Company Participants

- Bill Bishop, Co-Founder / Chief Architect
- Jennifer Bartashus, Analyst
- Tim Barrett, Senior Retailing Analyst

Presentation

Jennifer Bartashus {BIO 1827328 <GO>}

Good morning and thank you for joining our Bloomberg Intelligence Webinar on Assessing the Hard Discount Threats. I'm Jennifer Bartashus, the Retail Staples analyst for Bloomberg Intelligence and will be moderating today's discussion.

We have a terrific pair of experts, joining us today. Bill Bishop is the Co-Founder and Chief Architect of Brick Meets Click, that was widely recognized for his expertise including grocery industry studies and direct store delivery, customer loyalty, retail pricing and new store formats. He's founder Willard Bishop Consulting and holds a PhD from Cornell University. Tim Barrett is the Senior Retailing Analyst at Euromonitor. Tim is highly focused on how the industry is evolving, including e-commerce, marketplaces and the changing grocery landscape. He is based out of Chicago, Illinois, and holds a Bachelor's Degree in Economics and Philosophy from Northwestern University.

We'll be starting with some introductory slides and comments from both Bill and Tim and then we'll be moving into a conversation about some of the biggest questions around the Hard Discount Threat. But first, just a few quick housekeeping notes. Today's presentation will be recorded and available for playback. At the bottom slide -- of the slide window, you will notice that you can adjust the volume and maximize your screen. Please feel free to ask a question by submitting one to the right of the slide. We will address questions as part of the discussion portion of our program. A copy of the slides will be available for download in the post event email.

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With that, I'd like to turn the floor over to Bill Bishop. Bill?

Bill Bishop {BIO 19198031 <GO>}

Jen, thanks very much and it's a pleasure to be here today with you folks. In the introductory part of our webinar, I'm going to be addressing this question of how the hard discounters make money and a lot of that will focus on the tangibles, but I want to focus on the human components as well. Employee engagement is critically important in the success of these types of businesses and then they do well. And they focus on hiring quality people. One little known fact is that out the first 50 store managers that already hired here in the United States, most of them were graduates of Cornell University, and they were compensated at 20% over the average starting salary.

So from the beginning, that this human side of it has been important. It's not that easy to understand how they make money because quite frankly, it's not the standard business model, just put this catchphrase in here from the door to the floor and back at the store and more pausing for just a second on the floor, it turns out that almost all these stores, for example, have stone tiles, the guaranteed strength, low maintenance and a smooth ride is a product from the back of the truck to the shelf.

And what was interesting was, a number of years ago, all the deferred on the purchase of Franklin stores, a heavy discounter in Australia because this Franklin stores would not support the floors that already needed to put in. So the detail is important in these kinds of operations. Well here it is on one page, here is how they do it, here is how they make money. And just looking at our graphic, it starts with knowing how to shock people with price, because they're shocking people with price and they certainly do that well is what generates the traffic. That along with that traffic, they've got the support of stronger product profits and lower costs and together, those are the things that combine to give them the ability to make, not simply money but actually a very adequate return on their money.

So let's delve into each of those aspects directly. First, looking at the impact of lower cost of goods on strong product profit. What's happening here is that the retailer is actually exerting a fair amount of influence on how the product is produced. And as a consequence, what the product costs, that's enormous and it's very different from the way, our current retail model works in grocery, where the call it channel captain is the manufacturer, is a brand manufacturer who typically specifies these things. This is enabled basically because of the emphasis on own label.

Second aspect of the strong product profits has to do with the extensive product mix involved. The product mix starts with multi-brands, which allow the hard discounters to price to value, getting some additional pennies of profit in there and that's really highlighted in the premium brand segment of their offer, which has in high -- sort of intrinsically high penny profitability.

Probably the most important driver, however of strong product profits is the way they handle the extensive offer of general merchandise. They devote a lot of space to general merchandise, the general merchandise typically carries a higher price point, up to $30 is not unusual or those are a lot of 10, 12 and 15s in there, but the real trick is in any high efficiency retailers, they turn these inventories fast, very fast and so, it turns out to be a significant contributor of gross profit dollars.

Just a final touch on strong product profits. There are two other things that the hard discounters do that set them apart. Number one, they've successfully broken the connection between low price and low quality. When you go in there, you expect low price and high quality. And secondly, they very cleverly use small packages to increase the affordability of premium products. These products still carry a high penny margin and our premium products. So, what they've effectively done is take some of these premium products that would not be affordable in their standard size and that it reduced them in a limited size. So, those are the strong product profit contributors. Now let's take a look at the low cost operations first variable costs.

And the variable costs are basically reduced by three factors. Number one, the relatively high labor productivity and the entire store is designed to generate high labor productivity from the display ready cases to the gravity feed in a lot of the coolers and freezers. And something that isn't noticed very ready, but the next time you go into our new stores, take a look and that is -- that there are multiple SKUs or multiple different items in the same shipping case, which actually is a tremendous productivity for the warehousing and distribution function.

Minimal supply expenses are another characteristic of low variable cost, you have to bring your own bags and that supplies can be 1% of the sales or more in a typical supermarket and they use various devices to control the costs relative to cards those losing them with a quarter deposit in the case of all the -- and controlling them on the parking lot, which is sort of an energy or a insurance savings. And then lastly, these stores are highly energy efficient, the newer ones are all populated with LED displays and all of the refrigerated zones are either covered or handled with doors.

In terms of the low cost for fixed costs, these are leveraged by a couple of areas and it's really facility costs being leveraged by a high sales per square foot. And that leverage is enabled because of the limited nature of the assortment, 2,000 to 3,000 and so maybe 3,200 items, compared to 10 times that in a supermarket. And then inventory, that basic investment in the inventory, does limit choice in the category, but it also concentrates the volume in a particular category and a smaller number of SKUs. So if you're in a typical supermarket, you may, for example, a peanut butter have 30 items to choose from, there you are going to have four or five, but the same volume that would go to 30 now, it goes to four or five and as a consequence, the inventory turns much more quickly.

Looking to the future, there seems to be little question that hard discounter economics and business models have evolved and we can expect them to continue to evolve. The main focus here is driving sales without losing efficiency, that's a delicate balance, it's not that easy to do. As a shopper in these stories, I've seen increases in idle stock, not a lot but some. Certainly that wouldn't have happened a decade ago. As well as an occasional pricing error, again not a lot, but it can happen. So I think what's really going to happen here is that the rest of the grocery business will be influenced by this new business model and it will continue evolve, so stay tuned.

And that's it from me on how these stores make money.

Jennifer Bartashus {BIO 1827328 <GO>}

Great. Well, thank you so much. We're going to turn things over now to Tim Barrett and he's going to talk us through some of his perspectives from Euromonitor.

Tim Barrett {BIO 20763677 <GO>}

Thanks, Jen for having me. Thanks, Bill for the wonderful informative intro into how discounters actually make money and essentially how they work. And thank you all for joining us today. Today what I'll be doing, at least from my brief intro before we get into the round table component, is that, add a little bit of context to the discussion. Now that we know how discounters work, we're going to take a look at where they are growing? Why have they grown in the first place? Who is primarily responsible for this growth and a little bit about what you can do about it. If you are a retailer, we are going to compete against them or you maybe partner or work with the same retailers.

And before we get right into that, I'm just going to kind of tell you a little bit about my company and where the data is coming from. In order to set this context, I'm going to be looking at a lot of data and it comes from us, Euromonitor International. Our biggest strength is easily our global coverage, in any countries with analysts on the ground and each of them gathering the data, through their own networks in addition and to kind of our top down regional hubs also doing a bunch of analysis and work across countries.

So let's get into it. The first question I want to kind of address is, where is this happening and the idea here is to look at discounter sales and the lot of the countries where they're growing the quickest. The countries are selected, which we'll be looking out throughout the presentation are largely developed. There are some discounter countries, that are pretty large and the developing countries like Poland. Those countries are a little bit unique and don't deal with some -- they deal with some kind of unique competitors unlike all the (inaudible). So we are kind of limiting it to developed nations here.

And also for your reference, when you see the data played out in this presentation, I will be using US dollars typically always held for 2016. So, inflation is taken out in the picture with exchange rates also fixed for 2016, because as you all know that dollar has been getting pretty crazy. So if we take a look at discounter sales by country, we will see that the US is not only kind of reached into the top here, but it's going to grow really quickly. What this does leave out is one country which we'll be covering later on which is Germany, the home of the discounters. I had actually take them out of this chart, because they skew all the rest of the bottom ones to a place where you can't read them. Germany, for those who are curious has about 73 billion to 80 billion in sales throughout this very same time period.

But sales alone aren't a good indicator of the true potential of the market. We need to look at the share of total grocery sales from all discounters and when I say total grocery, I mean independent to mom and pops in addition to major chain of supermarkets, hypermarkets et cetera. And we'll see kind of in a historic contrast, in USA which had quite a bit of sales, including a large kind of spike moving into the forecast period. We see that actually fairly low penetration right here. The presence of Walmart and a bunch of other retailers in highly competitive and a lack of really aggressive expansion before this year has caused them to really not have a ton of share here. Compared to other places, you'll see the -- easily the largest rising one is the UK and the dark blue, but most notable is also Denmark and Germany, where discounters have been active for 40 years or so. They also indicate kind of -- and maybe a relative feeling, what might possibly the discounters, where -- in all these countries, what could their share possibly be? If we take a look at where they have been operating the longest and where they have been successful, we see definitely a feeling on where that share could get to. And it's pretty substantial.

I'm sorry. So not only we know where they're happening, we want to know a little bit why it's been happening that we've got three main reasons. The first is that recessionary spending habits are still in place. Here we're taking a look at growth median [ph] household income, both in the last five years and five years before that. The orange bar represents kind of when the recession happened and we see a lot of flat, sometimes negative growth with the exception of Australia. And then we take from fast forward into the next five years and we see that while there is some growth on an annual basis, it's super low and in some cases, even -- then Australia is at least lower than it was during the global recession.

So not only there are psychological holdovers for not having any income growth, but there are real economic impacts on that, that have not really moved the needle very much, and because of that, people are looking for price and who can be good at providing on price, but somebody that isn't, that is efficient and Bill talked a lot about this, so I won't stay too long on this side, but will just notice that taking unit prices of discounters and the countries that we're covering right now and we'll see that the first two orange and dark blue bars represent sales per growth, sales per square meter and sales per outlet, both pretty healthy and then that light blue is square meters per outlet. So your stores -- stores space and your store sizes and we'll see those are just typically much lower oftentimes in your flat growth in the past five years. So discounters can grow sales without having to grow their stores which is not always the easiest thing to do, especially in the US.

And then finally, we have the fact that prices isn't the only thing that matters, quality still matters and so I think the best comparison here is to compare discounters versus the dollar stores or fixed price stores to be more general. Here on the right, we see this is a comparison of all the countries we've been taking a look at. Discounter growth versus fixed price store growth and while there is some fluctuation between the two, we'll see that largely discounters are doing a lot better than dollar stores and they're competitive with the cost -- the fees. Discounters are able to bring in high-quality private labels that are notable to people, unlike the kind of more low quality fare that often times is associated with dollar stores. And it shows in the sales and the growth.

So that is why discounters have grown then now we're going to take a quick look at who are the global leaders and if you're here, you -- there is a good chance to probably know that it's Aldi and Lidl. They are the two big dogs that are moving into the US space here and they have been wreaking havoc in the UK and are based out of Germany for many years now. We see -- I want to just kind of put them in context of the rest of the space. While they are almost half of total discounter sales in 2016, there are still decent amount companies, but none of them really gets anywhere close to the share that they can get.

And what this means is that Aldi and Lidl are the big dogs, there maybe room for competition, especially if there is a lot more room for penetration rates of the discount model to increase. But we do want to take a little bit of a closer look at the both Aldi and Lidl, because they are the most important players in the space and almost definitely will be in the future. So we're just going to take a quick at the countries that they operate, most importantly and it looks like we've got a little bit of the formatting thing here, so I apologize for that.

It's a lot of Western Europe essentially, that last one they are below 5% I believe is the US. And it's basically Western Europe. They have a few Eastern Europe and Australia is also present here which is different than Lidl, which I just talked you through it. But we see that in the countries where they are bigger, they do have a significant share of value sales. But the main point here is that Western Europe and a couple of other developed countries like Australia and the US are fairly is -- or where they play and they have that kind of developed nation expertise.

Lidl is a little different. They actually while they do play in some of the same places like the UK and they are moving into the US, that's not -- that hasn't historically been their focus. Their focus as you can see is more Eastern Europe. This includes brands that aren't necessarily the legal banners but owned by the same company Schwartz and you can see that they have a little bit more expertise in moving into developing countries, countries where they typically are able to gain greater share because they can come into a country where this model really appeals and there is less high caliber proposition and they can steal a lot more share out of these countries. And that doesn't mean they're not playing in the UK and under developed countries as we all know. UK I believe it's at about 5% share, but it's just -- their focus has historically been developing countries.

And so that's what's happening and that's too is kind of make leaving the charge. I just want to go through a little bit and provide some data backed anecdotes on what you can do about it. And the first kind of share here -- slide here is just sort of kind of a cautionary tale and what happens when you don't do anything. And that happened in the UK, it's pretty well known that the discounters caught everybody there on the layers [ph] when the recession hit and then all the middle market players have been struggling to catch up sense. We can see that in the top four shares, which are the actual top four players in the UK grocery space and we see all of them pretty much losing share, Sainsbury's is mostly flat, thanks to kind of a more service based positioning, but everybody else not doing too hot.

And then we look at the next kind of -- next up of the topic, and we see Aldi and Lidl really doing very well for themselves, as doing the most share. John Lewis, the only actual supermarket, that's been able to kind of grow and has been doing so on the back of high quality goods, the good sag into our first kind of competitive strategy, which is creating a competitive merchandizing mix.

And under -- the German market is the best market to look at for this, that -- as the discounters have been operating there for years now. Edeka is the largest supermarket there and is now the largest actual grocer as of 2008. They've been able to surmount their competition by actually offering the same types of low quality or -- sorry high quality low price private label ranges, but they also put these alongside higher quality goods and services like bakeries, delis et cetera that you would expect out of a supermarket. So they have everything that discount shoppers want, but they also have everything that may be more selective shoppers want and are able to get more people on the stores to do that.

Another good way to focus is to create a more efficient store format. We see here Walmart's sales growth in the past five years by format, both of the blue ones represent their merchandisers, which are the regular Walmarts with no food, are -- with a little bit of packaged food but no fresh food. And then hypermarkets would sell [ph] kind of everything, hypermarkets have seen positive sales growth, which is why you see them kind of little bit higher. They're just about as sufficient on a sales per square meter basis, which is the ex-access [ph] and they are notable - -notably larger as -- that when we look at the bubbles.

The supermarkets, their Neighborhood Expresses are actually notably better both in efficiency and sales growth even though that's because they're coming from a smaller base they've been able to do this by focusing on smaller goods or smaller and more popular goods like fresh food and they are able to get into the cities by having those smart format, which has always been a big thing for Walmart. And then our final example here is just to create more scale, this is what happening in the US, notably in the past 10 years as we see a lot of competitors merging, a lot of high profile mergers and able to gain more bargaining power with everybody in the supply chain including the brands, which is very important.

Jennifer Bartashus {BIO 1827328 <GO>}

All right.

Tim Barrett {BIO 20763677 <GO>}

And that's it from

Jennifer Bartashus {BIO 1827328 <GO>}

Tim, thank you so much. So just as a reminder, if you'd like to submit a question, please do so at the right of your screen. And we're going to move now into a conversation and to a discussion about some of the trends that we've mentioned so far. So let's talk about the seriousness of the threat that the hard discount poses to the food retail industry. Why did these retailers pose a threat? Who is most at risk? And why is now the time to take the discounters seriously. Bill, do you want weigh in?

Bill Bishop {BIO 19198031 <GO>}

Sure, let me start with that. Why are they a threat. I think that the answer is you could tell that from my opening remarks that the hard discount business model is inherently more efficient than the massive supermarket model that we've lived with for 50 years. So they basically deliver products at a lower cost and consequently lower price. In the light of some of the demographics that Tim shared with us, you can find -- you can understand why that's compelling. Who is at risk, the undifferentiated store that is the stores that are basically shop because they're convenience -- that's the -- they're convenient, that's the only reason to go there. As well as those stores that appeal primarily on low price, but can't match the prices of the hard discounters.

So that means a lot of the sort of the softer discounters would be vulnerable and then that why now? I think if we step back and look all these and a lot of major markets and they're as is well recognized involved in a major revitalization of their stores triggered by the concern for Lidl. So they're busy disrupting quite a few stores. Lidl has come to town with stores that are bigger than most of what they run around the world, 38,000 square feet, that's close to a typical supermarket and so the experience that both of these stores are offering frankly is getting closer to the US customers experience shopping supermarkets. So it's like a supermarket but with a lot lower price.

Tim would you want to add on that?

Tim Barrett {BIO 20763677 <GO>}

Yeah, that's a great answer, not a ton to add. I guess as if Bill covered most of the supply side kind of arguments, I'll just cover the demand and sort of what people are really looking for and obviously, it's they're claiming for ways to stretch their dollars still. And discounters are offering that next to their finely tuned private label. That doesn't really sacrifice the quality that people used to expect out of store brands and they're starting to realize that maybe paying for all the name brands isn't always worth it and that they don't have to sacrifice on quality for a lower price and because discounters can offer more for less. They're going to -- they've been doing well and they are going to keep doing well as they expand even more aggressively.

Jennifer Bartashus {BIO 1827328 <GO>}

Alright, great and let's see, a next question could the hard discounters achieve the same sort of penetration levels that we -- in the US that we've seen in Europe? So why don't you start this off with that.

Tim Barrett {BIO 20763677 <GO>}

Yeah, this is a great question. Lot of nuance here and I think the main reason for that is Europe doesn't have Walmart and Walmart is such a low price leader in the US. It's got such a lock down on certain towns, certain -- like whole kind of counties, in some parts of the nation that, they really got a competitive mode around them in some of these areas and they've got such a scale here that they've got the ability to compete on price a little bit better than a lot of the European discounters. Also -- we also have grocers here that are not actually -- that are fighting back already. There is the high profile -- or not -- that the slightly high profile, if you follow the Kroger case where they've been suing Lidl for some of the names of their private label brands. Well, that seems to be more a delay tactic than anything else that shows that the grocers here are willing to put up a fight. They have a lot of scale as of recent years and they are expanding into more private label and kind of a greater range of store brands and higher quality brands. So the competition here is a lot tighter. So I don't think we'll necessarily see the penetration get to as high as that is in Europe. That being said, discounters do eat at the edges, and they are becoming a lot closer to what US consumers expect out of the store, but with lower prices like Bill just talked about. So I imagine they still have a great amount of share to get to, because they're only at about 3% nowadays. They could easily get up to 10, I think. But we'll see, it will be interesting no matter what. That will definitely grow.

Bill what do you think?

Bill Bishop {BIO 19198031 <GO>}

Well, I have a lot of respect for all the numbers that you've got and your experience, but I'm coming at it a little differently. I am seeing the hard discounters actually grow share thoroughly significantly more in the US than you're expecting. Mainly there is an interaction at two things here, one is the low price which we flog pretty strongly. The other is frankly something that it's been hard for me to appreciate and I think hard for many people on the call to appreciate and that is that there are millions and millions of US households who have experienced no income growth or even negative income growth over the last x-number of years and these folks may or may not be buying paycheck to paycheck, the low grocery prices appeal to a significant fraction of those.

Kind of interpreting slightly on the response side was huge sensitivity, I do not think that Walmart will be able to compete long-term on a price basis with the hard discounters. They will be very successful, but not because they compete with the hard discounters. So, I'm willing to suggest and Tim, will have to meet on this sometime in a couple of years, but the share of hard discounters could actually approach 20% sometime in the future here in the US, given the demographics and the nature of our competition, but the time will tell.

Jennifer Bartashus {BIO 1827328 <GO>}

All right. And I guess, so I would throw out to both of you, what are the strengths and weaknesses of Aldi and Lidl? And can you summarize some of the changes that they've done in order to compete in the US environment and how that format threatens grocers? Bill, do you want to grab that one?

Bill Bishop {BIO 19198031 <GO>}

Sure. On the strengths and weaknesses, strengths, low prices and shoppable, smaller shoppable stores, a lot of people like that small size. Weaknesses, limited access to advertised brands. There is no question that, that holds some back. And there is a requirement for heavier customer participation, particularly in the checkout process. I think you asked a little bit about changes they were making as well. I think the -- this is where semantics can get very difficult. Hard discounters are hard discounters, but they are offering around -- they are offering a softer shopping experience in the case of both Aldi and Lidl. And I think that's what is making them closer to the US supermarket shopping experience. But I guess Tim has got some additional thoughts on this as well.

Tim Barrett {BIO 20763677 <GO>}

Yeah, I would say that -- I would have started off with -- especially if you'd have asked me a few years ago, stores just aren't quite as nice. But that is something they're actively working on. So I think that only be a weakness for so long as they move kind of a little bit to the softer discount model. I think another weakness that is also temporary, is just the fact that the brand and the model -- the brands and the models are still largely unfamiliar to shoppers. They got to be a little bit more aggressive with our advertising and making sure people know about maybe kind of the lack of personnel and how the stores organized and what you might expect to find. So just a familiarization, will take a little bit of time, but I also think that, that's more of a short-term weakness than anything else. And you cover kind of the main weakness. I think one other also minor but interesting strength is that a lot of these while they focus on grocery, they have a really cool non-foods sections that rotate real quickly.

I mean you talked about turnover and these things move in a -- of sometimes weekly basis and but there are always really good deals and I often hear when people talk about them in a way that evokes someone like T.J. Maxx ask kind of appeal where there's is a treasure hunting vibe. We never really know what's going to be in there. I know I've gone in the stores one day and they've got lawn care equipment and then on the next day, they had a really cheap LCD TV and some kitchenwares. So all that stuff moves really quickly and kind of creates an interesting competitive advantage.

Jennifer Bartashus {BIO 1827328 <GO>}

All right. So let's talk a little bit about quality perception. So the quality perception of private label brands and the adoption of the multi-tiered offerings has really changed consumer acceptance of these products. What does this mean for hard discount growth and the opportunity here in the US? Tim, do you want to think -- you want to give any thoughts?

Tim Barrett {BIO 20763677 <GO>}

I'll do, Jen. I think the usage of private label for them is huge, particularly now, that they are really striking on the iron hot here. Store brand Stigma is a fraction of what it used to be and I think a big thing we can attribute this to is the kind of move towards fantasy brands. For those that are unaware fantasy brands are -- they are private labels just like a store brand but they're called something else. A good example is like Nice! at Walgreens are the farms [ph] they target where their private labels and all the -- there are store brands in other names. And sometimes people don't even know they're buying a private label and then they buy it and then they realize it's actually pretty good and then they keep on buying it whether or not they learn that it's from the store itself. And Aldi and Lidl have been doing this for decades. And they're able to get past kind of -- this is helping move us past the store brand stigma and now that people have been buying these and realizing that the odds are pretty or -- that the goods are pretty at quality -- high quality. They continuing to buy them more as private level penetration increases and just kind of are going to ride that wave to greater share and a greater growth in the US.

Jennifer Bartashus {BIO 1827328 <GO>}

Bill, did you have any thoughts on that?

Bill Bishop {BIO 19198031 <GO>}

I think Tim has set it on. I totally agree.

Jennifer Bartashus {BIO 1827328 <GO>}

All right. So what about national brands? So what sort of role do the national brands play and are there longer term ramifications on national brands and their manufacturers as a result of the growth in hard discount. Bill, what do you think?

Bill Bishop {BIO 19198031 <GO>}

Well, in terms of the role they play today, it's pretty interesting and of course we had the chance really to have studied Aldi more than Lidl. But in the case of Aldi, they have been included to fill unique needs product niches that really were very difficult to satisfy otherwise and might prompt a customer to go to another store to buy the brand. So they're filling unique needs. They also provide a really nice role in terms of illustrating the price advantage as the hard discounter. We've seen one question come through here on soft drinks. And in the case of soft drinks, again I'm going to concentrate on Aldi because we see more about it.

There seems to be an exclusive arrangement from a brand point of view between Coca Cola and Aldi and they're probably are if Coca Cola has 50 different items in packages in their red and black and white labels, there maybe three or four max in the Aldi store, all at a decent price but not a great savings that all making the private label looks extremely attractive. Now, longer term, we believe that consumer-centric orientation as a retailer and for your own label private label or fantasy label are -- is going to take considerable share more than it has so far, more than private label has so far from name brands, and the effect of this will be to undermine the nature of the business relationship between the national or name brands and the traditional grocers. And as I said relationship, that financial relationship is undermined. Frankly, both will become less influences in the market, at least that's where we see it right now. Tim?

Tim Barrett {BIO 20763677 <GO>}

Yeah, that's a -- that's pretty great. You mentioned soft drinks. I think there is a really good anecdote that I believe -- along with you Bill that private label still has a great deal of share to gain. But there are a few rockstar brands and particular categories that may be able to weather this storm. And in fact, actually make the kind of partnership with discounters a little bit more complicated. Soft drinks is one of those. There is actually a good anecdote from Europe where Lidl actually de-listed Coke products in the middle of a price war in order to get their prices lower and were actually forced due to customer reaction to bring Coke back. Probably not at as good of terms as they would have liked after shortly de-listing them.

So it is possible to be a little bit more independent on a few brands. I think the focus of the world are one, you know Gatorade, I know is pretty -- pretty prominent in some of these stores as well. Certain candies, as well hold a great deal of brand strength and if they're able to get into non-food home care, we know Tide is often extremely difficult to unseat in any capacity, if you don't have Tide, you're going to have a tough time selling laundry detergent. So while they're going to eat quite a bit of share from the many, many brands that are out there, there will be a few brands that will have the bargaining power needed to maybe get into the stores as they expand a little bit, stay in the stores.

Jennifer Bartashus {BIO 1827328 <GO>}

All right, so with all of this, on your -- all of this context, how do retailers create a winning strategy against the hard discounts threat? Now what can the Krogers, the Walmarts, the Albertsons, Ahold Delhaize in US, what can they do? Tim do you have any thoughts?

Tim Barrett {BIO 20763677 <GO>}

Yeah. I'll kind of reiterate because I think it's worth repeating the three main points that I talked about at the end of my presentation. The first is creating a competitive and comprehensive merchandising mix. You need private labels that can compete on cost and quality with discounters, but as a supermarket or hypermarket you can use your extra space and scale to also provide value-added services and products that are of higher quality, in a more premium level and you can even provide services like Walmart is looking to roll out Click and Collect a lot more aggressively this year and in the future. And that's something that discounters are just going to have hard time doing. And then you can differentiate yourself, because like Bill said, you can't beat them at their own game. You're going to have a tough time competing on price alone and doing so like some of the discounters or some of the supermarkets in the UK have been doing, just won't work.

The other two points are focusing on efficient models, smaller store formats, not only are more shoppable and make you focus on goods that have a lot higher turnover.

But they also let you get into better areas and more urban areas, where we know a lot of the growth was coming out of these days. And then finally creating scale oftentimes through mergers and acquisition can really improve your bargain power with everybody else that you're working within the supply chain.

Jennifer Bartashus {BIO 1827328 <GO>}

And Bill do you have any thought?

Bill Bishop {BIO 19198031 <GO>}

Just a couple to build on this. I think the traditional retailers need as Tim suggests to avoid directly competing with the hard discounters in some respects, the poor financial performance of at least some of the UK chains, I think were attributable to -- was attributable to sort of self-inflicted wounds in terms of maybe losing control of their pricing as they compete at simultaneously with both the hard discounters and the challenge of eCommerce, both coming out and at the same time.

So the trick I think is to maintain control of your pricing while accomplishing some of the goals we're talking about. The other point and it's been raised in a question here is whether a retail -- how a traditional retailer can put together the product mix, that will give them the prices that the discounters like, I love the way you said that Tim and everything else that the non-discount customers are looking for. Tim, you pointed out that that's true for Edeka and actually it's true for the hypermarkets in Finland as well. So we do have examples of where people have used a mix, and that's really another way of saying how they keep control to their business model. So just a slight build on what Tim had.

Jennifer Bartashus {BIO 1827328 <GO>}

Wonderful and I guess so, since already on this on this topic a little bit, what about other small format stores? So we saw some of the data that stores are kind of shrinking in size or that they're growing in popularity and that a lot of the chain -- larger chain operators are either running some of these smaller stores or experimenting with them. How does those concepts compete with the hard discount? Bill, do you just want to continue with your thoughts there?

Bill Bishop {BIO 19198031 <GO>}

Yeah, I'd be happy to. So I think the small store format for the most part, won't compete directly. It's a little like this complementary competition instead consumers will use the small formats to the kind of round out their needs, so they go to Sprouts for produce and Earth Fare to natural and organic products. The dollar stores and the drug stores however are both going to need to make significant changes in their assortment and pricing to be able to operate successfully in markets where there is a growing and active presence of hard discounters. That said, convenient stores are probably going to stay the course, they're on an immediate consumption orientation and doing very well, thanks very much. So there will be a split decision relative to the small stores kind of dividing out. I think along those lines, Tim?

Tim Barrett {BIO 20763677 <GO>}

Yeah, I don't really have a thing to add to that. I think Bill covered it pretty well.

Jennifer Bartashus {BIO 1827328 <GO>}

Okay, great. And so are there any retailers right now who are trying to do this themselves and have they had any success in trying? Tim, any thoughts?

Tim Barrett {BIO 20763677 <GO>}

Yeah, I mean there are a few, discount type experiments that have been going on, some of them still exist, some that have been sold. I don't think there is anything particularly notable because nobody has been really able to compete with them directly in a manner that makes us feel like they might be in the game for one of the leading discounters in the US in the future. That being said, I think we are seeing kind of more small format experiments that take a different tack and have more of a competitive differentiation. I think a good example there, well, a big one, of course is Walmart's Neighborhood Express that's their supermarket, Ahold and Wal [ph] it's not particularly innovative, it is growing at a pretty high clip in areas where you don't see a ton of Walmarts. And another more innovative small format, I think is Ahold Delhaize's Be Fresh, which is very small, not -- it's only in the Boston area still, but it's the kind of store that is focused on eCommerce, focused on delivery, focused on trying to draw dollars from city-dwelling millennials that want to take out and the delivery that the convenience that they are kind of often known for. And the whole thing is kind of themed around that purpose, along with fresh food. So taking I think competition will come less from grocers, creating their own discounters and maybe more from creating their own interest in maybe smaller format experiments.

Bill Bishop {BIO 19198031 <GO>}

You know I see something similar happening because it's done hard to replicate the model we've described. We see Kroger has a small effort going with their Ruler Stores and the only example that I can think of that has survived all of these many years is the no-frill hard discounters operated in Canada by Loblaws. They were created, I'm going to say back in the early 80s and have become a significant player in the Canadian market. So if one is looking for a hard discounter operated by a traditional retailer, that might be a place to look.

Jennifer Bartashus {BIO 1827328 <GO>}

Wondewrful. Thank you. And then we can not address everything else that's going on, it's a big theme in food retail. So what is the potential for hard discounters to become even bigger disruptors by joining the online evolution, whether it's through Click and Collect delivery or partnerships with Instacart or things like that? What do you think Bill?

Bill Bishop {BIO 19198031 <GO>}

Well, I think I have to admit, I was surprised as yesterday's announcement was Instacart's pilot partnership with Aldi but I also think it makes huge sands. We know that both Aldi and Lidl have fairly significant online grocery operations in other parts of the world and they sell wine and related products as well, sort of looking to the periphery Amazon has signaled the need for a physical presence to accelerate their growth was Amazon Go and now the purchase of Whole Foods, so I think it's entirely possible that we will see even more mergers to move in this direction. I wouldn't publish it as a headline yet. But Amazon buying Save-A-Lot is not inconceivable, where the two will converge. Ultimately, all of the research we do shows us that almost every household wants to go both ways on this. They what some online shopping opportunities and they definitely want the low prices they can score at the hard discounters. So I think this convergence is going to be inevitable and probably faster than what we might think. Tim?

Tim Barrett {BIO 20763677 <GO>}

Yeah. Thanks Bill. And this is kind of funny because for those listening, we've been talking about this as we prep for this webinar and I've historically been pretty bearish on discounters getting into the online space outside of -- maybe a few of the higher margin things that they've done elsewhere like selling wine over the Internet. It's because the model is so tight and efficient already and they have got other problems like making their stores nicer and making sure that people know what they are and who they are and what they do.

In the US, that I always thought online wasn't going to really be a focus. They don't have the money for it, they don't have the personnel. I mean the whole point of the model itself is that, just as many people working in the stores you need and as we know, creating online grocery opportunities outside of that typically involves more investment in personnel and that's going to raise prices and that's just not part of the discounter game plan. So I've always been pretty bearish on it -- but then yesterday it rolls around and we see all of these high profounders of them partnering with Instacart and that kind of throws my whole world view skew a little bit.

I think this is what makes the most sense for them because they're partnering with a company and they are able to offload a lot of the cost as online grocery, in that manner and it give Aldi a really good kind of high-profile partner, another high profile partner or Instacart gets them [ph] that. So they may be moving into some things a little bit faster than I've thought. I still don't think they're going to be running out their own services like, that -- Walmart is doing with its Drive Thrus or Kroger with its ClickList. But if they can find some partners that are willing to make a deal with them, at the -- when the price is right, which from our efforts from talking to brands is when you talk to discounters and started work with discounters, the price always has to be right. So I think yeah, people like Instacart, maybe other hyper local delivery company is to work with them, then we may see it a little bit faster than I even thought.

Jennifer Bartashus {BIO 1827328 <GO>}

All right. And a question for both of you is have -- do we have any idea at this point how successful Lidl has been in terms of sales in the US, or what to expect?

Tim Barrett {BIO 20763677 <GO>}

Yeah.

Bill Bishop {BIO 19198031 <GO>}

Tim, you can take the lead on that.

Tim Barrett {BIO 20763677 <GO>}

Yeah, I can jump in on that one. I have heard within the industry estimates of around 10 million in a store for 2017, which would put them this, they get to where they need to be at or around almost a little bit a less than 500 million for 2017, which would be substantial because that's actually about what a little bit less than what Kroger's Ruler Foods is predicted to do this year as well. So that was -- that kind of shows you a little bit how traditional grocers in US struggle to compete on this model.

Jennifer Bartashus {BIO 1827328 <GO>}

And I guess as a follow up to that. Oh, sorry, go ahead Bill, please.

Bill Bishop {BIO 19198031 <GO>}

I was just going to say 10 million a store is a big number if your store is still in this under 40,000 square foot range in terms of sales per square foot. And Tim has a lot of sales per meter and so forth data, we find a very strong correlation between sales per whatever it is, square foot or square meter and profitability. So getting to the 10 million I have to say that's quite successful from a financial point of view.

Jennifer Bartashus {BIO 1827328 <GO>}

Thank you Bill and just as a kind of a follow along to that, do you see that they have the ability to really sort of run at a loss for a little while at Lidl until they hit a certain threshold for their store base in the US and do you have any thoughts on what sort of store base they may be able to achieve in the next year or two? Do either of you have any thoughts on that?

Bill Bishop {BIO 19198031 <GO>}

Well, both the hard discounters are investing. One of the amazing things to me about Aldi over of the 40 years, they were in the United States is that probably 25 of those 40 years at least, their growth was financed almost completely by organic profitability. Obviously, recently there's been a tremendous infusion of debt and I think that makes huge financial sense and it's going to be a while before Lidl who has built offices and TCs [ph] and so forth, so are going to be able to have the scale to cover those overhead costs. I think I'm going to defer to Tim however in terms of the kind of the projected growth is probably a lot closer than I'm to that.

Tim Barrett {BIO 20763677 <GO>}

Yeah, I've got some pretty quality projections here for actual store counts. In 2017, we have seen 3,500 actual hard discount outlets, here in the US and as they're continuing to pick up expansion in the next five years, so by 2022, we actually expect that to increase to a little bit over 5,000. And to put that in perspective, that's an increase of 1500 over the next five years, whereas over the last five years have seen an increase of only about 500. So that ties into, we were seeing organic growth largely and it was pretty slow, but now, the game is on and the expansion has picked up at a notable pace, which is partially fueled by that like those I've been talking about.

Jennifer Bartashus {BIO 1827328 <GO>}

Wonderful. Thank you. Thank you very much. Tim, this one might be a little bit more for you. Among the US conventional grocers, is there anyone who is similar to Edeka in Germany, which has been able to thrive even with Aldi and Lidl in the mix? Do you know anything about the German players or is that something you can comment on?

Tim Barrett {BIO 20763677 <GO>}

Yeah. I mean, the question is who -- who has been able to compete in the US much like Edeka has and I don't know, I mean one of the discounts -- I mean, all these -- really the first thing you got to look at and their main base of operations has been that west and I don't know if we have anybody quite like Edeka, Mariano's kind of brings to mind and they really do come in within pretty decent brands and a lot of value-added services and things like Oyster Bars et cetera that everybody really loves. But I don't know if they are as strong on the private label with the Brownies brands. But I would say Kroger, I was actually just about to say Kroger good, good, good job. They don't compete quite as directly and you see them -- you see this because they're starting to be more aggressive when it comes Lidl moving into their territory, although they do have some things like in Indiana with Kroger. So I would say that the most applicable kind of equivalent to Edeka would probably be Kroger, because they have the more high tier private label, but they also have a lot of the value-added services like Kroger's ClickList which is their Click and Collect and even their Harris-Teeter banners which are of a little bit higher quality.

Jennifer Bartashus {BIO 1827328 <GO>}

All right. Wonderful. And we have one last question as we wrap it up for today. Has the average discount shopper changed overtime meaning, have we seen there a change in who it is that's actually going into these hard discount stores? Bill, do you have any idea?

Bill Bishop {BIO 19198031 <GO>}

Yeah, the research that we do tells us that they have definitely changed. There's been a common interest regardless of demographics and satisfaction derived from buying groceries inexpensively, getting at good price. But and even 20 years ago, you see that at parking lot of a novelties store in many areas of the United States and see the full range of automobiles from luxury down to clunkers.

So I think what's happened is more middle Americans have experienced the advantage, the price advantage and are probably shopping and will continue to shop the hard discounters on a fill in basis, which is consistent with the way customers are shopping today used to be just a couple three stores max, now it's five or six and it's easy to see how the population of shoppers will expand into the middle income as the hard discounters become part of their kind of portfolio of store choice.

So it's combination of what -- the changing shopping patterns, multiple stores and a broader cross-section of middle-income America. I want to come back to this notion of income not raising, I -- depending on how you look at the US income numbers, it's harder to see or easier to see. But there is at least half and it's probably approaching 60% of the population, who is really stressed from an economic point of view, not all, but some fraction of those folks are going to find these stores attractive. So the customers are changing, because quite frankly, the demand base in the United States is different. We didn't have this problem 10 years ago, or even five years ago. And I would define it as a social problem. And the only other thing I would add is I think Meijers and Grand Rapids, Michigan is another one to think about as, as you compare with Edeka.

Jennifer Bartashus {BIO 1827328 <GO>}

Thank you. Tim did you have anything else you wanted to add in on that?

Tim Barrett {BIO 20763677 <GO>}

No, really no. I think when Bill is right, he's right and I think he's been.

Jennifer Bartashus {BIO 1827328 <GO>}

All right. Well, on that note, I want to say thank you so much to everyone for joining us today. Our contact information is available on the slides that you, that you can see. In addition, we will be send out these slides, the slides after the webinar is over. Thank you so much for your time. Bill and Tim, thank you so much for joining us today and with that, we'll end the webinar and have a wonderful day. Thank you.

Bill Bishop {BIO 19198031 <GO>}

Thank you. Bye, everyone.