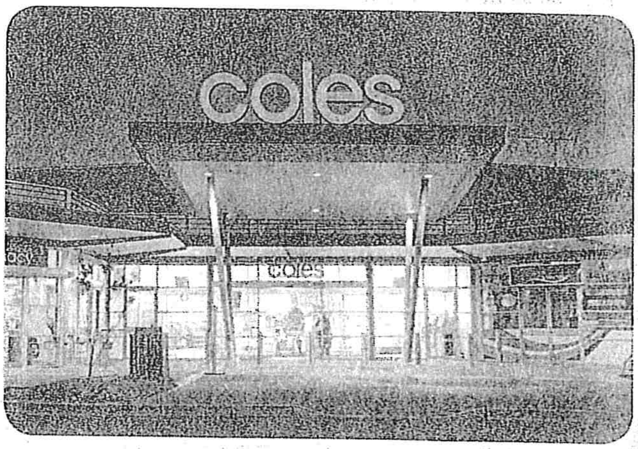
CASE 3

Dallas Hanson

Coles and Woolworths dominate Australian supermarkets with around 80 per cent market share of this vital industry. They have been mildly challenged by the Metcash brands (chiefly IGA) over a number of years but more recently they have been far more seriously challenged by the entry of the low-cost German brand Aldi. Coles and Woolworths are among the 20 biggest retailers in the world and have the greatest dominance of a domestic market in the world; their almost universal presence in Australian suburbs and towns is business-as-usual for locals but is surprising to citizens of other nations who are used to more-competitive landscapes. In early 2016, however, they were facing their biggest challenge for a generation: the rise of Aldi. Would it make life harder for the big players, already busy competing against each other? Their direct rivalry is complex because both Coles and Woolworths (Woolies) are bigger than they seem.

Coles is part of Wesfarmers, the Western Australian cooperative that grew to become a highly successful conglomerate. It owns Coles, Bunnings (which retails home-improvement goods and has 223 warehouse stores and 63 smaller-format stores), Officeworks (retails office equipment and has 150 stores) and Kmart (general retailer). There is also a range of chemical, energy and fertiliser businesses, coal mining and a safety products business in the stable. Coles itself operates over 750 full-service supermarkets, Vintage Cellars, BI-LO, Liquorland, 92 hotels (around 810 liquor outlets in total) and over 600 fuel and smaller convenience stores. In 2015, Wesfarmers employed around 205 000 people and generated A$62 billion in revenue.[1] It has been highly successful over a long period, cleverly allocating resources around the business units to improve overall performance.

A decade ago Coles was outperformed by Woolworths, but this started to change when it was acquired by Wesfarmers, which had resources to throw at the retailing empire. In 2007 it hired veterans of the supermarket chain Asda in the UK; the new team was led by Ian Mcleod. When he arrived, Coles' turnover was A$17 billion annually compared with Woolies' A$37 billion. The new team, with injections of funds from Wesfarmers, rejuvenated the stores and improved service. This



Source: iStock.com/Kokkai Ng

turnaround was based on the 'Tesco playbook' (low prices, well-stocked shelves, good staff, clean stores, nice displays) and started immediately. Meanwhile, the other arms of the Wesfarmers conglomerate performed well and Wesfarmers continued to fund changes to Coles. The growth of the home-improvement sector contributed to especially good performances by Bunnings and this helped the overall balance sheet.

Woolworths is also far more than just a supermarket chain. It operates 873 Woolworths supermarkets as well as Thomas Dux the Grocer (for upmarket grocery shopping), 527 liquor outlets and 327 other licensed outlets including Dan Murphy's and BWS, 600 Caltex Woolworths co-branded petrol outlets, and the Big W stores.[2] It is Australia's leading gambling business with the machines in its hotel empire. In early 2016 the disaster of Woolworths' Masters hardware chain was fully revealed when the six-year venture into home improvement was closed down. Losses were projected to blow out to A$1 billion and some 7000 jobs were put at risk. How did the expert retailer get to this point? The standard explanation was that it had tried to expand too quickly and was caught out by wage rises and the costs of new store development. Sadly, it left recently completed stores unoccupied.[3]

Competition between Coles and Woolworths remains constant and is often hostile. However, there is little strategic

TABLE 1 Wesfarmers group performance summary

Year ended 30 June ($m)	2015	2014	↕ %
Revenue	62 447	62 348	0.2
EBITDA	4 978	5273	(5.6)
EBIT	3 759	4150	(9.4)
EBIT (from continuing operations excluding NTIs)	3 759	3566	5.4
Finance costs	(315)	(363)	13.2
Tax expense	(1004)	(1098)	8.7
Net profit after tax	2440	2689	(9.3)
Net profit after tax (from continuing operations excluding NTIs)	2440	2253	8.3
Operating cash flow	3791	3226	17.5
Earnings per share (cps)	216.1	234.6	(7.9)
Earnings per share (from continuing ops. excl. NTIs) (cps)	216.1	196.6	9.9
Operating cash flow per share (wanos, incl. res. shares) (cps)	335.1	281.0	19.3
Full-year ordinary dividend per share (cps)	200	190	5.3
Special dividend (cps)	–	10	n.c.
Capital management paid per share (cps)	100	50	100.0
Return on equity (R12) (%)	9.8	10.5	(70 bps)
Return on equity (R12) (%) (from continuing operations excl. NTIs)	9.8	9.4	40 bps

Source: Wesfarmers, 2015, *2015 Full-year Results Briefing Presentation*, 5.

TABLE 2 Wesfarmers return on capital

	2015			2014
Rolling 12 months to 30 June	EBIT ($m)	Cap Emp ($m)	ROC (%)	ROC (%)
Food, liquor & petrol retailing	1783	16 276	11.0	10.3
Home improvement & office supplies	1 206	4 278	28.2	24.4
Department store retailing	522	3778	13.8	10.4
Industrials	353	424	8.3	11.7

Source: Wesfarmers, 2015, *2015 Full-year Results Briefing Presentation*, 7.

difference between them in terms of major moves or prices. For example, Woolworths was lagging Coles in the 1980s and then decided to become the 'fresh food people'. This strategy worked well and it dominated the market after a while, so Coles copied it. More recently, Coles had a successful 'down down, prices are down' marketing campaign (led by an extremely catchy Status Quo tune), so then Woolworths ran a campaign based on 'cheap cheap'. And when Woolworths made celebrity chef Jamie Oliver a marketing ambassador with his own line of crockery and cookbooks, Coles followed with its own chef, Heston Blumenthal (and then his ice-cream as well as his cooking ideas).[4] Basically, with two giant players in the market, neither can afford to let the other get ahead. As one goes into petrol retailing or travel points for purchases, the other must also do so. Each also gathers as much data on customers as possible using sales data from stores and store loyalty cards linked to the travel points that consumers seek (both chains buy seats from Qantas to handle travel claims based on the points; this is a major revenue earner for Qantas).

The supply chains for these supermarkets are very well established. Tight contracts are signed for fruit and vegetables. For example, they specify the size and quality of the individual products, which means farmers throw out much of their produce when it does not meet these specifications. There are also very tight time-specific delivery contracts for the trucking companies who deliver the goods. One outcome of this pattern is the difficulty truly independent grocers have in obtaining supplies of goods. The big two effectively lock them out by buying up the readily available supplies.

Another aspect of their operation is constriction of alternative market share: if there is a big supermarket nearby, a Coles and/or a Woolworths, it makes it difficult for a small player to operate if its prices are even slightly higher, particularly now that the big stores stay open late, thereby killing a traditional advantage for the smaller stores. One answer is for the smaller stores to become delicatessen-style operations, but even this is difficult as a core strategy because the big two have delicatessen and organic lines; indeed, Woolworths acquired the Macro organics business to answer this threat.

Both Coles and Woolworths strive to establish stores in all areas of population growth; the stores seem inevitable parts of any growth area. This is usually the product of years of planning, with careful demographic analysis behind any new store. As the population moves to the coast, so do the big two. Malcolm Knox, in his book about the big two, gives an account of how this can happen even in anti-big-business enclaves.

Mullumbimby on the NSW North Coast is a centre for small business and has a large 'alternative' community. The local supermarket was run by the Mallam family, and was an institution. A growing population meant it needed to expand in order to meet evident demand. The Mallams found a good block of land just outside town and proposed a brand-new, bigger supermarket. The local council needed to provide planning permission for this but, dominated by Green Party councillors dedicated to (very) small business, it insisted on very strict and expensive conditions being met. Knox suggests A$1.7 million in fees were on the table – a huge sum for one family-operated supermarket. Meanwhile, Woolworths had a store in the nearby tourism centre of Byron Bay but could not keep up with the demand there. It offered to buy the Mallam family out many times but was refused. It kept the offer open, though. The dispute between the Mallams and the council dragged on for six years before the family – getting older – got tired of it all and sold out to Woolworths. The community then decided they were in trouble and conducted a survey which

TABLE 3 Wesfarmers home improvement performance summary

Year ended 30 June ($m)	*2015*	*2014*	↕ %
Revenue	9534	8546	*11.6*
EBITDA	1228	1106	*11.0*
Depreciation & amortisation	(140)	(127)	*(10.2)*
EBIT	1088	979	*11.1*
EBIT margin (%)	11.4	11.5	
ROC (R12 %)	33.5	29.3	
Safety (R12 AIFR)	24.8	29.1	
Total store sales growth (%)	11.4	11.7	
Store-on-store sales growth (%)	8.8	8.4	

Source: Wesfarmers, 2015, *2015 Full-year Results Briefing Presentation*, 22.

found that 50 per cent of the town was against the Woolworths proposal. They sent this to Woolworths' head office, which suggested a formal town referendum on the issue was fair. The firm was, in other words, cooperative. But the referendum turned out to be beyond the community's resources. Woolworths then went to the state government which overruled the local council and the supermarket was constructed. It was one-third bigger than the Mallams' planned supermarket.[5] Woolworths was careful, patient and ultimately victorious in what is arguably the most anti-big-business town in Australia.

Metcash, the third player, is an ASX-listed company that operates as a wholesale distributor and a marketing business. It supplies 2400 independent retailers in Australia, including 1365 IGA stores (IGA stands for 'Independent Grocers Alliance', an international brand). IGA stores stock similar lines to Coles and Woolworths and strive for similar prices. It markets on the basis of local contact and local ownership. Metcash also handles Mitre 10 homeware stores (in competition with Bunnings) and alcohol sales via Cellarbrations and BottleO liquor stores.[6]

The Metcash system is struggling. The local grocer arm, IGA, has lost nearly a third of its market share over the last decade and Metcash itself has lost 70 per cent of its share value since 2007.[7] The problems are many: Aldi and its low-price offerings (more on this soon) are very hard to match, big supermarkets are staying open late and killing a traditional advantage of smaller players, the range in Coles and Woolworths is usually greater, and the huge marketing budgets of the big players cannot be matched. The Metcash operation may shrink further if it cannot develop answers to the problems it faces. It is possible it will prosper mainly in areas just too small for any of the big players to open in: smaller country towns for example. Metcash chief Ian Morrish is more positive. He has said of IGA: 'They are very good retailers and they have a particular offer, which appeals to some of the customers, and what we've got to focus on is our strengths and our strengths are very different to theirs'.[8] By 'theirs', Morrish meant Aldi's.

Aldi entered the Australian market in 2001 and by early 2016 had over 350 stores with another 120 planned, including expansion from the eastern states to South Australia and Western Australia.[9] (This poses more threats to IGA since these states are a stronghold for the firm.) Aldi is German-based and has over 7000 stores on three continents, and turnover of over US$80 billion annually. It operated the first self-service stores in Germany and has long since fine-tuned low-cost retailing. The company's mission is clear: 'All people wherever they live should have the opportunity to buy everyday groceries of the highest quality at the lowest possible price'.[10] Aldi seems to deliver on this: a 2009 survey by Australian consumer advocate *Choice Magazine* found that a basket of groceries from Aldi was 25 per cent cheaper than the nearest competitor.[11] The way Aldi does this is to tie suppliers into firm contracts and sell most products as home brands. The system is designed to cut all non-essential costs, with goods placed on display quickly and customers packing their own bags. It stocks a limited range of good-quality products, with limited choice. For example, there is usually one sort of potato in an Aldi, not the five or six commonly found in Coles, and there may only be three sorts of toothpaste, not the myriad choices in a Coles or Woolworths.

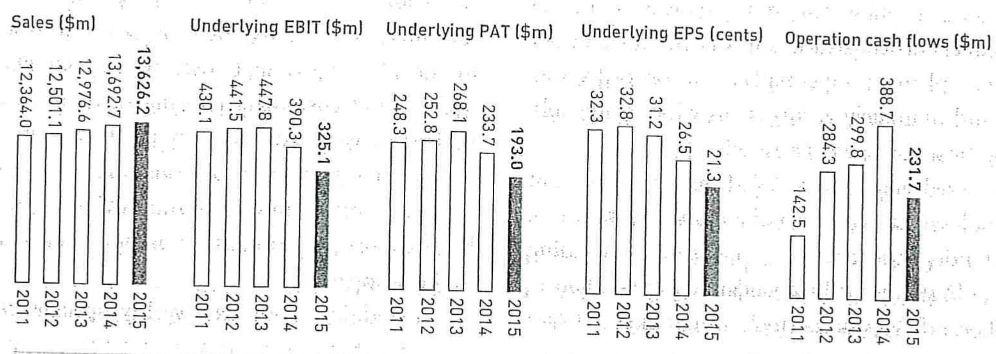
In addition, Aldi has weekly specials that are heavily marketed through catalogues in stores and a well-liked Aldi app. The specials are popular; for example, ski equipment (which is regularly offered); gardening gear in spring; bicycles, bike helmets and other bike gear; and a very wide range of other goods (some of which are surprising, such as lawnmowers and very large searchlights). Aldi is also committed to reducing its carbon footprint, maximising its energy efficiency and recycling. Perhaps to assuage concerns about how low pricing is achieved, it insists that all suppliers conform to a variety of ethical guidelines, including the UN *Convention on the Rights of the Child*. Basically, it aims to hit the hot buttons for both low prices and responsible business.

The current state of play for Woolworths, which has been behind Coles for several years and is being challenged by Aldi, is summarised by the head of its food division, Brad Banducci: 'What is clear is that while lower prices are essential, the true battleground is the overall customer experience. So we will not be beaten on price, and we will provide better convenience, superior freshness and a more appealing range, and a focus on innovation'.[12]

Woolworths understand the wider situation that all supermarkets face. Customers now have the ability to shop when, how and where they want. Mobile technology – the ubiquitous app – is rapidly changing how we view our world and giving us access to products and prices from around the world. The firm recognises that it needs to keep up and understand that customers want to move 'seamlessly and effortlessly' between physical and virtual stores and shop in a way that suits them (see the Woolworths Annual Report 2015 at http://www.woolworthslimited.com.au/icms_docs/182381_Annual_Report_2015.pdf).[13]

Metcash financial highlights

FINANCIAL HIGHLIGHTS



FIVE YEAR REVIEW	2015	2014	2013	2012	2011
FINANCIAL PERFORMANCE					
SALES ($M)	13,626.2	13,392.7	12,926.6	12,501.1	12,364.0
UNDERLYING EBIT ($M)	325.1	390.3	447.8	441.5	430.1
FINANCE COSTS, NET ($M)	55.1	57.2	61.6	67.6	66.3
UNDERLYING PROFIT AFTER TAX ($M)	193.0	233.7	268.1	252.8	248.3
REPORTED (LOSS)/PROFIT AFTER TAX ($M)	(384.2)	169.2	206.0	90.0	241.4
OPERATING CASH FLOWS ($M)	231.7	388.7	299.8	284.3	142.5
CASH REALISATION RATIO (%)[1]	87.5%	162.6%	112.9%	196.9%	48.4%
FINANCIAL POSITION					
SHAREHOLDER EQUITY ($M)	1,156.6	1,594.0	1,624.2	1,335.1	1,442.8
NET DEBT (HEDGED) ($M)	667.8	766.9	719.8	910.4	682.4
GEARING RATIO (NET HEDGED) (%)	36.6%	32.5%	30.7%	40.5%	32.1%
RETURN ON FUNDS EMPLOYED (%)[2]	15.8%	16.7%	20.0%	20.6%	21.1%
SHARE STATISTICS					
FULLY PAID ORDINARY SHARES	928,357,876	888,338,048	880,704,786	771,345,864	768,853,644
WEIGHTED AVERAGE ORDINARY SHARES	907,012,053	882,676,013	859,742,607	770,441,432	767,676,470
UNDERLYING EARNINGS PER SHARE (CENTS)	21.3	26.5	31.2	32.8	32.3
REPORTED (LOSS)/EARNINGS PER SHARE (CENTS)	(42.4)	19.2	24.0	11.7	31.5
DIVIDENDS DECLARED PER SHARE (CENTS)	6.5	18.5	28.0	28.0	27.0
DIVIDEND PAYOUT RATIO (%)	30.5%	69.8%	89.7%	85.4%	83.6%
OTHER STATISTICS					
NUMBER OF EMPLOYEES (FULL-TIME EQUIVALENTS)	6,398	6,174	5,794	5,166	5,638

1. Cash Flow from operations/Reported NPATDA (depreciation and amortisation not tax effected). In respect of FY2015 only, the ratio was calculated using Underiying NPATDA, rather then Reported NPATDA, as the $577.2m of Significant items expense was primarily non-cash.
2. In respect of FY2015, ROFE would have been 13.7% if the impact of the impairment charges on the balance sheet was excluded.

Source: Metcash, 2015, *Metcash Limited Annual Report*, 5.

Woolworths is now adding an additional 58 000 work hours to the system so customers get better service. In addition, it has reduced prices to the effect of A$125 million, and claims to have more than matched Coles on this. It is also expanding hours used for stocking shelves so goods on the shelves are more readily available.

The details of this strategy are available via simple web searches, hence Coles, Aldi and IGA know exactly what Woolworths is aiming to do. Among price reductions and more service staff, it is also using customer focus groups to identify customer preferences and in turn work out changes to processes. So far this has led to more half-sized trolleys being made available, bigger bags for groceries at the self-checking areas, and better bag packing by staff. Basically, the organisation is striving to be responsive to customers.[14]

The background to Coles' 2015 strategy reveals some useful data on the industry as a whole compared with the UK, and opportunities for Australia. The trend to smaller store sizes exists in Australia but is exceeded by the trend in the UK; there are greater online sales in the UK; there is more exposure to non-food sales; and the market share of discounters is about the same.

Coles, like Woolworths, seeks to understand customers better and will expand convenience-style stores (smaller stores) because its research indicates people shop in smaller lots and seek shopping convenience. It will also simplify its range (that is, have a smaller range of products). It will simplify its supply chain and seek to build better relationships with them (this will also, presumably, aid in production of home brands and help lock out other grocers from the suppliers). It will keep lowering prices for four more years (the 'down down' marketing push). Having discovered 30 per cent of its customers do not buy fresh food from Coles, the firm is improving fresh food offerings. It also seeks to embrace the digital world with a Coles app and improvements to the online sales process – based on data collected in the 'flybuys' system (the air travel points claims), Coles will email individual shoppers with a 'personalised weekly special' email. As well as striving to be cheaper than rivals, Coles wants to drive a point of differentiation with a range of products unique to it (including its high-quality line of home brands and celebrity chef Heston–based products). Suppliers will now deliver in a seven-day cycle to enhance freshness (it will also place increased pressure on many suppliers and supply chain providers such as trucking companies).

The Australian supermarket landscape is now complex and in a period of great potential change. The Coles and Woolworths strategies challenge the IGA system on many fronts: price, marketing power, digital reach, supplier control and coverage of markets. Metcash is marketing on price just to stay in the game and must claim localness to keep market share. Will the IGA system continue to wither? Meanwhile, Aldi is expanding into the market share of all the other players – when will their expansion end, if ever? Will Woolworths ever regain the ascendancy over Coles? And how much, if any, market share will it lose to Aldi?

Notes

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