

MarketLine Case Study

Tesco confronts budget rivals

Leading retailer reforms to compete against insurgent budget stores

Reference Code: ML00024-020

Publication Date: June 2017

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OVERVIEW

Catalyst

Confronted by the threat of rapidly expanding competition from budget food retailers, Tesco has undertaken reform. The business has been slimmed down, foreign ventures ended and prices lowered to improve competitiveness. However, there are other threats the company must respond to amid declining relevance of the megastore concept on which Tesco built its fortune. Amazon is seeking to supplant Tesco as the leading online grocery store and the merger with Booker, on which the Tesco board has staked much, is under pressure from regulators and shareholders.

Summary

Although the combined might of relatively new entrants to the UK food retail market Lidl and Aldi only amount to just shy of 11% market share in UK grocery sales, the impact of low prices and limited product ranges has elicited a response from Tesco – a company keen to maintain market share and restore revenues to match past glories. Tesco has been very public in responding to the growing threat of the two German budget stores, most notably in a spat with Unilever regarding costs following a fall in the value of the pound. Lower prices have been implemented to stem the flow of customers to the big budget food retailers.

For many years the maxim among major retailers dominant in their domestic market was to expand into overseas markets. Tesco pursued this strategy with mixed success; an adventure to the US was disastrous, whereas operations in South Korea succeeded where others had failed. Not content with simply lowering prices to compete better with budget outlets, Tesco has introduced new own brands and reduced the breadth of certain product ranges – measures designed specifically to increase brand competitiveness. The sale of additional brands purchased over the past decade has been all but completed, slimming down the business to concentrate resources upon the core UK food retail business.

The out-of-town megastore was the tool with which Tesco propelled itself past Sainsbury's to become the leading food retailer in the United Kingdom. But now that model is under pressure; Tesco has responded by reducing costs and introducing Curry's PC World to improve profitability. However, the company is competing to stop the trend towards a less organized culture consumers now exhibit. Shoppers are now much more likely to visit multiple outlets and with more frequency than has historically been the case. Some are predicting the demise of the megastore, but Tesco still depends upon them for revenue and is working to make them more competitive and restore customer loyalty.

A merger between Tesco and major supplier Booker is now under investigation by the Competition and Markets Authority (CMA). To make the deal happen many observers believe Tesco will have to sell hundreds of the Tesco Express stores to rivals. However, some leading shareholders are unhappy with the deal, claiming that it will cost too much and does not provide higher shareholder value. Conversely, Tesco believes the deal will provide substantial savings and boost profits at a time when the company is in a period of recovery following a series of poor financial results. Tesco wants the merger to enable the company to stem the advance of the expanding budget stores.

At a time when Tesco is competing against two large German budget stores, a new threat with aims to undercut Tesco on cost and convenience has emerged. Amazon Fresh has aims to deliver food orders to residents in London within one hour; Tesco has responded with a click-and-collect service which aims to counter that threat with a new nationwide service. Furthermore, Tesco Now will compete on ultra-fast delivery in major cities. Amazon represents a long-term threat to Tesco market share because the resources the company can call upon are massive and the brand is well known, eliminating two major problems most new entrants would encounter.

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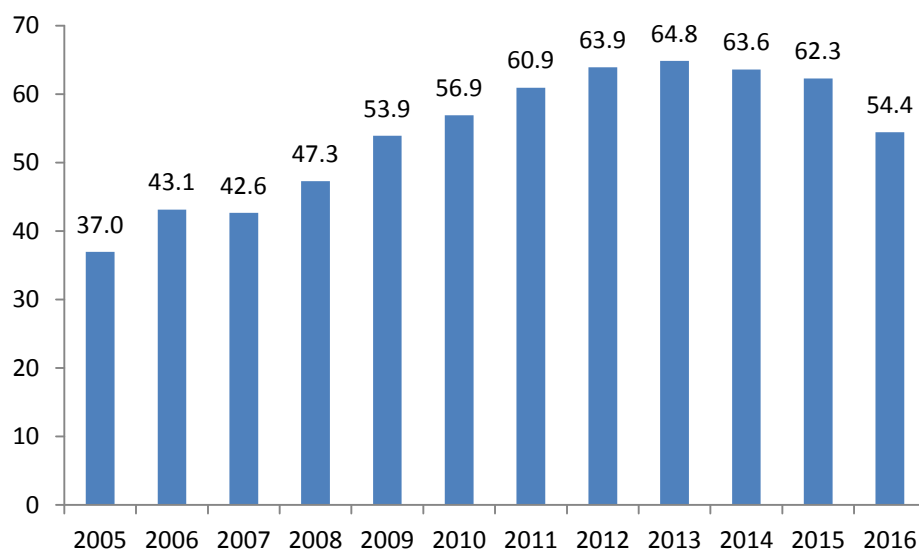
INSURGENT BUDGET STORES PUT TESCO UNDER PRESSURE

The position of Tesco as the leading food retailer in the United Kingdom was not widely predicted during the period of Sainsbury's domination. Having accomplished a market position few believed could happen, the retail giant is now under pressure from foreign budget food retailers able to undercut prices and offer a more dynamic business model. Whilst the extent of market share achieved in years gone by is unlikely to be repeated, Tesco has been able to respond to limit the inroads budget stores have been able to make. Now the company must concentrate on selling areas in which a competitive advantage can be claimed whilst ensuring the brand does not become linked with high prices.

Tesco response: Threat from German entrants is serious, not disastrous

Generally considered to be more dynamic and more able to provide basic goods at reduced prices than available at larger food retailers, comparatively new budget store entrants to the UK market have elicited concern from Tesco, a company which once reeled off 14 consecutive years of growth before hitting trouble. German insurgents, Lidl and Aldi, provide considerably smaller product lines sold in stores of a basic design. At present Aldi has over 700 stores in the United Kingdom; by 2022 the Essen based company intends on expanding the network to 1,000. Lidl has undergone a similar rise since opening stores outside of Germany for the first time in 1994 and now boasts over 600 stores. Combined, the two companies accounted for 10.8% of the food retail market as of September 2016, mostly achieved through attracting consumers away from the leading supermarket chains through lower prices, and taking advantage of changing shopper behavior. Many consumers have shifted away from the 'everything under one roof' culture that companies such as Tesco propagated through the creation of massive out-of-town megastores.

Figure 1: Tesco revenue (£bn) 2005-2016



SOURCE: Company Filings

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The threat posed by the relatively new entrants to the leading players in the UK market is genuine. Furthermore, were ambitious expansion plans to succeed, the market share of the leading players would erode even more. Yet reason exists to suppose Tesco is not in as bad shape as some observers feared. Aldi announced in September 2016 record sales (unlike other major food retailers, Aldi does not release like-for-like sales) and a £300m (\$387m) investment plan to renovate stores. The price has been declining profits. Operating profit fell by 1.8% at the end of 2015, attributed to 'continued investment in prices'.

That the budget, no-thrills style stores feel the need to reduce profits to boost their leading selling point demonstrates the extent of rivalry that now exists in the market. Pressure imposed by Tesco and other retailers, it seems, has placed serious pressure on the insurgents. Aldi claims prices were cut on 30% of products (roughly 1,500 various products) to maintain the price gap after reductions also occurred in rivals. Which company will blink first in this prolonged price war remains to be seen, but Tesco is in better condition than many suspected would be the case because of the investment Aldi and Lidl are having to stump up.

Whilst the German new entrants intend to reduce prices even further to maintain a vital competitive advantage over the established players, the gap in price is unlikely to remain or even grow. Walmart owned Asda, approximately 10% more costly as of February 2016, announced investment to reduce the difference to just 5% in 2016. However, growth in market share shows little sign of slowing in the immediate future. Tesco and other market leaders should provide equal attention to their competitive advantages as the budget stores have on costs. Tesco can provide a far greater selection of products than Lidl or Aldi can or even want to, including leading brands. Reducing prices close to those of the budget stores should ease any damage to revenues and market share, but the extra choice available to consumers must be trumpeted as Tesco is no longer regarded as the most cost-efficient food retailer.

Unilever dispute reveals cost pressure Tesco must respond to

Launched in 1993, Tesco Value, along with the then revolutionary club card scheme, helped transform how British consumers shopped. The brand became synonymous with low cost food and embarked on a remarkable sustained period of growth. Now under pressure to respond to lower prices available at budget food retailers which have since entered the market, the dispute with Unilever gained popular attention late in 2016 and evidences the willingness of Tesco to head off the threat. The dispute began when Unilever, supplier of many household brands, increased costs by 10%. Citing the higher cost of importing goods following the drop in value of the pound following the vote on membership of the European Union, even though some products were made entirely in the United Kingdom, Unilever was forced to confront a bellicose Tesco board. Products provided by Unilever were removed from store shelves in a public act of defiance. Headlines around the country reported the removal of dozens of products; rival stores even experienced a surge in sales on certain products, such as Marmite. Less than 24 hours after the dispute began, it was over. Unilever announced tersely that the 'supply situation has now been successfully resolved'. Ultimately the result reflected what some analysts had predicted: a middle-ground solution. Unilever probably came off worse; following the spat, Marketing Week reported a drop in brand perception of products such as Marmite, which fell 16 places in terms of reputation and was only ranked 19th on brand perception soon after. Other brands such as PG Tips suffered a similar fate.

Figure 2: Empty shelves at Tesco during Unilever dispute



SOURCE: The Sun

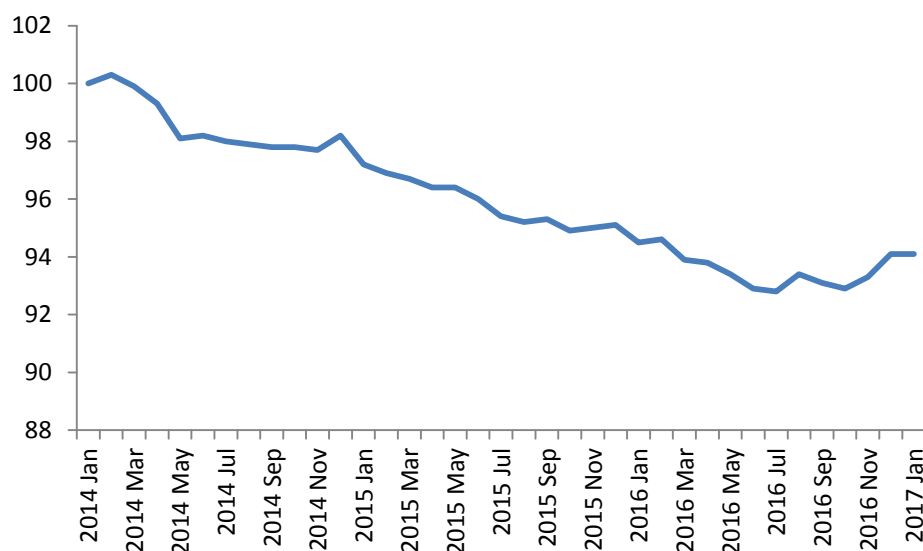
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The spat between a major retailer and global leading food stuff supplier was a public demonstration of willingness from Tesco to remain price competitive with Aldi and Lidl. Tesco has suffered a multitude of problems during recent years, the impact of which still affects the company. In being seen to be refusing to pass on costs to consumers, the growing perception that lower costs could be found elsewhere met crucial resistance. Evidence for this can be seen in the financial returns provided in April 2017. In the year up to 2017, Tesco reported the first growth in sales achieved by the market leading company since 2010 with like-for-like sales up 0.9%. (The international arm fared less well, however, with operating profit tumbling 12.5% to £320m, due in part to a price war in Poland.) In engaging so publically, Tesco managed to avoid putting up prices of Marmite before rivals Asda and Morrisons did. Had the company submitted to Unilever prices would have been raised earlier. Consequently, the price rise which did eventually occur in Tesco stores has not impacted the company and the competitive advantage of being the last major retailer to increase prices was gained.

Tesco own brand takes on Aldi, Lidl and Asda by price matching

Despite the downturn in fortunes of the company as a whole – international operations are being wound down to allow resources to be pumped into the domestic core business – the degree of price matching against rivals was intensified towards the end of 2016 in a deliberate attempt to strangle the main selling point of budget retailers. Before the change in pricing policy only 500 product lines were price matched; now that number has ballooned to 11,000. The supermarket giant announced the quality and price of at least 60% of Aldi and Lidl products will be matched but the premium brands will be excluded from the pledge. Yet there are risks involved with such a move. In attempting to provide Sainsbury's or Waitrose quality level at the prices conventionally associated with Aldi, Tesco could be over extending itself. With the days of multi-billion pound profits seemingly gone, at least for the foreseeable future, resources to fund the price reductions could soon dwindle if the anticipated results do not materialize. Were Aldi and Lidl to expand market share following the completion of highly aggressive expansion strategies – which is likely given the number of stores forecast to be constructed over the next five years – then Tesco would have very limited space to act in.

Figure 3: UK food prices, Detailed indices of food consumer prices, Jan 2014 – Jan 2017 (Jan 14' = 100)



SOURCE: Office for National Statistics

MARKETLINE

After the vote to leave the European Union, consumers would appear to have become even more price conscious than was previously the case. One survey conducted by Retail Economics found 48% of 2,000 consumers questioned would switch to cheaper own-label alternatives if their weekly food shopping bill rose by just 3%. Some analysts have predicted between April 2017 and the conclusion of 'Brexit' negotiations, prices will rise by 8%.

As of April 2017, the price of everyday foodstuffs had risen 2.3% compared to 12 months previously.

Given the inflation in prices, the strategy currently being pursued by Tesco could run into trouble. The Irish Cattle and Sheep Farmers' Association's (ICSA's) Sheep Chairman John Brooks said the prices being demanded by Tesco for spring lamb are 'unsustainably low' and that producers are being undermined. Pressure to lower prices from retailers could well have finally met significance resistance and could be reversed. The saving grace could be rival retailers are likely to be adversely affected, maybe even more so than Tesco. Both Sainsbury's and Asda have been in discussions regarding prices demanded by suppliers.

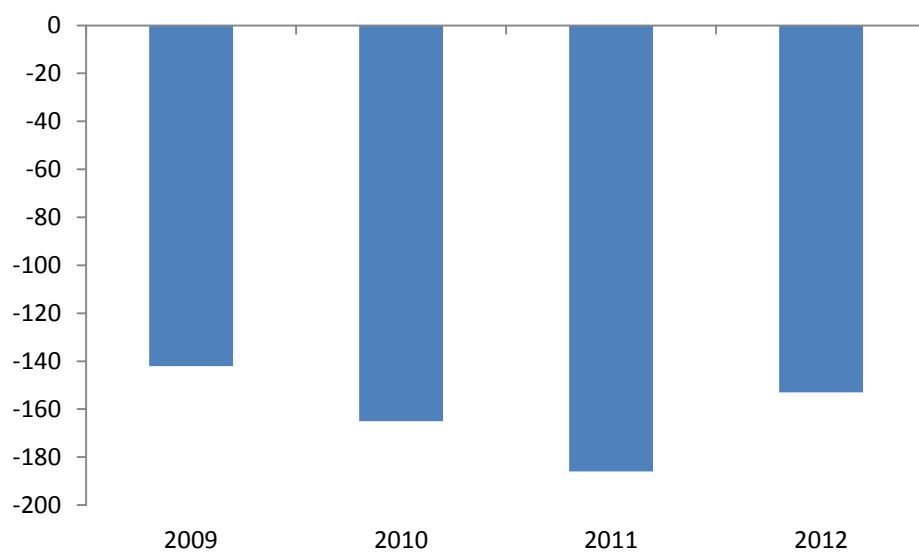
TESCO SLIMMED DOWN BUSINESS TO STAY COMPETITIVE

For a while the prevailing idea within retail dictated that brands dominant in a domestic market had to explore overseas markets to increase revenues. This involved buying and then investing in small players or beginning a new brand from scratch. Tesco reached into several foreign markets but a decline in fortunes and failed ventures – most notably in the US – incited a timely change in strategy. Even stores in the United Kingdom are having additional businesses sold off. The result should be a leaner, more nimble business more able to shape itself to suit market conditions.

Foreign ventures have been sold off to streamline business

The record of Tesco reaching into foreign markets has proved to be patchy. Efforts at establishing the company in the United States were an unmitigated disaster, costing the company dearly; however, Tesco succeeded where others had failed in breaking the South Korean market. Homeplus became the second largest in the country in terms of sales after promoting goods in the same style as market hawkers. Whilst the brand was a success, the need to shore up the balance sheet necessitated a sale. Private Equity Company MBK Partners purchased Homeplus in 2015 for \$6.1bn. For the investment MBK received 141 hypermarkets (ranking the company number two), 610 supermarkets and the largest online presence of any offline retailer. Better still, margins are said to be among the highest achieved globally.

Figure 4: Fresh & Easy losses (£m)



SOURCE: Tesco

MARKETLINE

Whilst the sale was undesirable given the commercial success and low likelihood of another competitor being able to repeat the success – Walmart left the market in 2006 after selling 16 outlets to Shinsegae Co for \$872m just weeks after Carrefour also left the market – other foreign ventures failed. The US brand 'Fresh & Easy' comprised 200 stores across California, Nevada and Arizona, and had been losing money since opening in 2007. In October 2013, the store filed for bankruptcy; Tesco loaned Yucaipa £85m (\$130m) to take over the brand.

Tesco revealed losses of £1.2bn (\$1.84bn) in the ill-fated venture. The resulting fall in pretax profits was the first the company suffered in 20 years. Other operations in Turkey were sold in 2016 to local competitor Migros after efforts to merge the business with Turkish retailer Anadolu and BC Partners-owned Migros failed. Losses whilst the under the ownership of Tesco were substantial: £137m (\$211m) in the 2014-15 financial year.

Selling off foreign tentacles became necessary to concentrate resources on the core domestic business. Not only were certain brands losing money but investments were taking away investment in UK stores, investment which was necessary to shore up the market leading position Tesco currently maintains. Whilst Tesco accounted for one in seven pounds spent in retail shops across the United Kingdom, resources could be allocated to risky foreign ventures. But now the domestic brand is under pressure to respond to intensifying competition from rivals, money allocated to the core business has become more important. Moreover, waning profits mean losses could no longer be so easily absorbed and risk-taking had to be scaled back. Had the threat from Aldi and Lidl not been so strong, the need to retreat from certain international markets would not have been so pressing.

Selling in-store services refocuses attention on core market

Whilst the unravelling of foreign brands has been taking place for several years, the strategy to simplify the business is much more nascent. The range of the sell-off is comprehensive. Opticians, Euphorium, Dobbies, Giraffe and Harris and Hoole have been sold to provide resources to be ploughed back into the core food retail part of the business. Some have been situated inside Tesco stores for some considerable time. In April 2017 the opticians business, consisting of 206 practices, was sold to vision express. All 1,500 staff will be transferred to the new owners. Matt Davies, boss of the UK & Ireland part of Tesco, said that the deal 'allows us to further simplify and strengthen our UK business and ensures our customers are still able to enjoy high quality eye care services from Vision Express in our larger stores'.

The company is still seeking to attract customers using the 'under-one-roof' strategy but can no longer accept the financial risk of owning the extra in-store outlets. Selling to another owner is therefore the best solution: customers may still be enticed to enter a Tesco store through access to an optician, granting Tesco a far improved opportunity to capture custom for the food retail business, but the required investment in the opticians is no longer the responsibility of the giant retailer. Although the sum Vision Express paid for the business was not disclosed at the point of sale, other in-store outlets are known to have been losing money.

Figure 5: Giraffe restaurants, formerly owned by Tesco



SOURCE: BBC

MARKETLINE

Both Giraffe and Dobbies are examples of Tesco losing money whilst chasing extra business through expansion into other markets.

Giraffe was purchased for £49m (\$75m) in March 2013 but has since been sold for an undisclosed sum; industry observers believe Tesco made a loss on the sale price as well as losses incurred whilst the restaurant chain was under its ownership. Boparan Restaurants Holdings, owner of Harry Ramsden's fish and chip shops, will take over the ailing company. Former chief executive Phil Clarke saw the family-friendly food chain as an opportunity to lure more customers into the largest Tesco stores.

However, Giraffe continued to rack up losses; in the financial year 2014-15 the business lost £4.1m (\$6.3m). This and other sales are about protecting the wider business from further losses. At the point of purchase Tesco viewed the food retail market as being sluggish and considered the restaurant chain to be a lucrative growth opportunity. Despite Dobbies generating a profit of £17m (\$26m), the 35 stores have also been sold to free resources for internal investment. Harris + Hoole artisan coffee shops have also been sold on.

Without the distraction of additional businesses, the task of combating the encroaching new entrants through a competitive pricing structure whilst maintaining a brand image which can capture customers of Sainsbury's is made easier than would otherwise be the case. Furthermore, in finding buyers for businesses which were attached to out-of-town megastores, Tesco has managed to maintain a competitive advantage Aldi and Lidl are unlikely to be able to match.

New brands launched to repel low-cost alternatives from rivals

Despite adverse publicity in the UK press concerning the labelling of food as having come from farms which do not exist, Tesco has attributed growth achieved in mid-2016 to the introduction of the 'farm food' range. According to Tesco, over two-thirds of customers have purchased products from the new range of foods. The 'farms' brands comprise seven distinct brands across fresh, meat and poultry categories offered below the existing 'Everyday Value' range in terms of price. Each carries its own look and takes aim at the lowest priced products available in budget stores. 76 brands are now being sold under the seven brands and supplied using existing suppliers. Unusually, the prices of products will remain consistent in supermarkets and smaller convenience stores, where consumers are normally charged a premium for convenience.

The point of expunging the convenience store premium is to target the cheap products available at Aldi. The premise is 'why go to Aldi to get fruit and veg when you can get it at Tesco for the same money but at a better quality'. In undercutting Tesco on price, the budget stores also eroded the 'everything under one roof' concept which had proved so successful from the 1990's onwards. The wider importance of the products to the future of Tesco is shoring up the perception of Tesco as a value brand. Mass appeal and the idea of the superstore depend upon the public believing they will get the best deal. Time will tell how much impact upon the expansion plans of Lidl and Aldi the 'farm foods' series of brands will have. Many brands in the history of UK consumer culture have had a positive birth, just as the latest offering from Tesco has, but have gone on to lose relevance. Virgin Cola, for instance, had good initial sales but consumers lost interest and reverted quickly to previous habits.

Figure 6: New 'farm food' brands at Tesco



SOURCE: BBC

MARKETLINE

Tesco previously attempted to introduce new product lines to target global leading suppliers such as Unilever. Whilst initial results from the new brands have been positive, no guarantee of sustained success exists. In 2011 Tesco launched Venture Brands, the intention of which was to create a series of brands to take on premium offerings from companies such as Unilever and Procter & Gamble. The hope was the products would boost loyalty to Tesco by offering shoppers products they couldn't find anywhere else, providing greater pull factors. At the time of launch the logic made sense: Tesco was posting strong profits and rising revenues, but few remember Venture Brands now. Tesco should learn the lessons from the problems encountered with the 'farm foods' brands – taking aim at large players does not necessarily pay off.

TESCO NEEDS MEGASTORES, BUT DOUBT SURROUNDS THEIR LONG-TERM FUTURE

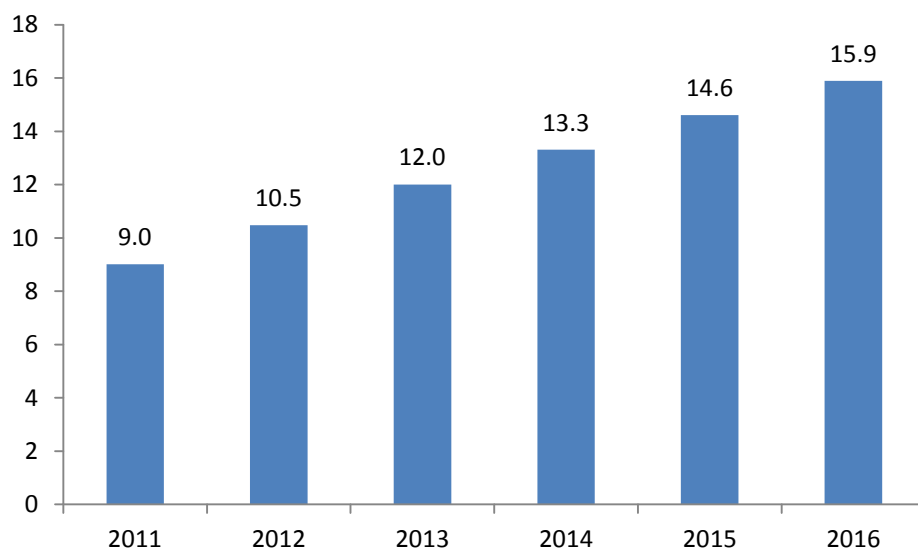
No longer the sure-fire winner that it was in the 1990s, the fortunes of out-of-town megastores have waned over the past decade. Shopping habits have changed as many consumers have become time poor, causing them to turn instead to small, and inner-city convenience stores in preference to travelling to shop. Given the dependence Tesco has on the model, the company cannot let the concept dwindle, but the evidence for reducing relevance and for steady commercial decline is strong. The leading food retailer in the United Kingdom is taking steps to prevent further damage. Given the circumstances, largely brought about by budget retailers, Tesco has been forced to change strategy.

Shopping habits have changed, placing the idea of the megastore under pressure

The out-of-town megastore achieved popularity because they provided a degree of previously unheard-of convenience and fulfilled lifestyle ambitions through an explosion in choice. One estimate stated to reach the entire UK population, a retail chain required 1,200 stores; now the number is a little over a third of that because of online shopping. Choice is no longer the purveyor of success it once was; budget stores have built reputations for low prices by the removal of choice, bringing about reduced product lines at Tesco. Shopping from multiple outlets has now become commonplace, cutting customer loyalty dramatically and making outlets work much harder to maintain footfall. Time poor shoppers are far more impulsive than their organized counterparts and shop more frequently. 'Segmented shopping', as it has become termed, describes this change.

Most consumers now use four different shops each month on average; almost half of this group will use two different stores in the same shop according to food research company IGD. Increasingly shoppers expect grocery retailers to be organized around them rather than building their routines around store opening hours. This has enabled the growth of internet food retail, but as yet that model has not supplanted physical stores. However, despite the doubts which surround the megastore concept, many still believe for leading companies they remain a safe bet, but not the success story they once were.

Figure 7: UK online grocery retail (\$bn) 2011-2016



SOURCE: MarketLine

MARKETLINE

With more than half of consumers having given up on the weekly shop, 'tap-and-go' contactless payments have soared at small convenience stores. Such payments have a £30 (\$39) limit and are therefore of little use in big out-of-town stores. The average contactless payment in December 2016 was just £9.52 (\$12.32) compared with £80 (\$104) online. According to the UK Cards Association, contactless payments now account for £25bn (\$32.3bn) worth of spending. Convenience and speed, therefore, undermine the idea of travelling to walk around a vast shop, which is a problem for Tesco given the historic dependence the company has had on that style of shopping. The trend could raise doubts about the Tesco merger with Booker. Most observers believe Tesco will have to sell a big proportion of the Express stores to make the deal happen, but these stores are increasingly where revenue is gathered.

Tesco makes big stores cheaper to run to pay for price cuts and remain competitive

A hallmark of the megastore was 24-hour opening. Never closing except for certain bank holidays came to symbolize the new way of going shopping that out-of-town stores brought about. Yet that has now come to an end, at least regarding 76 Tesco stores. Initially the reduction occurred in just 20 stores. Long opening hours are an inefficient use of resources but for a long time worked because they reflected the shopping culture at the time. Now the culture is different, and to make those stores more competitive resources must be utilized wisely. Cost reductions are important because the money is ploughed into price drops, making products sold much closer to the prices charged by the growing budget retailers. Reducing nighttime operations is believed to have resulted in significant job losses, although estimations vary significantly regarding exactly how many. The main cost saving to come from cuts to staff hours. Most cuts will happen to nighttime staff, who typically earn more than daytime staff.

Tesco trials Currys PC World brand in megastores to boost profitability and entice footfall

At a time when many additional brands have left Tesco or are in the process of leaving, the move to bring in the popular Currys brand on a trial basis would on first impression appear to be a surprise. The aim is to fill unused space with a profitable brand and avoid store closures. The first Currys PC World store will open in July 2017 at Tesco's Milton Keynes Extra store, in central England followed by a second concession at its Weston Favell Extra store in Northampton during August 2017. This is part of a wider strategy to provide buying opportunities that cannot be matched by budget rivals, expanding the competitive advantage Tesco has in this area. Other retailers such as Sainsbury's have been following the same strategy. Last year, Sainsbury's purchased the parent of Argos, Home Retail, for £1.1bn (\$1.4bn) after a successful trial of Argos outlets in some of the larger stores.

Finding a successful brand to occupy space in the large out-of-town stores is vital to their continued future, even if it would appear to go against the grain of consumer trends. Not only is a point of differentiation found, but the Curry's PC World brand is desirable, marking it out from previous efforts Tesco has made towards importing brands into the large stores. The business risk to Tesco is also limited, which is important given the risks some shareholders believe the company is taking with the Booker merger. At a time when the margins on food have become finer due to ongoing price wars with rivals, inserting an opportunity for a higher margin product into stores could provide much needed breathing space.

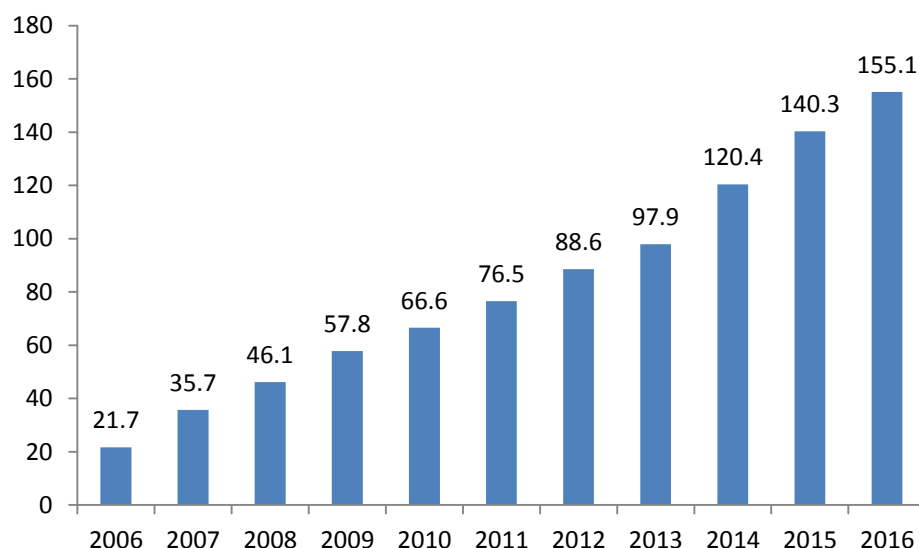
MERGING WITH BOOKER IS A RISKY MOVE, IF IT HAPPENS

The proposed merger with Booker, a multi-billion-pound supplier to the food retail industry, is perhaps the highest risk move Tesco has made to protect market share from the new budget stores. Some shareholders have concerns about the Competition and Markets Authority (CMA). Assuming the deal were to proceed (some have expressed severe doubt that it will), Tesco hopes it will provide the company with a competitive advantage no other food retailer in the United Kingdom can seriously match. The reasoning behind the deal is to make it easier for Tesco to compete on price with the budget retailers. Were this to happen and given the reductions already in place, life would become much tougher for the likes of Lidl and Aldi.

Attention from regulators raises uncertainty over multi-billion-pound deal

Leading industry sources have been reported as saying the deal would hand the enlarged company too much power over the food supply of the country. If the regulator presses this point hard, Tesco would likely have to let go of stores because Booker does not own the large bulk of shops in its network. Instead Booker operates Londis, Premier, Budgens and Happy Shopper on a franchise basis. The counter argument from Tesco – that the deal would not grant the retail giant an excessive degree of power over the food retail market in the United Kingdom – was struck a blow after it was announced. Booker conceded to journalists that the supplier did exert some control over prices and products in shops operating under its brands. Furthermore, Nick Read, head of convenience chain store Nisa, complained the merger could threaten his company because of the increased buyer power Booker would have and an exaggerated ability to lower prices. However, the company protested that this only concerned 15 stores which were sold to the Co-Operative group. Regulators will raise concerns about places such as Peterborough. Data obtained by The Telegraph newspaper reveals 37 out of the 117 food shops in the city are run by the two companies. In all likelihood, there will be more such places over which the merger will be fought.

Figure 8: Booker Group Operating Profit (£bn) 2006-2016



SOURCE: Booker Group

MARKETLINE

Investigations from the Competition and Market Authority initiated much talk about which stores would be sold if required, and who prospective buyers may be. Industry insiders are generally agreed that the most likely store to go would be hundreds of Tesco Express outlets.

Given developing consumer behavior which has moved away from large shops and towards irregular but frequent trips to small shops, there is doubt concerning the extent to which Tesco would be happy to proceed were that to be the price demanded by regulators. As of the financial year end in 2016, Tesco Express stores numbered 1,732. Last year 32 stores were closed and 29 others opened. Another point of concern about the possible sale of this part of the business is the public presence the Express stores provide. For many people, the most common sighting of the Tesco brand will be through either travelling past or entering an Express shop. Other rivals, such as Asda and Sainsbury's, would maintain their versions of small convenience shops, meaning those brands would be much more visible to passing consumers than Tesco would be.

Who would take-over the store is another serious problem regarding how Tesco chooses to combat strengthening rivalry within the market. McColl's is generally accepted to be the favorite were several hundred Express stores put up for sale. Under the stewardship of Johnathan Miller, the convenience chain store became the second largest retailer in terms of number of stores after investment bank Rothschild provided the opportunity to buy 300 stores from the Co-Operative group. The deal put the number of McColl's stores at approximately 1,300 and 350 newsagents across the United Kingdom. However, the specter of taking over hundreds of the Express stores would raise another competition issue for the CMA to examine; the number of McColl's branded stores would rise significantly, occupying a hefty chunk of the small convenience store market.

In recent years the CMA has become closely involved with other major deals such as the takeover of Vocalink by MasterCard. Few expect the regulators to wave through the Tesco-Booker deal. Were they to do so, uproar would likely ensue and heaping pressure exerted for a reexamination. Submitting to speculation, it is reasonable to surmise both Booker and Tesco believe this and are over-pitching in anticipation of the CMA diluting the proposal to make it acceptable. For Tesco the prize is significant, especially after the public spat with Unilever. Gaining control over a greater amount of the supply chain process would make the task of matching budget outlets across the product range easier to achieve. Furthermore, that the deal is a merger means large outlays of the past would not be repeated.

Some shareholders are not happy with proposed merger, increasing pressure on Tesco board

Getting the deal past regulators could likely prove to be easier than getting it past shareholders, of which there are many. Schroders, owners of a 4.5% stake and third largest shareholder in Tesco, made concerns public in a damning letter about the principal behind the merger and the cost to Tesco. Schroders claim the empirical evidenced demonstrates takeovers are generally bad for shareholder value. The letter continues to argue margins at Booker rose from 1.2% in 2007 to 3.1% in 2016; profits have risen £36m (\$47m) to £153m (\$198m) during that time. Both are now at their highest ever levels, meaning Tesco is proposing to pay 23 times the peak operating profit. The high multiple would make the task of succeeding in getting a return a difficult undertaking. Artisan Partners, another large shareholder, expressed similar sentiments when describing confusion at the reasoning behind the deal.

Discontent among shareholders has the potential to kill the deal even before regulators conclude investigations: a majority of shareholder support is required for completion to happen. An as yet untapped source of concern is the scope of businesses that Booker supplies to, which include Michelin star holding restaurants. Consequently, joining with Booker would take Tesco back into the restaurant business, from which the company only recently extracted itself. Tesco claims within three years £200m (\$259m) would be added to annual profits, more than half of which would come from procurement savings. For that degree of saving a \$3.7bn outlay would appear to be a lot of money, especially so given the profit margins of Booker are unlikely to rise from the current historic high. Consequently, the prospects of Schroder gathering support to expunge the proposal would appear to have a realistic chance of success. Any rebellion would, however, run into the problem of Blackrock, the largest shareholder, who raised their stake in Tesco, suggesting the investment management corporation is in support of the merger.

Concern about the scale of deal rests not only with shareholders and competition regulators, but with small outlets and suppliers as well. Hermes Fund Managers, a major investment group, declared the deal would give Tesco too much power. Potentially the announcement of concern could be important. Although the group does not hold shares, it does act as a consultant for other investment operations.

AMAZON FRESH CREATES NEW THREAT TO TESCO DOMINANCE

In what has come to be described as the 'supermarket time wars' new services have been launched during the past year which drastically reduce the time taken to deliver goods to consumers' homes and create a new level of convenience for the time poor shopper. So far only available in large cities, Amazon entered the market to great fanfare in June 2016 but has since failed to make a significant impact. That, however, has not halted the belief that such services will not come to be a major part of the food retail market. Amazon Fresh hit the market with prices lower than Tesco, proving the giant company with another budget store threat. Having only just got to grips with the impact of two budget retailers, Tesco is now involved with fighting off another.

Amazon Fresh brings fast delivery and low overheads: Tesco responds

At least for the early part of its existence, Amazon Fresh must be considered as a budget store. Amazon deliberately entered the food retail market at attractive prices to make a splash, but the low overheads the business has suggest prices which undercut Tesco are here to stay. Combined with an excellent infrastructure network, Amazon can provide low prices due to not having physical stores and the additional costs attributed to them. Not only does the new entrant pose a threat to Tesco, but to the likes of Lidl and Aldi too who so far have no such business in place which can replicate that of Amazon despite persistent rumors that such a move is underway behind the scenes. In response Tesco created a same-day click-and-collect service in August 2016 – shortly after the launch of Amazon Fresh. Heading off the threat to market dominance is important given the increased stress consumers place upon time and convenience compared to cost.

Figure 9: Amazon Fresh



SOURCE: Reuters

MARKETLINE

Time will have to pass before the relative success of the ventures can be judged, but there are key differences which Tesco should pay head to. One of the problems Tesco has had is the falling popularity of big out-of-town supermarkets; in some cases, car park space has been leased out to other businesses following falling attendance at certain stores. A new click-and-collect service was initiated at 300 such stores. The giant food retailer is betting on popularity being restored, or at the very least not dropping further. The same-day grocery collection service will mean that shoppers who place their order before 1pm can pick it up from a nearby store after 4pm. Tesco is planning a marketing push aimed at Brits abroad who want to pick up cupboard essentials on their return home from their local store.

Customers will have to pay to use the service and book a slot before arrival.

Some believe expectations around the supposed revolution in shopping have yet to materialize. The online grocery market is fragmented: Tesco remains the biggest player but only occupies 3% market share; to match that Amazon would have to find three million customers, each of whom would on average spend £264 (\$342) per year according to data from Kantar Worldpanel. It could take a long time to get there; Ocado, the closest business to Amazon Fresh took 15 years to achieve profitability. Whilst the threat remains small for now, given the resources of Amazon and the customer reach the brand has, the likelihood is Amazon will occupy a significant share of the online grocery market sooner rather than later.

Tesco trials 1-hour delivery service in London, taking on Amazon and rival brands

Tesco signaled it was working on an instant food delivery service when in 2015 the 'Tesco Now' name was registered at Companies House. In May 2017, the company announced a trial of a 1-hour delivery service in zones 1 and 2 of London. So far, the range of products is very limited, certainly compared to the range offered by Amazon, but the price charged for the service is less and the vast infrastructure required is already in place, granting Tesco important competitive advantages whilst the available range is built up. For now, the trial is taking place with courier service Quiqup Whether that will grow to become a lasting relationship remains to be seen, but Tesco already has an extensive network which can be developed to provide the 1-hour service. For now, Tesco Now is not going to impact marketplace sellers today, but it may well do so in the future.

In establishing a presence in the ultra-fast delivery industry now, Tesco will be able to compete on equal terms rather than playing catch-up as has been the case with Lidl and Aldi (the damage from the delay is still being inflicted upon the retailer). As UK consumers increasingly reject the idea of the weekly shop and turn to app based services (which Tesco Now is), Tesco must develop the model to succeed in much the same way as the company changed food retail with big out-of-town megastores in the 1990s. In addition, delivery by robot is under trial. But rather like the Amazon demonstration of delivery by drone, Tesco is experimenting with what technology may look like in the distant future; in the short-term the trials have more to do with creating a technically sophisticated brand image.

CONCLUSIONS

Tesco has changed much to meet growing budget store threat, but there is no guarantee of success

Although the combined might of Aldi and Lidl, two comparatively recent entrants to the UK food retail market, form a considerable threat to the future prosperity of Tesco, the cost both companies are paying to achieve lower prices than the rest of the market is eating into margins and profits. Tesco publically made a show of efforts to reduce prices through the dispute with Unilever in late 2016. Price reductions and shrinking of product ranges have allowed Tesco to lessen the perception the new budget stores are cheaper whilst keeping a greater range of options available to consumers. Such steps are important regarding market share because both Lidl and Aldi have ambitious expansion plans. Tesco has at least provided both brands with a serious problem.

For much of retail history over the past two decades the prevailing wisdom has been a dominant domestic brand must expand overseas to keep growing, but that view is no longer in vogue. Faced with a worsening financial situation, Tesco has abandoned overseas operations in favor of concentrating upon the core market, an essential move given that is where the primary threat lies. A slimmed down business is refocusing attention on what the company is good at and improving the overall package to stay ahead of the competition. The creation of new brands would appear to have succeeded, although time will tell if consumers switch back to old buying habits. A leaner, nimbler Tesco is now capable of meeting the threat from budget stores in a way in which was previously not possible.

Budget stores which have gained popularity through undercutting Tesco and other major retailers on price and convenience have been able to do so because shopping trends have changed. No longer does the 'everything under one roof' model of megastores have the same relevance as was once the case. In reducing costs through fewer nighttime opening hours Tesco has reduced running costs. Investment into cutting prices has eroded the budget stores competitive advantage in that area. Whether the experiment of bringing Currys PC World into certain stores to provide greater profitability will work remains to be seen, but it shows a concerted effort to build on areas where Tesco has an advantage over the competition.

The merger with Booker, a major food retail supplier, is an attempt to improve profits by controlling more of the supply chain. Tesco estimates the deal could add £200m (\$258m) per year after three years have elapsed. Over half of the gain is believed to come from savings in the supply chain. However, industry regulators are investigating and some large shareholders are unhappy at the move, accusing Tesco of not adding value to the company and paying above the odds. Merging comes with risks, but if Tesco can make them work the task of competing on price against the likes of Lidl and Aldi lessens in difficulty. Whether Tesco will accept the conditions from regulators once investigations have concluded and what those will be is currently unknown.

Amazon Fresh was launched in the United Kingdom last year to much fanfare but has so far only made a limited impact. Yet that should not be used against the company. Others have taken extended periods of time to gain relevancy, and Amazon has massive resources at its disposal. The challenge to Tesco is Amazon represents another budget retailer aiming to undercut the grocery giant on price and convenience. In response, the click-and-collect service has been created and a speedy 1-hour delivery service is coming too. Dynamic creations to take on new challenges mean Amazon has serious competition in the initial stages of brand development, protecting the market share Tesco holds.

APPENDIX

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Further Reading

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