted growth:

- German shoppers are noted for their restrained approach to spending, so the continued uncertainty regarding a possible Greek exit from the eurozone could spur renewed consumer caution.
- The cooling of European relations with Russia, including embargoes on both sides, as well as Russia's imminent fall into recession, will hit demand for German exports in Russia.

We expect consumer confidence, and willingness to spend, to be weak on the back of these developments.

The Retailers

Note: Aldi is technically two companies, Aldi Nord and Aldi Süd, though their origins are in one company and there is evidence of increasing cooperation with regard to elements such as sourcing and promotions. These two companies divide Germany between them (north and south) and international markets are also carved up, with only Aldi Süd venturing beyond Europe (to the US and Australia).

Figure 20. Germany: Top Four Grocery Retailers' Sales and Market Shares

	Net Revenues		**Market Shares***	
	2013	**2014 (Est.)**	**2013**	**2014 (Est.)**
	€ Bil.	**€ Bil.**	**%**	**%**
Edeka (Incl. Netto)	43.01	43.96	21.9	21.9
Schwarz (Lidl and Kaufland)**	28.60	28.89	14.5	14.4
Aldi**	24.09	24.20	12.3	12.1
Aldi Nord	10.13	10.17	5.2	5.1
Aldi Süd	13.96	14.03	7.1	7.0
REWE Group (Incl. REWE and Penny)	23.20	23.90	11.8	11.9

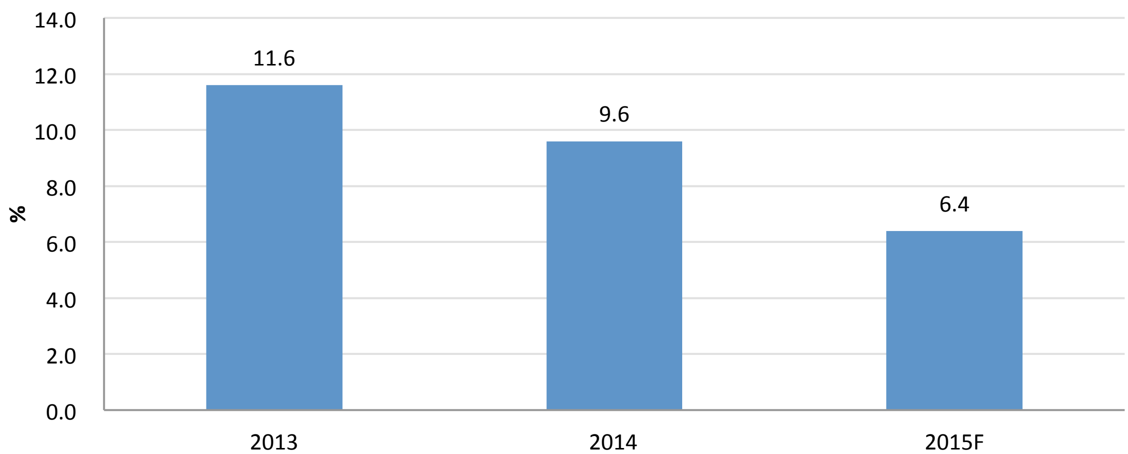
**Share of grocery sector sales. The grocery retailers' sales data exclude sales tax, so we used tax-adjusted sector sales to calculate market shares. No adjustment was made for grocery retailers' revenues from products or services not included in the grocery sector size, e.g., automotive fuel, so market shares may be overstated.*
***Estimated*
Source: Company reports/Eurostat/FBIC Global Retail & Technology analysis and forecasts

China

Summary

- Supermarket sales grew by just under 10% in 2014, we estimate, and we forecast weaker growth of around 6.4% for 2015.
- Chinese economic growth is slowing and the grocery sector is maturing, hitting annual growth rates.
- The supermarket sector is complemented with a still-large traditional/informal retail sector, i.e., stalls and markets.
- German hard discounter Aldi is reportedly planning entry into China, and we think its small-store format could work well there.

Figure 21. China: YoY Grocery Sector Sales Growth



Source: National Bureau of Statistics of China/FBIC Global Retail & Technology analysis and forecasts

The Context

Figure 22. China: Country Data

	2014
Population (Millions)*	1,361
GDP: Real-Term YoY Growth	7.4%
Consumer Price Inflation: All Items**	2.0%
Consumer Price Inflation: Food**	3.1%

**2013 data*
***FBIC estimate from monthly data*
Source: National Bureau of Statistics of China

The Sector

Figure 23. China: Retail Sales Data (Including Sales Tax)

	2010	2011	2012	2013	2014E	2015F
Supermarkets (RMB Bil.)	680	754	851	950	1,041	1,107
Annual % Change	19.4	10.8	12.9	11.6	9.6	6.4
All Retail Excl. Automotive Fuel (RMB Bil.)	3,005	3,786	4,515	5,302	5,949	6,514
Supermarkets as % of All Retail	22.6	19.9	18.9	17.9	17.5	17.0
Supermarkets ($ Bil.)*	100	117	135	153	169	180

**2015 conversion to USD at rates for January 1–March 31, 2015*
Source: National Bureau of Statistics of China/FBIC Global Retail & Technology analysis and forecasts

The Issues

A Market up for Grabs

It is relatively simple to characterize grocery sectors in many countries. France, for example, is hypermarket focused, Germany is dominated by discounters and Japan has a strong convenience subsector. But Chinese retail continues to modernize and consolidate, so there are fewer established market characteristics to identify as certainties.

This means, of course, that the shape of the market is, to a greater extent, up for grabs. Early movers and those building the greatest scale stand the best chance of influencing the future shape of the market—whether it will be focused around big-box stores, town center shops or convenience stores, and to what extent it will be price driven versus quality focused.

Here's our view:

- Although many of the major entrants have been big-store retailers such as Walmart, certain attributes of urban Chinese consumers, such as living in small apartments and having low levels of car ownership, suggest that convenience stores and small supermarkets could end up the preferred formats in cities.
- So far, Chinese shoppers have tended to reward those retailers with strong fresh food offerings that are closer to those of traditional "wet markets." As prosperity continues to increase, there's little reason to think that shoppers will become any less discerning.

The message is that while major retailers have a chance to shape the market, they can only do so within the limits established by consumer preferences.

Consolidation and Development

Chinese retail continues to modernize, driven by increasing prosperity and urbanization:

- Between 2000 and 2010 (the latest date for which data are available), the country's urban population grew by nearly 21 million.
- In the years 2004-13, consumer spending more than trebled.
- Between 2005 and 2013, sales of food, beverages and tobacco through chain stores boomed by 283%.
- The Chinese government's most recent five-year plan, for 2011–2015, made increasing domestic consumption one of its areas of focus.

So, it's no surprise that major international players such as Walmart, Carrefour, Tesco and Auchan have sought to tap into the market's potential.

But It's Not All Smooth Sailing

International market entrants have not had it easy, however. Over recent years, domestic retailers have increasingly become the dominant force in grocery retail, while foreign retailers have struggled. Some operators have slowed their pace of expansion, while others have reduced operating areas or even closed poorly performing stores. For instance, Walmart closed 14 stores in 2013 and 16 in 2014.

The big mistake for international retailers is to assume that they can easily tap the rising market by simply transplanting their existing models into China. Arguably, that's what Walmart did.

It would be wrong to say that Walmart, Carrefour and Tesco have failed in China, but it's reasonable to say they have not had as much success as domestic (or domestic joint venture) retailers such as China Resources Enterprise (trading as China Resources Vanguard) and Sun Art Retail Group (trading as RT-Mart and Auchan) have.

Walmart's fundamental error appears to have been opening the same style of big-box stores that it operates elsewhere in the world, without much consideration for how shopping behavior varies from country to country. It's a mistake Walmart has made before, when it entered the discounter-heavy German market in 1998.

Carrefour appeared to adapt more carefully, structuring its operations around Chinese regions, empowering local managers, showing flexibility in store sizes and tailoring ranges to regional demands. More recently, it has been improving its fresh food offering through staff training.

The problem these retailers face is an apparent preference for "little and often" shopping by many Chinese consumers, including frequent purchasing of fresh foods from wet markets. Walmart, in particular, was set up for big, weekly grocery shops of the type undertaken in the US and Europe.

Sun Art has more successfully catered to local demand. Its stores are still big, but it is offering a fresh food proposition that bridges the gap with traditional channels, with prominent wet-market-style fresh food departments. It also overcomes the urban-living/big-box divide by offering free shuttle bus services to its stores.

Joint Ventures Prove Safer Territory

Sun Art is a joint venture that has allowed France's Auchan to tap the Chinese market in partnership with Taiwan-listed Ruentex. It's a model that appears to work by bringing together developed Western retail formats and local knowledge, particularly with regard to relationships with suppliers.

From 2009 to 2013, Sun Art posted a compound annual growth rate of 17.4% in revenue. Tesco China's rate was 10.7% in revenue over the same period, but Carrefour's was just 5.6%. Walmart doesn't split out Chinese revenues, but in the fourth quarter of 2014 the company said its Chinese sales had dropped 0.7% year over year, or 2.3% on a comparable basis (on a constant currency basis, excluding e-commerce).

Tesco, too, has now adopted the joint venture formula. In 2014, it finalized its divestiture of direct operations in the Chinese market in favor of a joint venture with state-owned market leader China Resources Enterprise (specifically, its Vanguard grocery unit).

The joint venture effectively gives troubled Tesco a way out of its loss-making Chinese chain, allowing it to concentrate on fixing problems in its UK operations. And Tesco gains in scale by tying up with a retailer with massive scale: China Resources Vanguard operates 2,986 stores to Tesco China's 134. Tesco has a 20% stake in the joint venture. Given the difficulties of establishing a profitable Chinese operation, Tesco looks wise to be a minor partner in a large-scale operation rather than having full control over a relatively niche chain.

Could we see others follow this path? Rumors circulated in mid-2013 that Carrefour, with 236 stores, was planning to exit China. Carrefour denied such an intention. A joint venture, though, could be a future possibility. One possible problem for Carrefour is that Tesco's deal with China Resources Vanguard denies Carrefour the opportunity to tie up with the biggest domestic player.

Smaller Stores Closer to Home

As is the case with other nations discussed in this global report, smaller-format grocery stores are proving popular in China. Consumers' changing expectations of convenience have impacted China's retail sector, with smaller retail configurations becoming popular in grocery.

Supermarket players are offering more services targeting single people and smaller households, especially young adults and the elderly, who find smaller and more accessible stores more suitable for them. And, as noted earlier, urban trends for little-and-often shopping appear to support further development of smaller, more local store formats.

Aldi Coming to China?

German hard discounter Aldi was reported in 2014 to be planning a market entry into China. The highly secretive company has given no confirmation of this. But we think it would stand a good chance in China. The apparent demand for local, smaller stores should help support small-store Aldi.

There is a risk that Aldi's conventional format would not have sufficiently broad fresh food ranges for some consumers' tastes, but the retailer has recently shown a willingness to improve its fresh ranges and tailor its proposition for different markets.

Provided Aldi tailors its offering to the market, we think it could do well in China. And that would further heighten the competitive pressures on more established, international players such as Carrefour and Walmart.

Big Nonfood Sales Need Big-Store Shopping Habits

If, as we suggested earlier, the future belongs in large part to convenience stores or smaller supermarkets, then grocery retailers will face problems as they try to sell nongrocery products.

Building share in nonfood categories such as clothing, electrical goods and housewares, tends to depend on shoppers buying their groceries from large stores: nonfood sales piggyback off the footfall driven by grocery.

So Chinese shoppers opting for smaller stores presents a long-term threat to grocery retailers building scale in general merchandise. Online is an alternative way for grocery retailers to grow sales in nonfoods, but it's likely to be harder work.

Grocery Retailers Seek Growth Online

Total online retail sales surged by 59.4% year over year, to reach RMB1.89 trillion in 2013, according to iResearch, which forecast a further 45.8% jump, to RMB2.76 trillion, in 2014. Note that these figures include a substantial (though waning) proportion of consumer-to-consumer sales, so they cannot be directly compared to our total retail sales data above. And we don't have segmented data for grocery sales online.

But, given this boom, it's no surprise that major retailers are pushing into the online channel:

- Late to the party, RT-Mart launched its online grocery and general merchandise platform, Feiniu, only in December 2013 and added fresh foods to the offer in early 2015.
- Walmart owns a 51% stake in Yihaodian.com, a pure play that offers more than three million SKUs; Yihaodian originally focused on food, but has since branched out into general merchandise.
- Treading the opposite path, Suning, originally a household appliance retailer, launched its online grocery site in 2014 and announced plans to ramp up its online offering across food as well as nonfood in 2015.
- Auchan has been offering drive-through collection of online grocery orders at selected stores since 2012.
- Tesco began rolling out an e-commerce site in mid-2013, before the announcement of its joint venture.

Longer term, we expect more stand-alone e-commerce sites (like Feiniu and Yihaodian) to come under the umbrella of their parent, store-based retailers: a consistent cross-channel proposition looks to be stronger than segmented offline/online fascias.

Prospects for 2015

Retail has benefited from the focus on domestic consumption in the government's latest five-year plan. But that plan draws to a close in 2015, so we wait to see if there will be further efforts to boost consumer spending.

More immediately, China's economic growth is slowing. The increase in GDP fell to its lowest level in a quarter of a century in 2014, 7.4%, and is expected to slow further, to around 7%, in 2015. While recovering economies such as the US and the UK should place greater export orders, sales of goods to struggling eurozone and embargo-hit Russia are likely to soften.

The Retailers

Figure 24. China: Top Four Grocery Retailers' Sales and Market Shares

	Net Revenues	Market Shares*
	2013	2013
	RMB Bil.	%
China Resources Vanguard (China Resources Enterprise)	92.4	11.1
Sun Art Retail Group (JV: Ruentex, Taiwan/Auchan, France)	86.2	10.3
Walmart (US)**	72.2	8.7
Lianhua Supermarket (Including Quik Convenience Stores)	68.8	8.3

**Share of supermarket sector sales. The grocery retailers' sales data exclude sales tax, so we used tax-adjusted sector sales to calculate market shares. No adjustment was made for grocery retailers' revenues from products or services not included in the supermarket sector size, e.g., automotive fuel, so market shares may be overstated.*
***Estimated*
Source: Company reports/China Chain Store & Franchise Association/National Bureau of Statistics of China/FBIC Analysis and Forecasts

For more coverage of grocery retailing in China, see FBIC's reports *China Retail: Hypermarkets and Supermarkets in China* (February 2015) and *China Retail: Convenience Stores* (July 2014).

Conclusions and Key Takeaways

Discounters

Carrefour and Tesco offer some lessons in what to do – and what not to do – when faced with the rise of no-frills discounters:

- Fancy store refits are little use in short-term, price-led battles. The argument that flash stores offer points of difference to discounters appears to cut little ice with shoppers.
- Sharpening prices and moving closer to everyday low pricing on core lines is a much more attractive option.
- Tailoring in-store ranges to local catchments can also benefit trading; it emphasises the distinction between range choice at full-range supermarkets and uniformity at discount stores.

Small-Store Shopping

While small store formats offer established grocers opportunities to target new catchments, retailers must be aware of risks:

- Adding more space in low-growth markets threatens to push down average sales densities.
- New convenience stores can cannibalise shoppers from the retailers' own big stores, when they open nearby.
- Encouraging small-store shopping can lose grocers sales in the general merchandise ranges that are stocked only at their larger stores.

E-Commerce

As shoppers begin to migrate to the less-profitable online channel, retailers can find ways to limit the cost disadvantages:

- In-store collection cuts out the costly labor hours and delivery fleets required for home delivery.
- Grocers must be set up to offer an online service (preferably focused on click and collect) but it is not to their advantage to push customers towards the online channel.
- Integrating general merchandise and grocery e-commerce sites, wherever possible, can cut down on lost cross-category shopping.

Deborah Weinswig, CPA
Executive Director—Head of Global Retail & Technology
Fung Business Intelligence Centre
New York: 917.655.6790
Hong Kong: +852 6119 1779
deborahweinswig@fung1937.com

Cam Bolden
cambolden@fung1937.com

Marie Driscoll, CFA
mariedriscoll@fung1937.com

John Harmon, CFA
johnharmon@fung1937.com

Amy Hedrick
amyhedrick@fung1937.com

Aragorn Ho
aragornho@fung1937.com

John Mercer
johnmercer@fung1937.com

Charlie Poon
charliepoon@fung1937.com

Kiril Popov
Kirilpopov@fung1937.com

Stephanie Reilly
stephaniereilly@fung1937.com

Lan Rosengard
lanrosengard@fung1937.com

Jing Wang
jingwang@fung1937.com