Chartered Institute of
Management Accountants

CIMA

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Pre-seen materials

Merchants

Contents

Introduction

Merchants is the largest grocery and general merchandise retailer in Pictland with sales reaching $38 billion in the 2013/14 financial year and a market share of 24%.The grocery retailing sector in Pictland, a country in Western Europe, was worth almost $150 billion in sales value in 2014. The market is dominated by four major players who account for almost 60% of the market share by sales value. The market is epitomised by overcapacity and stagnating demand resulting in fierce competition, price cutting and reducing margins.

Hypermarkets, which are the largest stores in terms of square footage, represent the largest channel in grocery retailing with 44% of total sales value, followed by supermarkets with 22% of sales value. The ratio of grocery to non-grocery sales for hypermarkets is 30%/70% whereas for supermarkets 87% of the total sales value is in groceries. Grocery retailers are generally reducing the amount of shelf space given to non-grocery items since these represent a low profit alternative to groceries due to the retailers' lack of buying power in non-grocery items.

The global financial crisis and the subsequent recession has resulted in a change in buying behaviour of consumers, a significant proportion of whom have switched to discount supermarkets whilst others have moved upmarket to the higher quality supermarket. The main impact of the consumer switch was felt by the supermarkets operating in the mid-value sector of the market. A major concern for the supermarkets is that customers who have switched may not be inclined to switch back despite the improvements in economic growth.

Major market trends

Consumer demand for better value products has had a number of effects on the market. The resultant price war between competitors has driven one of the major players to change its business model to try to compete at the discount end of the market. The discount supermarkets have reaped the benefit of the consumer switch with growth in sales value of 20% in the last year and the announcement of major expansion plans in the number of outlets. The other major players have responded with price cuts and price match campaigns. There has been a move towards the middle market by all players as the leading retailers expand private label product lines and the discount supermarkets offer their own 'premium' brand.

A reduction in household disposable income, as a result of stagnating wages and increased prices, has driven consumers to try to save money and has resulted in a change in the way they shop. In an effort to reduce food waste, the traditional weekly grocery shop is less likely and the consumer is more likely to do a smaller weekly shop and top-up as required throughout the week. This trend combined with an attempt to cut fuel costs has made out-of-town retail locations less popular and led to an increase in the number of convenience store outlets which are located in the high streets of towns. The growth in convenience store outlets has been driven by the leading retailers, some of whom have already opened a number of new outlets and are planning to open more in the future. The focus has switched from growth in square footage to growth in number of outlets.

Online retailing has shown strong growth over the past few years and attracted new players into this growing market. Two of the leading players have established a strong presence in this market and benefited from double figure growth last year. The operating model differs however, with some establishing separate outlets or ‘hubs’ that are not open to the public, to fulfil online orders and others filling orders from the existing retail sales outlets. The growth trend in online retailing is expected to continue and further fuel the demand for convenience stores as consumers use online retailing for the bulk of their shopping and purchase fresh foods on a daily basis from local convenience stores. Customers’ expectations are increasing with demands for free delivery, no substitutions and long sell-by dates. This presents a challenge for the retailers in a channel which is already significantly less profitable than retail store sales.

High delivery costs and inconvenient delivery times have led to a demand for grocery ‘click and collect’. This allows customers to order their shopping online and collect it themselves from a location at a time that is convenient for them. All the major players now offer a ‘click and collect’ service with different outlets ranging from their own retail stores to train stations. Compared to non-food retail, ‘click and collect’ in groceries is more complex due to product perishability but retailers are embracing this as part of their strategy to offer customers the convenience that they demand.

The higher profitability of retail store sales compared to online retailing has resulted in retailers attempting to draw consumers back into stores. They have attempted this by improving the appearance of stores, the range of products and the services being offered within the stores. Retailers are investing in store refurbishments and forming partnerships with companies to provide additional services within the existing stores.

Competitive Analysis

The grocery retailing market is extremely concentrated with four major players accounting for around 60% of the total sales value. This proportion has risen steadily over a number of years but has remained static in more recent years.

The competitive environment is fierce as each retailer tries to protect its market share. The realisation that consumers can easily compare prices has resulted in an environment dominated by short-term promotional campaigns and lowest price / price matching promises.

Merchants is the leading player with a 24% market share but its growth has slowed dramatically. Despite this it still maintains a significant 12% lead over its nearest rival. Strong growth was also reported by the main discount supermarkets as consumers looked for a cheaper food option. It is anticipated that the discount supermarkets are also poised to enter convenience stores.

Future Outlook

Growth in convenience stores is expected to continue in both the short and longer term. Consumers are expected to continue avoiding large weekly shopping in an attempt to reduce food waste and fuel costs. The dissatisfaction with the standard of fresh food provided by online retailers is also expected to fuel this trend.

It is thought that discount supermarkets will record the highest growth rates in the next few years whilst hypermarkets are expected to remain the largest channel. Online retailing will pose the major threat to both hypermarket and supermarket growth. Growth rates in this channel are forecast to be in double figures as the channel’s leading operators continue to implement a multi-channel retailing strategy.

The rise in both convenience stores and discount supermarkets has been fuelled by the lowering of disposable income as a result of the economic recession and the resultant change in shopper buying habits. It remains to be seen whether this will continue as the economy recovers and food prices fall as a consequence of the fall in fuel prices.

As convenience stores and online shopping continue to grow, retailers need to decide what to do with their large out of town stores. These may be converted into ‘click and collect’ locations or online retailing hubs. This could potentially develop into a ‘drive through’ shopping concept.

The change in consumer buying behaviour has resulted in the need for additional investment but this is proving difficult against a background of stagnating demand and reducing margins.

Company Background

Merchants is the largest grocery and general merchandise retailer in Pictland with sales reaching $38 billion in the 2013/14 financial year and a market share of 24%. The retailing of packaged food is Merchants' core business, although the company has increasingly diversified over the years to become a general merchandiser.

The company operates its outlets under four brands with the size of the outlet determining the brand that is used. The 'Merchants Quick' brand convenience stores have an average store size of 260 square metres. The 'Merchants Town' brand comprises small supermarkets, all of which are located on high street sites. 'Merchants Town' supermarkets are generally around 1,000 square metres in size. The larger supermarkets are operated under the 'Merchants Super' brand, which are usually 2,600 square metres in size and 'Merchants Total' brand hypermarkets generally have floor space in the region of 6,700 square metres.

The company has struggled over the past few years to achieve growth, mainly due to strong competition from discount supermarkets and other similar grocery retailers. Pictland consumers are no longer keen on the large hypermarkets which were once regarded as the future of grocery retailing in Pictland and which have been continually developed by Merchants over a period of several years as a key part of the company's expansion strategy.

At the end of 2014, Merchants was operating 3,356 outlets in Pictland, 131 more than at the end of 2013, with its retail selling space expanding by less than 1% over the course of the year. Although the number of Merchants outlets in the country increased by 4%, this represented the lowest growth in this measure in recent years, as the company's focus changed towards the refurbishing of existing outlets and the expansion of convenience stores, which accounted for more than half of the new Merchants outlets opened in Pictland during 2014.

Merchants sell a comprehensive range of its own private label (often referred to as 'own brand') products. There are different ranges under Merchants' private label to appeal to different market segments. The company's major range is the 'Merchants Own', which includes a wide variety of mid-priced products. The retailer also sells the much cheaper and more basic 'Merchants Value' range, while higher quality products are sold under the 'Merchants Deluxe' range. As demand for products which cater to those with specific dietary needs has increased steadily in Pictland, Merchants has introduced the 'Merchants Healthy Eating' range, which includes products which are free from gluten, wheat and/or dairy.

Current Strategy

The company is currently focused on building a multi-channel retailing strategy. At the same time, the company is emphasising its online grocery retailing and changing from further expansion of large-format retail outlets to focus more on convenience stores.

Merchants plans to continue pursuing its “Make Merchants Better” strategy. This involves refurbishing its store-based retail outlets with the aim of improving the customer shopping experience. During the 2013/2014 financial year, more than 100 'Merchants Quick' outlets and some 70 'Merchants Super' stores had their interiors refurbished.

Merchants' strategy also involves improving its product range by launching new products and redesigning its existing ranges, focusing in particular on its fresh food ranges, ensuring the best prices for customers. During 2014, Merchants launched a major marketing campaign, designed to strengthen the retailer's position in the retailing of fresh food and highlight the quality of its produce as well as unit price.

Another focus of the strategy is on improving their environmental performance. The company's track record in this area has been unimpressive. Each of the stores has recycling facilities for customers and as a result of government pressure, Merchants now charge for plastic carrier bags but otherwise very little has been done in this area.

Following the decline in sales of non-grocery product lines the company has decided to scale down the range of consumer electronics it offers as these items tend to occupy a lot of shelf space whilst making a modest contribution to its overall sales. The company aims to expand its sales of general merchandise such as homeware and clothing, items which occupy less shelf space and can generate higher profits.

The company recently appointed a new director to help develop and foster relationships between farmers and producers across the globe, which should help the company to build a more transparent supply chain.

Overall, the low unit prices of the products sold in Merchants stores remains a key element in the appeal of Merchants. The recent launch of the Merchants Price Guarantee, a system which compares Merchants' prices with other leading supermarkets and automatically produces a money off coupon, has proved highly popular and has already resulted in a marked improvement in the number of customers who consider Merchants' ability to match or beat competitors' prices as very good or excellent. The Price Guarantee compares the prices of branded products but also private label products.

As part of its campaign to achieve improvements in its operations, during 2014, Merchants launched its Loyalty card website, which has been designed to emphasise the rewards on offer to Loyalty card users and allows customers to rate and review these rewards. Merchants' profitability improvement programme led to 40 'Merchants Quick' outlets being launched during the first three months of 2015, with strong increases in sales reported.

Online retailing

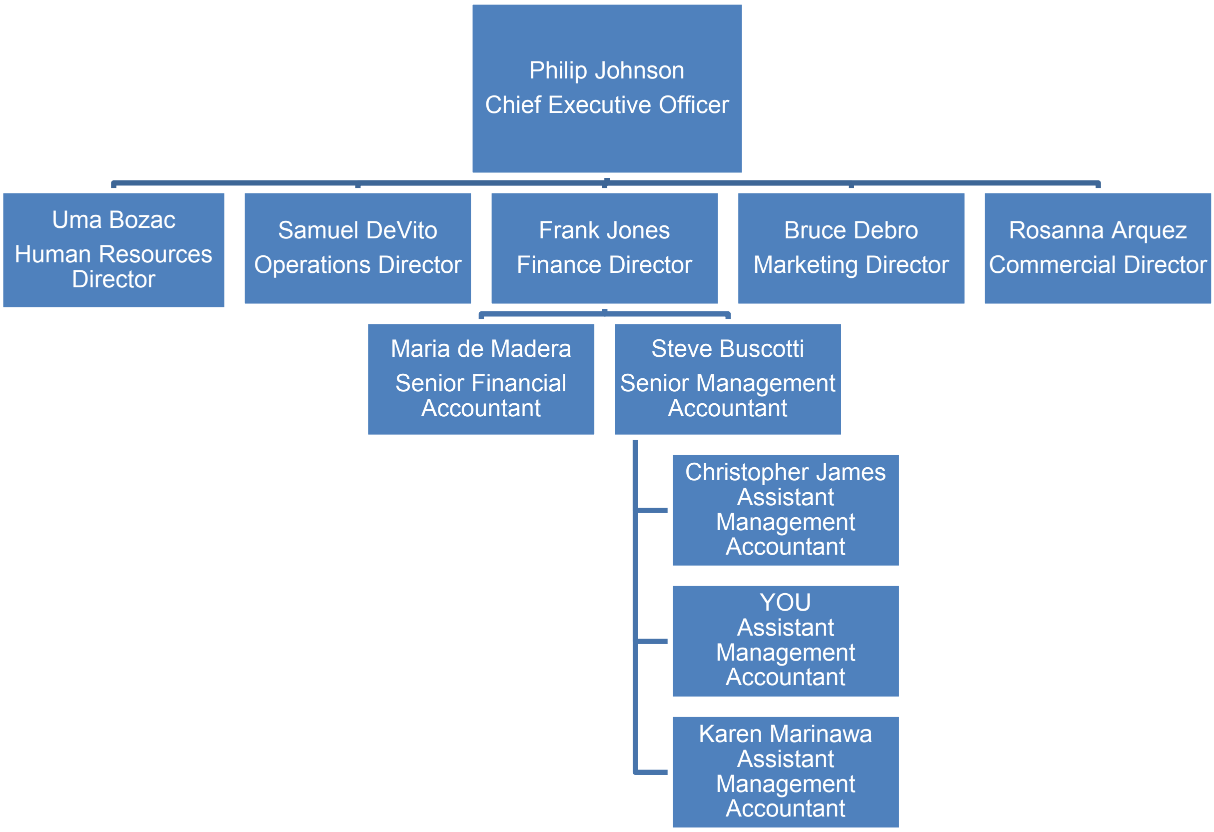
Merchants is one of the largest internet retailers currently operating in Pictland, with growth of 13% reported in its online sales over the 2013/14 financial year. The company is in a very strong competitive position as it was one of the first grocery retailers to establish an online business. Merchants fulfils online orders by operating many 'hubs' throughout Pictland. The hubs are warehouses which are not open to the general public but are used to fulfil online shopping orders. Merchants intend to maintain a strong focus on its online sales for the foreseeable future by strengthening its product range and improving the availability of products.

Growth in Merchants' online sales has been driven in part by the success of the Merchants 'Click & Collect' service, which allows Merchants' customers to select the items they want to purchase online and then pick them up from any of Merchants' click and collect locations. The company recently rolled out new drive-through locations for its Click & Collect service, with a total of 56 of these now in place across Pictland.

Customer Focus

The company has recently introduced new trolleys fitted with scanners to allow customers to “Scan and Bag”. This allows products to be scanned at the time at which they are removed from shelves and packed immediately into bags, enabling customers to simply pay at the end of their shopping trip, without the need to queue to have their shopping items scanned. Merchants are also testing new outlet designs in some outlets. In the company’s refurbished retail outlets, fresh food is being promoted with attractive pictures of food being displayed and the origins and health aspects of the products being highlighted. Brighter colour schemes have been introduced with the aim of generating a more relaxed, welcoming environment within the store.

Extract from Merchants organisational chart



Merchants
Statement of profit or loss
Year ended 30 September

	2014 $m	2013 $m
Revenue	**38,134**	**38,044**
Cost of sales	**(35,728)**	**(35,552)**
Gross profit	**2,406**	**2,492**
Administrative expenses	**(994)**	**(889)**
Profits/losses arising on property-related items	**167**	**(174)**
Operating profit	**1,579**	**1,429**
Finance income	**115**	**115**
Finance costs	**(338)**	**(310)**
Profit before tax	**1,356**	**1,234**
Taxation	**(209)**	**(317)**
Profit for the year	**1,147**	**917**

Merchants
Statement of Financial Position as at 30 September

	2014 $m	2013 $m
Non-current assets		
Goodwill and other intangible assets	2,277	2,617
Property, plant and equipment	14,694	14,921
Other investments	655	655
	17,626	18,193
Current assets		
Inventories	2,146	2,246
Trade and other receivables	1,314	1,515
Short-term investments	610	354
Cash and cash equivalents	1,741	1,507
	5,811	5,622
Current liabilities		
Trade and other payables	(6,357)	(6,656)
Borrowings	(546)	(459)
Current tax liabilities	(296)	(311)
	(7,199)	(7,426)
Net current liabilities	(1,388)	(1,804)
Non-current liabilities		
Borrowings	(5,455)	(6,041)
Net assets	10,783	10,348
Equity		
Share capital	242	242
Share premium	3,012	3,012
All other reserves	411	411
Retained earnings	7,118	6,683
Total equity	10,783	10,348

Merchants
Cash flow statement
Year ended 30 September 2014

	2014 $m	2013 $m
Cash flows from operating activities		
Profit before tax	1,356	1,234
Depreciation and amortisation	940	931
Net finance costs	223	195
Impairment in goodwill	340	45
Profit / Loss on disposal of non-current assets	(167)	174
(Increase)/decrease in inventory	100	125
(Increase)/decrease in trade and other receivables	201	(104)
Increase/(decrease) in trade and other payables	(299)	265
Cash generated from operations	2,694	2,865
Interest paid	(338)	(310)
Corporation tax paid	(224)	(347)
Net cash generated from operating activities	2,132	2,208
Cash flows from investing activities		
Proceeds from sale of property, plant and equipment	333	109
Purchase of property, plant and equipment	(879)	(1,094)
Net investments in short-term investments	(256)	232
Dividends received	37	31
Interest received	78	84
Net cash used in investing activities	(687)	(638)
Cash flows from financing activities		
Increase in borrowings	87	492
Repayment of borrowings	(586)	(835)
Dividends paid	(712)	(710)
Net cash from/(used in) financing activities	(1,211)	(1,053)
Net increase in cash and cash equivalents	234	517
Cash and cash equivalents at beginning of the year	1,507	990
Cash and cash equivalents at the end of the year	1,741	1,507

Tax Regime in Pictland

Corporate Profits:

- The corporate tax rate applicable to taxable profits is 20%.
- Unless otherwise stated below, accounting rules on recognition and measurement are followed for tax purposes.
- The following expenses are not allowable for tax purposes:
    - accounting depreciation;
    - amortisation;
    - entertaining expenditure;
    - donations to political parties; and
    - taxes paid to other public bodies.
- Tax depreciation allowances are available on items of plant and machinery (including vehicles used for business purposes) at a rate of 25% per year on a reducing balance basis.
- Tax losses can be carried forward to offset against future taxable profits from the same business.

Extract from Management Accounts

Profit by product group

	Food and beverage	Clothing	Homeware	Electrical	2014 Total
	$m	$m	$m	$m	$m
Revenue	25,787	5,560	6,185	602	38,134
Cost of sales	(24,163)	(5,287)	(5,653)	(625)	(35,728)
Gross profit	1,624	273	532	(23)	2,406
Administration Expenses	(672)	(145)	(161)	(16)	(994)
Operating profit	952	128	371	(39)	1,412

Retail Statistics

	2010	2011	2012	2013	2014
Number of stores	2,678	2,929	3,048	3,225	3,356
Total sales area ‘000 square metres	3,672	3,908	4,050	4,182	4,223
Average FTE employees	201,325	204,582	212,678	216,875	213,432
Revenue per employee ($)	171,369	179,409	182,082	175,419	178,670
Weekly sales per square metre ($)	180.7	180.6	183.9	174.9	173.7

Retail Today

Supermarkets and their suppliers – a marriage made in heaven?

In the multi-billion dollar supermarket industry, the relationship between the retailers and the companies who supply the products they sell is far from straightforward.

Competition between suppliers for prime positions in stores is fierce and suppliers are willing to pay hundreds of thousands of dollars, knowing that the best spot can generate sufficient sales to make these payments worthwhile. Shelf space is not the only thing that suppliers are being asked to pay for, there are numerous fees and charges which are widespread throughout the industry. Such 'commercial income' has become a lucrative source of additional profits for the supermarkets.

But in a highly competitive market with little growth, are supermarkets using their buying power to exploit their suppliers?

The supermarkets deny mistreating suppliers, saying that they work closely with suppliers for the benefit of both parties. In fact, many suppliers have seen spectacular growth as a result of their supermarket contracts.

However, for many customers, the recent disclosures that suppliers pay retailers to hold promotions and place their products on prominent shelves is concerning. Consumer groups and groups representing small businesses are calling for dramatic improvements in the regulation of the relationship between retailers and suppliers.

This short-term approach to supply chain management may have severe long-term consequences if it discourages small businesses from investing and innovating. The industry needs to realise that the key to growth is in developing the supply chain and nurturing new businesses.

Waste Management Weekly

Editorial: FOOD WASTE – Can we control it?

Some companies have made very good progress in recycling waste and reducing waste to landfill whilst also reducing waste within their operations. There is however, still a significant opportunity to reduce waste within businesses and across supply chains.

So what are the benefits of taking action to reduce waste?

Wasted food and its packaging and the storage of products have a number of direct and indirect impacts on the environment including loss of resources, creation of pollution from carbon and greenhouse gas emissions, and consumption of water. Impacts arise from:

- loss of the materials and resources embodied within the wasted product such as energy, water, fertilisers and transport fuel;
- waste of resources involved in storing products and displaying them, for example energy used to refrigerate goods; and
- traditional waste disposal routes such as landfill.

The most basic commercial reason is that better control of waste will allow companies to cut their costs. The overall value of food and packaging waste from the food and drink supply chain is estimated at $10 billion a year which translates to between $1,450 and $2,400 per tonne of waste. So it's easy to see that the potential savings of waste reduction actions are substantial.

A recent study has found that the average waste reduction potential for a retailer is $1.5 million from just the top few no/low cost waste reduction opportunities.

To remain competitive, businesses need to assess the environmental risks associated with their supply chains and work with their suppliers to ensure they have a sustainable future.

In a leading retailer's recent shopper survey, 71% of respondents 'stopped buying a product because they had previously wasted it'. Consumers want manufacturers and retailers to help them reduce waste in their homes and expect them to do their bit to reduce waste in the supply chain – and the industry needs to respond to this.