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Tesco Plc.

Our strategy is to take a successful U.K. company and make it a world leader in an industry we think will become an international industry. Neither of these things is proven yet: we haven't made the transition, and the industry hasn't yet become international.

—Terry Leahy, Tesco CEO, 2002

We will have more space overseas than in the U.K. by 2003/04.

—Tesco Interim Report, 2002

The 1990s had been a successful decade for Tesco, the British supermarket chain. The early 1990s found Tesco staggering under the effects of the recession that had hit the United Kingdom. Sainsbury's, Tesco's number one competitor and archrival, was announcing yet another record year. Marks and Spencer, another vaunted food rival, was still one of the world's most admired retailers. By the end of the decade, things were a bit different. Tesco was the number one food retailer in the United Kingdom, Sainsbury's was scrambling to recover and had been rumored as a takeover target, and Marks and Spencer had stumbled at home and internationally. So successful had Tesco been at almost everything it had touched, even Tesco.com, its Internet/home delivery service, was profitable, probably the only such example worldwide.

At the start of 2002, Terry Leahy, CEO since 1997, had reason to be pleased. Not only had the company's stock price more than doubled, from 89 pence¹ in April 1996 to 206 pence in October 2002, he had personally been recognized by the Queen for his services to food retailing and was now a knight, Sir Terence. At the tender age of 46, Leahy was not about to sail into the sunset. For one thing, at his accession to the role of CEO he had announced an aggressive 10-year growth plan for the company to (1) develop a strong core U.K. business, (2) be as much in the nonfood business as in food, (3) develop a profitable retailing services business, and (4) be as strong internationally as domestically. For another, competition showed no signs of weakening. One of his main competitors, Asda, had been bought by Wal-Mart, the American retail giant. Asda, along with Morrisons and Tesco, occupied the value segment of U.K. supermarket retailing. With a recovering Sainsbury's together with another grocery competitor, Safeway, at a slightly higher price point and continuing vigorous competition from European discounters such as Aldi, Netto, and Lidl at lower price points, Tesco would not be number one for long if it grew complacent. What would the story be at the end of the next 10 years? Had Tesco deserved its success, or had it merely survived against inept competition? And if it had deserved its success, was that success transferable to Tesco's small but thriving international ventures?

¹ One pound (£1) was worth \$1.57 in December 2002. One pound = 100 pence.

Professor David E. Bell, with assistance from Senior Researcher Cate Reavis of the Global Research Group, prepared this case. HBS cases are developed solely as the basis for class discussion. Cases are not intended to serve as endorsements, sources of primary data, or illustrations of effective or ineffective management.

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Company Overview

In 2002, Tesco operated 1,023 stores in 10 countries (750 in the United Kingdom), employed 260,000 people worldwide, and had access to a population of 280 million people. Since 1999, turnover had increased 38% and net profit 37%. (For more financial information see **Exhibits 1** through **4**.) Tesco's main competitors included Sainsbury's, Safeway, Asda, and Morrisons supermarkets. Since the mid-1990s, Tesco's stock had outperformed those of its competitors as well as the industry index (see **Exhibit 5**).

In addition to its traditional supermarket format, Tesco operated Tesco Metro (urban convenience stores targeted toward office workers who wanted ready-made meals), Tesco Express (a convenience store often near Esso gas stations), and Tesco Extra Hypermarkets. Tesco had achieved a 4% share of the nonfood market² in the United Kingdom and was well on its way to achieving its goal of a 6% share. Worldwide nonfood sales had increased to £7 billion. The company offered a number of retail services through the Tesco Personal Finance division.

In addition to the United Kingdom, Tesco had operations in Ireland, Hungary, Poland, the Czech Republic, Slovakia, Thailand, South Korea, Taiwan, and Malaysia. Tesco's international business accounted for 42% of the company's total floor space but only 10% of its net income.

Table A First Six Months of 2002

	Sales	Operating Profit
United Kingdom	£10.5 billion	£537 million
International	£2.3 billion	£59 million

Source: Company.

^aOne billion pounds in Asia, £1.3 billion in Europe.

Company History

In 1919, Jack Cohen invested his serviceman's gratuity worth £30 in a grocery stall in London. In 1924, he introduced Tesco Tea, his first private-label product. (The name Tesco came from the initials of his tea supplier, T. E. Stockwell, and the first two letters of Cohen's name.) The first Tesco store opened in 1929 in London, and by the end of the 1930s there were over 100, mainly in London. After a visit to the United States in the mid-1930s, where he discovered the American self-serve supermarket model, Cohen decided to adopt the same "pile it high and sell it cheap" format. The first American-style Tesco was opened in 1947, the same year the company (Tesco Stores Holdings) went public. Cohen's emphasis on self-service led to his paying more attention to his suppliers and, in effect, ignoring his customers.

² Nonfood includes clothing, music, appliances and the like but not normal grocery items like shampoo and not automobiles.

The fortunes of the once-thriving chain declined so much in this period that “doing a Tesco” became British jargon for snatching defeat from the jaws of victory. As a final insult, the Imperial Tobacco Company, Britain’s major player in the tobacco industry, having considered an acquisition of Tesco as part of a diversification strategy, eventually declined on the ground that Tesco might damage Imperial’s brand image.

Recovery—Improving Operations

In the early 1980s, Ian MacLaurin became the first nonfamily CEO. MacLaurin reputedly had great charisma; he would lift the morale of any store just by entering it. But coming from the operations side of the business, he realized that the company needed to be streamlined to have any hope of survival. He closed many of Tesco’s smaller stores and built larger, more economical 30,000-square-foot stores in the suburbs. His aggressive expansion into a core business of over 200 superstores and a centralized distribution system that left Sainsbury’s trailing, as well as advances in fresh food and its own label, set Tesco up well strategically. As for the merchandising side of things, innovation was fairly straightforward—copy whatever Sainsbury’s was doing.³

The economic boom of the 1980s provided some breathing space for Tesco, but it also permitted the company the (complacent) luxury of higher margins through higher prices. The recession of the 1990s exposed this copycat merchandising strategy; the lower-priced continental discounters attracted the value conscious, and Sainsbury’s did a better job at attracting the quality conscious. Tesco had no differentiated offer to maintain the loyalty of its customers. Just at this time, as Tesco’s fortunes again plummeted, the newspapers were rubbing it in with headlines announcing Sainsbury’s most profitable year yet and the selection of Marks and Spencer as “Britain’s most admired retailer.”

Recovery—Focus on the Customer

In 1992 Leahy, by then director in charge of fresh foods, was elevated to the board with responsibility for marketing. He realized that if Tesco continued to lose 1% to 2% of share per year, the company would be in dire shape very quickly. As a good marketer should, he began to investigate a basic question: Why, exactly, were customers leaving? Based on focus groups, Leahy concluded that Tesco had squandered a lot of goodwill with its core customers. Their anger had less to do with a rational comparison of what the company had to offer but rather that Tesco had so obviously been chasing Sainsbury’s, copying them on this, copying them on that, instead of trying to satisfy its own customers. By March 1993, Leahy was able to report to the board. He summarized what he thought Tesco needed to do:

1. Stop copying Sainsbury’s as a merchandising strategy.
2. Institutionalize listening to customers.
3. Build a merchandising offer based on responding to what Tesco’s own customers wanted.

Tim Mason, now marketing director, coined the phrase “bricks in the wall” to describe this incremental approach to merchandising: no sweeping innovation, just patient responses to customer needs. Describing the strategy internally, Leahy used the slogan “Tesco: The Natural Choice for

³ One of the young up-and-coming managers in charge of doing the copying was one Terry Leahy, hired in 1979.

Ordinary Shoppers,” indicating that the chase for the upscale customer was over. Externally the slogan was “Every Little Helps,” an expression that resonated with the people who had accused the company of deserting them.

In the fall of 1993 the first customer-driven innovation occurred with the introduction of a “value line,” a low-priced, no-frills range of basic items. The investment community was aghast at the move. Critics said this would cheapen Tesco’s image and no one would “lower” himself or herself to buy such things. But they were wrong. Some customers did buy them, but perhaps more importantly, the rest saw the value line as an indication that Tesco was trying to help. In the fall of 1994 Tesco introduced “One in Front,” a commitment to keep lines short at the checkout counter. Cashiers were to signal for help if they saw more than one person waiting in line. As Leahy recalled:

In the busy days of the 1980s, stores were so crowded, long lines were the norm. Customers accepted that waiting was a necessary part of shopping, and management accepted that acceptance. But it didn’t mean customers liked it. A consequence of “One in Front” was that we needed more cashiers, at least, more people who could be cashiers. So we progressed to have more staff—more multitasking staff—in our stores.

It wasn’t long before I noticed a pattern in our focus groups. No matter what the focus group was talking about, whether being critical or not, there was always a point where somebody would stand up and praise the staff at Tesco. And the group would nod in agreement. So we made our staff the heroes of our “Every Little Helps” advertising campaign. We had a constant character, “Dotty,” an elderly, difficult-to-please customer. Everyone in the U.K. got to know and love Dotty. And our staff were the heroes.

In February 1995 Tesco introduced the “Clubcard,” which offered a penny back per pound spent (1%). Leahy thought of the rebate idea while sitting on a train. “I recalled shopping at the Co-op store when I was a boy. You gave your Co-op number when you bought something and at the end of the year got a dividend based on your purchases. The Co-op stopped doing it years ago, but in the ’50s, when times were hard, it meant a lot to their customers.” The Clubcard concept was tested in a few stores for a few months, with great success, and then rolled out nationally. The Clubcard was immediately productive in that it got a lot of people to try Tesco again. The Clubcard also offered an opportunity to use direct mail to target customers. The best customers, those spending in excess of £600 per quarter, were given special offers, such as flights not available to all or cash coupons.

Observers were not impressed with this innovation either, one critic referring to it scornfully as “electronic Green Shield stamps,”⁴ but Tesco management credited the Clubcard, now with 10 million members, as a major contributor to the Tesco turnaround. One manager commented, “A loyalty card is a ‘must have’ these days for a retailer. Some have suggested that a loyalty card can be used as a device to merchandise to the best customers, but that’s not how retail works. Once you’ve opened a store, you want everyone in your store, not just the big spenders. We don’t think there is such a thing as a bad customer. Success in retailing comes from the last 3% of customers.”

Telephone operators and the Tesco Web site together fielded over 100,000 customer queries per week, many relating to the Clubcard program (lost cards, enquiries about point accumulation) but also to the quality of products. All managers had online access to these customer comments. The company credited knowledge of customer needs derived from Clubcard data with adding three points to its in-stock percentage.

⁴ Green Shield stamps were a widely used “money-back” scheme, popular in the 1960s and 1970s, in which customers collected stamps at various participating retail stores and, after suitable accumulation, traded them in for gifts.

And the focus groups continued. Mason observed:

We learn things all the time. We discovered that people didn't like our stainless steel refrigerators. They reminded people of a hospital. So now we install refrigerators that are colored. We also learned the importance of clean toilets. We all know they ought to be clean; what we didn't fully appreciate is that customers relate the hygiene of the toilets with the hygiene of the store as a whole.

Recovery—Focus on Employees

Tesco's focus on customers soon extended to employees. Leahy began meeting with "focus groups" of employees: "I would ask each group what Tesco stood for. A typical response would be 'caring for customers.' Then I asked what they would *like* Tesco to stand for, and they would use words like teamwork, praise, and trust. These are part of our core values today. People want to enjoy being at work. The goodwill of the staff is the main productivity lever that you have."

Leahy knew that reenergizing the staff would require an attitude of respect, meaningful work, and training—throughout the organization. He said, "Too many people at high levels had vaguely defined roles; too many people in the stores were performing elementary tasks." From 1996 to 1998, all managers were put through a training program designed to teach fundamental aspects of management: how to run a meeting, how to identify the causes of a problem and, perhaps most importantly, how to spot resistance to change and to learn methods for dealing with that resistance. Treating employees with respect extended to job security. So far as possible, employees whose positions were eliminated were found jobs elsewhere in the company.

Recovery—Focus on Growth

When Leahy became CEO in 1997 he was satisfied that Tesco had become a stable, competitive player in the U.K. supermarket business. But growth was only keeping up with inflation. The company he envisioned in 2007 would derive much of its revenue from nonfood products, and international business would be as important as the U.K. business. Leahy also announced the ambition of making Tesco an "essential part of the landscape" in the United Kingdom. He wanted the company to be a British institution, like the BBC or Marks and Spencer had been in their prime.⁵

Leahy's ambitious growth goals could be achieved in three ways:

- By increasing the effectiveness of the existing U.K. business;
- By finding new ways to deliver value to U.K. customers;
- By accelerating the pace of international expansion.

⁵ This latter goal was accomplished not only through being an increasingly important part of customers' retail lives but also by touching their daily lives. Tesco had spent £77 million on a "Computers in Schools" program whereby customers could donate till receipts to a local school that in turn could trade those receipts for computer hardware and software. Tesco organized a running event, "Race for Life," which had attracted a quarter of a million women and had raised £12 million to support cancer research. Other programs integrated retail objectives as well as entering the fabric of peoples' lives. About 500,000 Tesco customers were members of a "baby club." A woman would be a member during pregnancy and until the baby was two years old. Every three months a member would receive a brochure appropriate to the age of the infant providing information about health and development of the child and tips about the concerns mothers typically faced. The brochure also contained coupons for relevant products.

But in order to be able to execute his strategy, Leahy knew that he would need an organization that would work hard, and effectively, in pursuit of the goals he had laid out. The organizational strategy was to communicate very clearly where the company was headed and empower everyone to make it happen. To make the empowerment succeed, Leahy ensured that each person had a set of quantifiable objectives relevant to the employee's situation and a set of incentives for achieving them.

The approach, described as "the Tesco Way," was summarized in a widely distributed brochure (see **Exhibit 6**). One of the core values was "simplicity." Dido Harding, now a director of food procurement who joined Tesco after a stint at Woolworth's, noted that Tesco was run rather differently: "There was a clear message that bright people weren't supposed to use their intellect to make things more complicated, but rather to make things simpler." Tesco's corporate affairs director, Lucy Neville-Rolfe, said the notion of simplicity extended to communications:

We have a message of the week that is sent by e-mail to our top 2,000 managers, any of whom can reply directly if they have a question. They in turn pass it on, perhaps translated appropriately. No one in management has a private secretary—even Terry sometimes picks up his own phone—which makes for good communication. It's the same on the outside. We don't use lobbyists because it is easier to communicate if we do it in person.

Another cornerstone of the Tesco Way was the "steering wheel," which laid out the objectives that managers would be judged by. Each quarter a manager would be shown the wheel and how his or her performance rated against those objectives, color-coded for impact: green indicated good progress, yellow a caution, and red declared a problem. A store manager's steering wheel included objectives such as shrinkage and the results of visits by mystery shoppers. The store manager was also measured on how well the store's employees understood the store's performance on key measures. As a result, employee back rooms were plastered with graphs on which key indicators were updated daily.

Increasing the Effectiveness of U.K. Stores

Logistics

According to industry observers, Tesco's U.K. stores had one of the best distribution networks in the world. This was in spite of Tesco's reputation of being "obsessed with stores" rather than operations. Tesco spent £200 million to £300 million per year on its logistics systems, mostly on upgrading existing facilities.

The emphasis was on using existing resources more efficiently. For example, the distribution centers were increasingly using cross-docking, a system by which goods flow directly from inbound trucks to waiting store-bound trucks. Adoption of this technique was hampered by the lack of loading bays, which meant some doors needed to be used for loading and unloading. The critical bottleneck at the warehouses led to a number of creative initiatives designed to increase the ability to coordinate arrival and departures of trucks. One initiative was to use Tesco's own trucks to collect goods from suppliers, a technique known as primary distribution. Another initiative had store managers visiting the distribution centers to see firsthand the problems created if a truck was not unloaded at a store promptly.

Most stores currently received two deliveries per day: a "fill-up" delivery and a "top-up" delivery, though the goal was to move to two main deliveries per day, thus increasing turns and reducing out-of-stocks.

Procurement

The steering wheel for buyers included performance objectives such as delivered cost, product quality, and delivery reliability, but, said Harding, "We are mainly measured on gross margin because that's the only cost measure that is unique to the buying function. Even though we are held to account on gross margin, the attitude is to deliver for the customer: in our case, the store manager. That permeates everything. The customer really is king."

Negotiations with key suppliers usually occurred once per year. A pricing system would be agreed upon that laid out the price Tesco would pay as a function of the quantity it ultimately ordered and the reliability with which it was delivered. Tesco's goal was to hold as little inventory as possible, so flexibility was a key component of vendor selection.

Tesco had followed a trend in the industry by encouraging some vendors to dedicate themselves, or one of their factories, exclusively to its needs. "In part, we were forced to do this by competitors, like Marks and Spencer and Sainsbury's, who were tying up suppliers," Harding said. Harding went on to describe Tesco's relationship with vendors:

There are a lot of relatively small vendors who supply us with Tesco-branded merchandise. We are an important customer to them, so we have to make sure that our contracts are win-win. Dealing with larger vendors is a different story. With dedicated suppliers we need to think of cost in terms of total operations. With large vendors we like to concentrate on calculating their *marginal cost*. When a supplier has many customers, some will be more profitable than others. We want to be their most demanding customer. But even though we may fight like cats and dogs over the price we need, we also cooperate about increasing sales in their category. This isn't an easy adjustment to make. Sometimes when we hire people from other companies they cannot understand the notion of cooperating with vendors.

The Tesco spirit of simplicity in communication extended to suppliers. They had access to the company's sales data, though not necessarily in real time. Twice a year, Leahy laid out to assembled vendors exactly what Tesco was up to in the coming months.

The Stores

Though promotions were not unusual, the general pricing philosophy at Tesco was that of everyday low pricing (EDLP). There was a strong push to give more authority to store managers. A manager hot line was set up. A new program dubbed TWIST (Tesco Week in Store Together) required all corporate managers to spend a week in a store working on a specific store task. Phillip Clarke, the board member in charge of logistics and IT, spent a week stocking shelves, and Leahy had worked a cash register. Mason, the director of marketing, indicated that plans were afoot to use technology to permit store-specific plan-o-grams that would allow store managers to modify buyer-designed core offers. He continued:

The Tesco brand has been transformed over time from being cheap, downmarket, and distressed to that of market leader and most admired. We did that by simply thinking of ourselves as being in "the shopping business." We aimed to provide the "best shopping trip for everybody." We recognize that Sainsbury's attempts to justify higher prices by being aspirational, but we find many customers with children are reluctant to shop there because they are afraid their children will misbehave. Asda is proud of its low prices, but they are perceived by many as a bit too cheap. We hope no one can complete the sentence, "I don't shop at Tesco because. . ."

Extending the Retail Offer to U.K. Customers

Alternative Formats

Building on its core supermarket business, Tesco had three additional store formats. Metro stores were small convenience supermarkets located in busy downtown areas, having a particular emphasis on sandwiches and casual food. Express stores were smaller convenience stores often located next to Esso gas stations. Finally, Tesco's hypermarket format, called Extra, was the major vehicle by which Tesco could fulfill Leahy's objective of growing rapidly in the nonfood area. **Table B** summarizes Tesco's store formats.

Table B Tesco Retail Formats, United Kingdom Only, 2002

Store Format	Number	Average Sq. Ft.
Express	100	2,000
Metro	180	10,000
Superstore	408	35,000
Extra	62	90,000

Source: Company.

Retailing Services

In 1997 Tesco began offering financial services; by 2002 it had 3 million registered customer accounts. The goal was to provide customers with convenient financial products during their shopping trip. Customers could open a bank account enabling them to deposit checks as part of a register transaction; £6 million was deposited in a typical week. Money could be withdrawn from any ATM. Tesco also sold car insurance and by 2002 had 600,000 policies outstanding. Travel insurance could be bought as a routine register transaction, and loan applications could be filled out and handed in on the spot. Tesco's profits from these services were £20 million in the 2002 financial year.

Tesco.com

In December 1995 five people were assigned to study the idea of home shopping. Microsoft developed a Web site, and 12 stores were selected to act as shipment points. Orders were to be taken by phone, fax, or over the Internet. Launched in December 1996, the project soon foundered. Taking orders by phone and fax proved prohibitively expensive. Moreover, as John Browett, CEO of Tesco.com (a legal subdivision of Tesco Plc.), observed, "We discovered that the 5% of the British population who had Internet access didn't buy groceries."

For a year the operation was held in a limited number of stores until it could be executed properly. Browett recalled the analysis that followed:

Around this time the belief spread that the best way to do home shopping was from a dedicated warehouse, but we studied the economics with great care and decided that was not

correct. A lot of companies are afraid to do the numbers. They either don't want to or can't. But doing the numbers allows you to make the right call. For example, when we lower prices we know exactly how low we can go. Our analysis suggested that a given store would get no more than 500 orders per week. People argued that if we were filling online orders in the store we'd be crowding out our traditional customers. But our stores have an average of 40,000 customers per week. The online orders, which could be done at off-peak times, weren't going to bother anyone.

On the idea of dedicated warehouses, there is no way you could afford to stock all of the SKUs [stock-keeping units] you'd need to give a full assortment. The fact is, a lot of our early customers were shopping online precisely to find obscure items they couldn't find in their local store.

Tesco.com was relaunched with orders taken over the Web and fulfilled from the stores. Logistics were improved in two ways, one by reducing the flexibility of delivery windows and the second by improving the order-picking process. Customers could select one of two delivery windows, either 7–9 p.m. or 8–10 p.m. It was believed most people would be home on a weekday evening. The evening delivery times permitted more flexibility about when the orders could be picked and improved the delivery scheduling. Each store had several specially designed shopping carts with six containers to hold different orders. A touch screen on the cart informed the picker, who was a regular store associate and who followed a set path around the store, when to pick an item off the shelf and which container to put it in. In that way shopping for six took not much more time than shopping for one.

Store managers were happy with the presence of Tesco.com; the store was credited with the sales as if they had been made to a conventional shopper, the sales were largely made in off-peak periods, and, as an added bonus, the picker would notice irregularities such as out-of-stocks that could then be corrected.

As of 2002, Tesco.com covered 95% of the United Kingdom and was filling 100,000 orders per week worth nearly £10 million, or about 2% of Tesco total sales. Commenting on the kinds of customers that Tesco.com was attracting, Browett said:

Tesco.com appeals to the cadre of people who have been doing it for a while and have become very adept; for them they can do an entire week's shopping in 10 minutes. Another group of regular users are people with small children at home for whom a trip to the supermarket can be a nightmare. A third group is the single professional for whom a trip to the store is a poor use of time. For them a £5 delivery fee is well worth it even if they buy only a few items.

Browett believed that in-store delivery would continue to be the most sensible system even if online sales became as much as 10% of store sales. Not only had Tesco.com reported a profit in 2001, as a further indication of the prospects for this channel, Tesco had exported the model to the Republic of Ireland, to South Korea and, via a joint venture with Safeway, Inc., to the United States.

International Expansion

Like many retailers facing a zero-sum game in their domestic markets, the lure of potentially fast-growth foreign markets was strong. In the mid-1990s, as its cash flow began to recover, Tesco made some decisions about what its international strategy should be. Leahy recalled:

There were no texts on how to be successful at international retailing. It worked in our favor that we didn't start out believing we had all the answers. We thought about how we could add value for us and for customers. We needed countries where we would be early entrants, countries that were stable, and countries with sufficient spending power per capita and with growth potential. We also recognized that our skill set involved opening networks of stores rather than integrating preexisting chains. This thinking led us to identify the former Communist countries of Eastern Europe and a few emerging overlooked countries in Asia.

David Reid, vice chairman of Tesco and the person in charge of the international venture, described how Tesco selected the hypermarket as the correct vehicle for Tesco abroad:

We knew that we did not have a ready-made international format. We had no hypermarkets in the U.K. at that time, but it became obvious that it was the right format. It was the only format that would help us achieve our goals for nonfood growth. It also helped that tastes are more international in nonfood than in food. It was also the right choice logistically. It didn't make sense to build distribution centers to service many small stores, at least not in the early stages. And finally, it seemed to us that no matter how we started, we'd end up opening hypermarkets, so it made sense to skip the first step and open hypermarkets to begin with.

Tesco recognized the advantages that local partnerships could provide. In Asia, Tesco found partners in the CP group (Thailand) and Samsung (South Korea), but in Eastern Europe there was a dearth of possibilities. Tesco instead identified small thriving retailers and bought them to obtain their managements, which were then given the task of building the number one retailer in their country. The first foreign country was Hungary, in 1994, quickly followed by Poland, the Czech Republic, and Slovakia. Later in the 1990s Tesco established a presence in Thailand, South Korea, Taiwan, and Malaysia.

Since Tesco had no experience with hypermarkets and no knowledge of the local customers, it gave great autonomy to the local management. According to Leahy: "Even today, with 65,000 employees overseas, there are only 70 of our U.K. managers living abroad. And they are trainers, not operating managers. We've told the local managers that they are to be the number one in their country, but we don't tell them how to do it. As a result, their enthusiasm is sky high."

The role of the trainers was to be sure the values of the local teams were in keeping with those of the parent. The Tesco Way, with its emphasis on simplicity, on the customer, and on steering wheels, was a constant, but not the retail solutions. Reid believed the Tesco Way had been absorbed and understood by senior management but less so as one went lower in the organization. Foreign managers had problems understanding the notions of empowerment and promotions based on merit; indeed, some actively resisted it.

The international strategy seemed to be working. By 2002, Tesco claimed market leadership in six out of the nine countries it had entered and profitability in eight, with a combined contribution to operating profit well in excess of £100 million. The company believed it was the most profitable international retailer in both Asia and Central Europe. Tesco had 150 hypermarkets overseas and had plans to start introducing other of its domestic formats, such as Express stores. As Tesco opened its 62nd hypermarket in the United Kingdom, it was clear that its overseas investments were paying off in more ways than simply providing operating profit.

Leahy reflected on the success of its strategy:

You could say that we had pursued a "pull" strategy overseas by letting the local market dictate what we offer. A "push" strategy would have presumed we knew what could work

and would have proceeded by rolling out store after store. I think there are very few economies of scale across countries in food retailing; what's important is not to lose any local economies of scale. That is why it is important to be number one within a country, rather than simply to build sales across countries. There are some cross-border synergies like IT and sourcing, but the main advantage we have is by exporting our culture. Global retail brands won't be the norm in my generation. After all, consumer goods companies have taken 100 years to achieve an 8% share. I doubt if it will be much different in retail. Most of our overseas customers think they are shopping in a local store.

The Next Five Years

At the end of 2002 Tesco was on track to achieve the goals Leahy had set out in 1997. Tesco was nearing his goal of being 50% international, and perhaps most incredibly of all, it had become the most admired retailer in the United Kingdom, "an essential part of the landscape."

A lot had happened to Tesco since the early 1990s. But despite that success, it could be argued that Tesco faced stronger competitors in 2002 than it had in 1992. Domestically, Asda had become a formidable foe under the ownership of Wal-Mart and Sainsbury's had begun revitalizing its stores, and internationally Carrefour and Wal-Mart were being increasingly aggressive. Tesco International still benefited significantly from the strong financial condition of Tesco in the United Kingdom.

In the 1970s, "doing a Tesco" was a characterization of failure. In the 1990s, "the Tesco Way" was a symbol of retail revival. The new decade would reveal whether the Tesco Way was purely a local solution or a formula for international retail success.

Exhibit 1 Tesco—Income Statement (millions of pounds)

Year to February	1999A	2000A	2001A	2002A	2003E	2004E	2005E
Sales—U.K.	15,835	16,958	18,372	20,052	21,461	23,049	24,708
—Europe	1,167	1,374	1,756	2,203	2,614	3,026	3,554
—Asia	156	464	860	1,398	2,343	3,573	4,955
Group sales	17,158	18,796	20,988	23,653	26,418	29,649	33,218
<i>U.K. gross margin</i>	25.4%	25.3%	25.3%	25.4%	25.4%	25.4%	25.4%
Operating profit—U.K.	919	993	1,100	1,213	1,308	1,409	1,516
—Europe	48	51	70	90	145	180	214
—Asia	(2)	(1)	4	29	70	125	190
Group operating profit	965	1,043	1,174	1,332	1,523	1,714	1,920
<i>Group operating margin</i>	5.6%	5.5%	5.6%	5.6%	5.8%	5.8%	5.8%
Income from associates	6	11	21	42	58	72	88
Net interest payable	(90)	(99)	(125)	(153)	(190)	(206)	(218)
Adjusted PBT	881	955	1,070	1,221	1,390	1,580	1,790
Exceptionals/amortization	(39)	(22)	(16)	(20)	(10)	(10)	(10)
Reported PBT	842	933	1054	1,201	1,380	1,570	1,780
Tax charge	(237)	(259)	(333)	(371)	(427)	(485)	(550)
<i>Tax rate</i>	28.1%	27.8%	31.6%	30.9%	30.9%	30.9%	30.9%
Net profit	605	674	721	830	954	1,085	1,230
Minority interest	1	0	1	0	(2)	(5)	(8)
Net attributable profit	606	674	722	830	952	1,080	1,222
Dividends	(277)	(302)	(340)	(390)	(435)	(491)	(551)
Retained profit	329	372	382	440	517	589	671
FRS3 EPS (p)	9.1	10.1	10.6	12.0	13.7	15.4	17.3
Adjusted, diluted EPS (p)	9.4	10.2	10.7	12.1	13.6	15.3	17.2
Total dividend (p)	4.12	4.48	4.98	5.60	6.25	7.00	7.80

Source: Company reports and Schroder Salomon Smith Barney estimates.

Exhibit 2 Tesco—Balance Sheet (millions of pounds)

Year to February	1999A	2000A	2001A	2002A	2003E	2004E	2005E
Intangible fixed assets	112	136	154	154	134	124	114
Tangible fixed assets	7,441	8,391	9,884	11,349	12,774	14,117	15,381
Inventories	667	744	838	929	1,000	1,091	1,188
Debtors	151	252	322	454	477	521	570
Investments	201	258	255	225	225	225	225
Cash	127	88	279	445	445	445	445
Total assets	8,699	9,869	11,732	13,556	15,054	16,523	17,923
Shareholders' funds	4,382	4,769	4,978	5,530	6,097	6,735	7,457
Minority interest	(5)	29	36	36	36	36	36
Provisions	17	19	402	440	440	440	440
Long-term debt	1,218	1,559	1,925	2,741	3,320	3,753	3,991
Short-term debt	830	847	1,413	1,489	1,489	1,489	1,489
Trade creditors	1,100	1,248	1,538	1,830	2,053	2,304	2,580
Other short-term creditors	1,157	1,398	1,440	1,490	1,619	1,766	1,930
Total liabilities	8,699	9,869	11,732	13,556	15,054	16,523	17,923

Source: Company reports and Schroder Salomon Smith Barney estimates.

Exhibit 3 Tesco—Cash Flow Statement, 1999–2005E (millions of pounds)

Year to February	1999A	2000A	2001A	2002A	2003E	2004E	2005E
Operating profit (EBITA)	965	1,043	1,174	1,332	1,523	1,714	1,920
Depreciation	401	428	468	524	585	657	736
EBITDA	1,366	1,471	1,642	1,856	2,108	2,371	2,656
<i>EBITDA margin</i>	<i>7.98%</i>	<i>7.83%</i>	<i>7.82%</i>	<i>7.84%</i>	<i>7.98%</i>	<i>8.00%</i>	<i>8.00%</i>
Interest and taxes	(366)	(344)	(433)	(555)	(542)	(605)	(670)
Working capital	(19)	48	295	182	130	115	130
Net cash flow from operations	981	1,175	1,504	1,483	1,696	1,880	2,117
Dividends	(238)	(262)	(254)	(297)	(325)	(363)	(405)
Capital expenditure (net)	(1,005)	(1,211)	(1,910)	(1,835)	(2,000)	(2,000)	(2,000)
Exceptional items	(26)	(6)	0	0	0	0	0
Acquisitions/disposals	(274)	1	(76)	(96)	0	0	0
Other	0	(18)	(58)	(85)	0	0	0
Free cash flow	(562)	(321)	(794)	(830)	(629)	(483)	(289)
Shares issued	42	20	88	82	50	50	50
Noncash movements	(9)	(39)	(38)	(8)	0	0	0
Opening net debt	(1,191)	(1,720)	(2,060)	(2,804)	(3,560)	(4,139)	(4,573)
Closing net debt	(1,720)	(2,060)	(2,804)	(3,560)	(4,139)	(4,572)	(4,810)
<i>Gearing</i>	<i>33.7%</i>	<i>37.3%</i>	<i>48.7%</i>	<i>56.4%</i>	<i>60.1%</i>	<i>60.6%</i>	<i>58.2%</i>

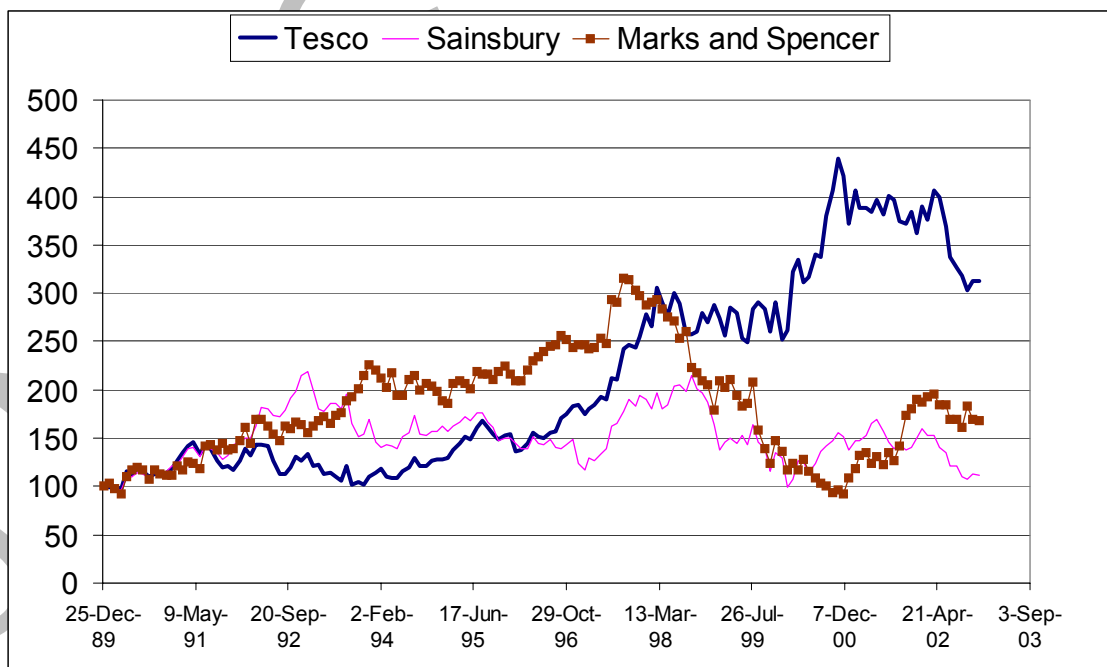
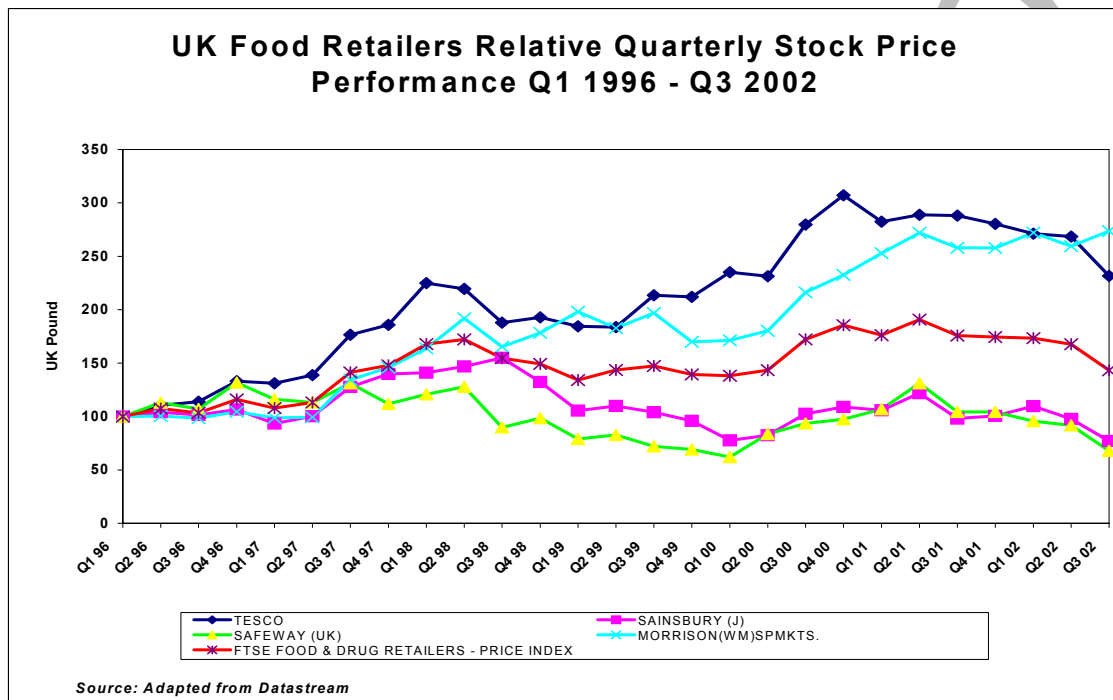
Source: Company reports and Schroder Salomon Smith Barney estimates.

Exhibit 4 Tesco—Key Data, 1999–2005E

Year to February	1999A	2000A	2001A	2002A	2003E	2004E	2005E
Dividend cover	2.3	2.3	2.1	2.2	2.2	2.2	2.2
Interest cover	7.7	7.1	6.6	6.2	5.9	6.1	6.5
Book value per share (p)	77.0	82.6	84.7	91.7	99.0	107.5	117.1
ROCE	15.3%	14.5%	14.5%	14.4%	14.6%	14.8%	15.2%
Asset turnover	1.95	1.88	1.82	1.77	1.75	1.79	1.85
Payment period (days)	31.4	32.5	35.8	37.8	38.0	38.0	38.0
Collection period (days)	2.1	3.5	4.5	5.2	5.0	5.0	5.0
U.K. store numbers	639	659	691	728	792	827	882
U.K. sales area (000 sq. ft.)	15,975	16,895	17,949	18,822	20,076	21,106	22,136
Sales (ex VAT) per sq. ft. /wk. (£/wk.)	19.56	19.95	20.39	21.09	21.24	21.52	21.97
U.K. profit per sq. ft. (£)	1.14	1.17	1.22	1.28	1.29	1.32	1.35

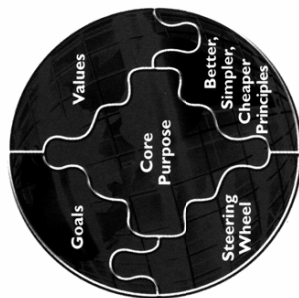
Source: Company reports and Schroder Salomon Smith Barney estimates.

Exhibit 5 U.K. Competitors' Stock Prices



Source: Graph based on data from Commodity Systems Inc. via Yahoo!

Introduction



The Tesco Way

Over the years we've developed an approach to doing business and this has become known as the Tesco Way. We have drawn together the five elements of that approach and this booklet summarises them. They are:

- **Our Core Purpose** the reason for all that we do
- **Our Goals** what we have set out to achieve
- **Our Values** the way we want to behave
- **Our Principles** Better, Simpler and Cheaper
- **Our Steering Wheel** which measures progress against our priorities and provides a visual reminder of our plans

This booklet is a reminder of the key messages, first delivered at the company conference in 1999. Understanding and managing the Tesco Way is a key ingredient for success at Tesco. The Tesco Way is a way of working which is:

BETTER, SIMPLER and CHEAPER



The Core Purpose

Our core purpose is all about customers:

To create value for customers to earn their lifetime loyalty

For us customers are at the heart of all that we do. The purpose, values and goals work together to create the culture and clarity of direction which enable us to achieve success.

Our strong UK core business has increased its market share and we are successfully expanding overseas because we understand better than others what our customers want - and how best to provide it. We create value for our customers because we understand them and improve our business for them.

The expansion of our non-food, e-commerce and Tesco Personal Finance businesses are all examples of our Core Purpose in action - delivering products, which delight customers and increase their loyalty to us.



Our Goals

Our goals provide a key framework for us all.

Tesco is a successful growth company and our success has come from focusing on the goals:

- **Tesco will be a growth business**
- **Tesco will become the business people value more than any other**
- **Tesco will have the most loyal and committed staff**
- **Tesco will be a global retailer**
- **Tesco will be as strong in non-food as in food**

In any business, direction is crucial and in Tesco it is our goals that provide it. For example, by developing a personal strength in non-foods we can enable our goal of being as strong in non-food as in food. Later in this booklet we show how our goals are reflected in the Steering Wheel and in our various one year plans.



Our Values

Our Values are our code of conduct - they are the way we have chosen to work at Tesco and drive the whole way we do business. They are:

NO ONE TRIES HARDER FOR CUSTOMERS

- *Understand customers better than anyone*
- *Be energetic, be innovative and be first for customers*
- *Use our strengths to deliver unbeatable value to our customers*
- *Look after our people so they can look after our customers*

These customer values reflect that in Tesco everything starts with the customer and that our passion to provide customers with value and service overrides all else.

TREAT PEOPLE THE WAY WE LIKE TO BE TREATED

- *All retailers, there's one team ... The Tesco Team*
- *Trust and respect each other*
- *Strive to do our very best*
- *Give support to each other and praise more than criticise*
- *Ask more than tell and share knowledge so that it can be used*
- *Enjoy work, celebrate success and learn from experience*

We want our people to be well managed and to work in an environment that is based on trust and respect. We have learnt over the years that well motivated and managed staff will give customers great service: by living the people values we create a good place to work and one where great service is delivered.



Our Principles - Better, Simpler and Cheaper

Better, Simpler and Cheaper are our guiding principles and underpin the Tesco Way.

As we go about our work and, most importantly when we are making changes, we have an unwavering commitment to make Tesco Better, Simpler and Cheaper.

Our senior managers have been applying these principles for some time as they seek to improve the business. They were inspired by three business writers:

- **Better** (from Reichheld's "The Loyalty Effect")
- **Simpler** (from de Bono's "Simplicity")
- **Cheaper** (from Jones & Womack's "Lean Thinking")

The combination of these three principles provides a powerful tool which we must all understand and employ when making decisions.

The adoption of Better, Simpler, Cheaper principles leads us to change which is:

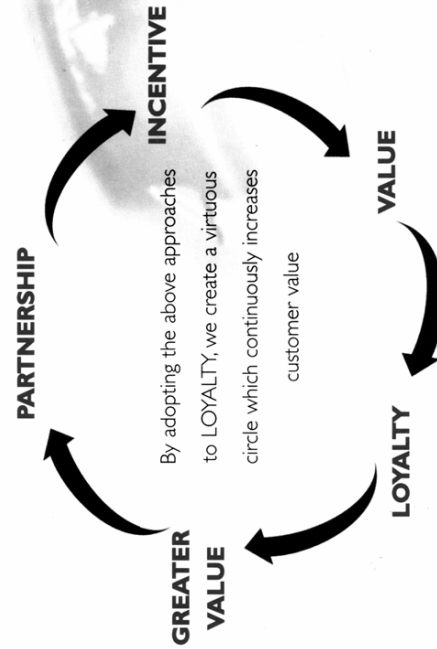
BETTER for CUSTOMERS
SIMPLER for STAFF
CHEAPER for TESCO

BETTER

Successful businesses grow by retaining their existing customers whilst attracting new ones; creating lifetime loyalty is part of Tesco's Core Purpose. In the Loyalty Effect, Reichheld explains that there are six core approaches to loyalty based management.

- **Grow the business** by attracting and retaining customers
- **Improve productivity** by recruiting the right people, developing them, ensuring loyalty and managing their careers
- **Measure value** by tracking the behaviour of customers, employees and investors - and measuring their impact
- **Create intellectual capital** by attracting and retaining the right people
- **Maximise shareholder value** by attracting and retaining the right investors
- **Build strategic advantage** by designing business systems on the principles of value, loyalty and partnership between customers, staff and shareholders

The virtuous circle of loyalty is illustrated below:



Continued investment in customers is enabled by investment in employees who deliver better service and higher productivity. This in turn can be reinvested in creating value for customers.

SIMPLER

In de Bono's book he says that as the world becomes increasingly more complex, so simplicity becomes a key value. Since the pace of change is not going to stop, we have to make a conscious effort to make things simpler:

Making things simple is in itself, complex - and requires creativity and real effort. It can be achieved by knowing where to pay attention and what to ignore.

A **SIMPLE** approach can increase productivity through:

- Reducing stress and anxiety
- Enabling us to work faster
- Increasing safety
- Reducing errors
- Different jobs being simpler to do

Identifying simpler approaches is challenging; it requires exploration and lateral thinking! At Tesco we always look for improvements which are simpler for staff. It's an art!

CHEAPER

LEAN THINKING is a way of working which increases value through the elimination of waste. It has guided our supply chain thinking for over six years. Womack and Jones define waste as:

- Errors
- Overproduction
- Waiting for people, equipment or materials
- Unnecessary transport of goods
- Unnecessary movement of people
- Excess stock
- Poor process design
- Dissatisfied customers

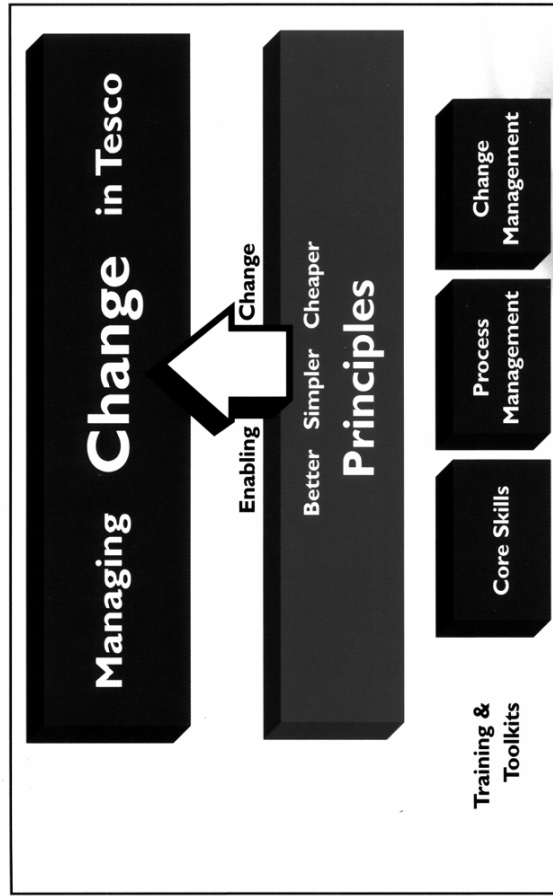
.... and suggest an approach to reducing waste:

- Specifying **value** by defining the value a customer places on any good or service
- Lining up all the value-creating activities for a product along a **value stream** which reduces the eight wastes
- Making value **flow** smoothly, through the **pull** of the customer; in pursuit of **perfection**

APPLYING THE PRINCIPLES

At Tesco we improve the business for customers by living the Values - **no one tries harder for customers and treat people the way we like to be treated.**

Recently we have developed a framework which should be used for managing the changes which are required to make the business better for customers.



THE SKILLS DEVELOPMENT PLAN

Our **Core Skills** modules provide basic ways of working that are **Better, Simpler and Cheaper**. These are being built on with training modules on:

- Change Management
- Process Management (Project Process and Programme Management)

These training solutions are part of our Leadership Academy

Our Plans

Like any successful business we have a long term plan. It is owned by the PLC Board and its purpose is:

to create value for customers to earn their lifetime loyalty

On an annual basis we produce a series of integrated business plans - one each for Customers, Operations, People and Finance. Each of these plans engages our people and focuses effort where it will deliver the best return.

The **Customer Plan** contains projects which deliver real improvements in the year for our customers - to build their loyalty.

The **Operations Plan** focuses on making Tesco simpler and more cost efficient so that we are able to reinvest savings in our customers and our people.

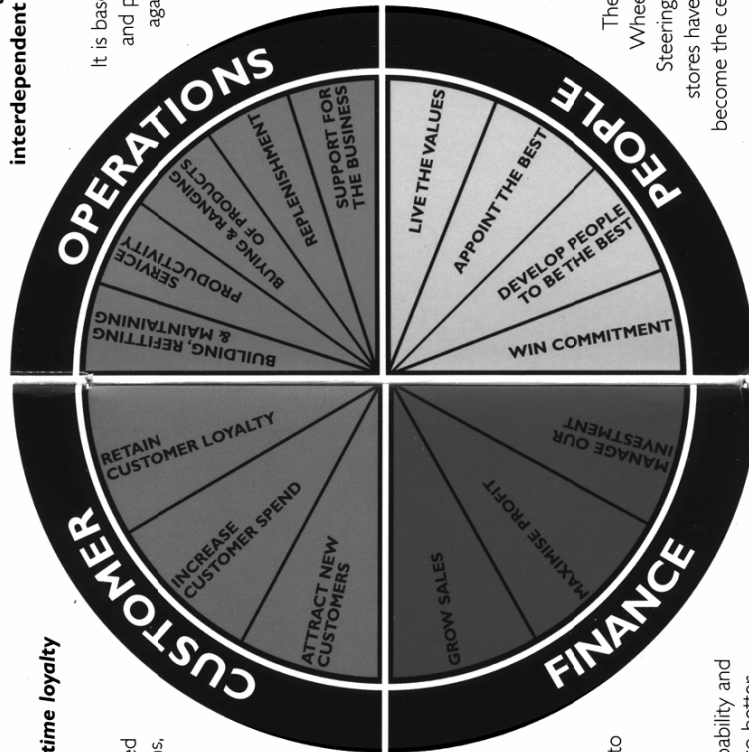
The **People Plan** focuses us on developing the capability and commitment of people so we are able to make Tesco better, simpler and cheaper

The **Finance Plan** ensures that the output from the Customer, Operations and People Plans delivers value for our shareholders.

The Steering Wheel

The Steering Wheel is the tool we use to help us to manage in a balanced way. It has an important role in communicating both our strategy and our performance. The four quadrants are interdependent - and we give equal emphasis to each of them.

It is based on Kaplan and Norton's "Balanced Scorecard" and provides a very visual indication of our progress against our plans.



The segments within each quadrant show those objectives we've set and how we perform against them.

The highest level Steering Wheel is the corporate Steering Wheel. Each of the major functions in Tesco has their own Steering Wheel which feeds off the corporate one. All UK stores have had an individual Steering Wheel since 1997 and it has become the centre of management, measurement and motivation.

In this way, the business strategy comes to life in every major operating unit. The PLC Board's vision is translated into visible objectives and measures which are tracked using the Plan-Do-Review cycle. In stores and distribution centres this cycle may be as frequently as weekly; in the Boardroom it is quarterly.