Tesco's crisis
A hard rain

Even if the British grocer's accounting scandal is soon forgotten, its failure to protect itself from hard discounters like Lidl and Aldi will still hang over it

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OF ALL the dark days that Tesco has seen recently, September 22nd was the blackest. That was when Britain's biggest grocer—and the world's third-largest retailer—confessed that it had overstated its already dismal profits for the first half of its fiscal year. They were £850m ($1.4 billion), not £1.1 billion, as Tesco had said in August. Its share price has slumped by about 15% since the disclosure. Credit-rating agencies have put its debt on watch for a possible downgrade.

Tesco's accounting fiasco (see article) follows a series of profit warnings and the ousting in July of its boss, Philip Clarke. His successor, Dave Lewis, has promised "a comprehensive independent investigation" and suspended four executives, including the chief of the company's British business, its biggest unit.

Serious questions are being asked about how such a huge, established company could get into such a mess. Do its directors know too little about selling groceries? None of the ten board members has direct experience of managing a retailer. Is Mr Clarke somehow to blame? He was said to be a micro-manager, and several executives have left, including the chief finance officer in April. Did Tesco have a corner-cutting culture? Analysts have worried before that its accounting policies were more adventurous than those of its peers.

Whatever investigators now find in Tesco's books, it is clear that its problems go deeper. They started under Mr Clarke's much-praised predecessor, Sir Terry Leahy, who widened Tesco's lead over its rivals but built too many big stores and led ill-judged forays into foreign markets like America. Its profitability, as measured by return on capital employed, fell by one-third between 1998 and 2010. When Mr Clarke arrived, he splashed out on store upgrades but let Tesco's prices creep up, driving away customers.

That was a killer mistake, given the threat that Tesco and other conventional supermarkets, from America to Australia, face from "hard discounters", which sell food far more cheaply without compromising on quality. The most fearsome are a family-owned, publicity-shy trio from Germany: Lidl and two firms called Aldi, which separated to form northern and southern branches in 1960.

In Europe the sales of discount grocers (including those of a softer sort, like Penny Markt of Germany and Dia of Spain) will grow at a rate of 4.8% a year until 2017, predicts Kantar Retail, a market-research firm. Those of conventional supermarkets will rise at a rate of just 3.1%. The difference sounds small, but soon adds up: by 2017 discounters will have almost one-fifth of the European market.

The hard discounters grow fastest where their sort of retailing is least developed. In Britain the sales of Aldi and Lidl jumped 29.1% and 17.7% respectively between the 12 weeks to September 15th 2013 and the same period this year. Tesco's British sales meanwhile dropped 4.5%. Whatever the motives behind its miscounting of revenues, it had the effect of disguising how much Tesco was having to sacrifice profits to limit the decline in sales.

Hard discounters differ from standard supermarkets in several important ways. They typically stock fewer than 2,000 products rather than the 40,000 or so in a big, conventional supermarket. Most are own-label rather than the manufacturers' heavily advertised brands. They arrive at the shops in "shelf-ready" packaging, which avoids laborious stacking. Discounters shun the special offers that supermarkets and their suppliers use to boost sales (and that were the reason for the rebates that Tesco miscounted). Instead, they sell at consistently low prices, which in Britain are about a fifth lower than those of their mainstream competitors.

Simplicity begets efficiency. When you sell just one or two types of mustard rather than 30, notes Matthias Queck of Planet Retail, a consulting firm, you get high volumes for each one, easier handling at warehouses and less risk of stock running out or hitting its sell-by date. Promotional offers mire supermarkets in wrangles with suppliers; discounters' consistent prices make for easier negotiations, which focus on quality and cost. Discounters plaster their items with bar codes, shaving fractions of a second off the time to scan them; and the low prices make shoppers less fussy about customer service. So discounters need fewer staff.

Lidl has swept across western and central Europe. Aldi North is in France, Spain and the Benelux countries; the southern branch is in Britain, Ireland and Austria. In Australia Aldi South broke up a cosy oligopoly, starting in the early 2000s, and has claimed about 10% of the market.

In America they have "barely scratched the surface," says Bryan Roberts of Kantar Retail. Yet Aldi South, which operates under its own name, has already caused "huge local disruption to pricing"; Aldi North's American venture is Trader Joe's, a slightly upmarket version of the German original. Their expansion will add to the woes of Walmart, which is already fighting competition from "dollar stores". Lidl also has its eyes on America, though it recently postponed its entry from 2015 to 2018.

As they chase conventional supermarkets the discounters themselves are changing. Just as Ryanair and easyJet are cautiously adding some of the features of the full-service airlines (such as flexible tickets for business travellers), so as to continue demolishing them, the hard-discount grocers are compromising a little on their principles, all the better to keep grabbing customers from Tesco and its peers. The range of items in a typical Aldi has widened from 1,000 or so five years ago to 1,300-1,400. Diet Coke now appears alongside Aldi's own Vive diet cola. Fresh and chilled food, which had been a sideline for the hard discounters, now accounts for a large share of their sales. Lidl is shifting faster. Its German stores stock 500 more items than Aldi's, says Mr Queck, and it has begun to offer supermarket-like special offers.

The strategy is working. The recession encouraged shoppers to give the discounters a try. They kept coming back in part because they could find cosmetics and croissants as well as cola and cornflakes. The range has grown enough that discounters can now serve as one-stop shops for some people.

The discounters could go too far: as they add frills like wine, which has to be stacked by hand, and start spending on television ads, they "risk falling into the trap of complexity" that has ensnared the mainstream supermarkets, says Mr Roberts.

But right now, the march of the hard discounters looks set to continue. Even in places like America and Britain where economies are growing, real wages are stagnant or falling. Tesco and its peers were horribly late in recognising the lasting effect that squeezed incomes have had on shoppers' budgets.

Belatedly they are slashing prices to buy back a bit of market share—Carrefour, France's biggest hypermarket operator, has had some success with this. But it will knock a hole in their profit margins, and does nothing to solve another problem: they are burdened with huge, edge-of-town outlets that look out of place in the online-shopping age. The discounters' smaller, more central stores are better suited to changing consumption patterns.

Shareholders of the mainstream grocers should be angry at how they have let these cut-price rivals steal customers from under their noses. Tesco's especially: after all, the discounters are only following the advice of its founder, Jack Cohen: pile it high and sell it cheap. Tesco lost sight of that simple message a long time ago.

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