

Small & Green

When Tesco opens its first Fresh & Easy Neighborhood Market in the U.S. this fall, it could be ideally positioned to take advantage of four of the most significant trends impacting the retail marketplace today: 1) The apparent end of retail consolidation; 2) fragmentation of consumers and retail formats; 3) shoppers using a portfolio of formats to meet their needs; and 4) natural foods, energy efficient processes and an environmental message.

Let's look at each of these trends and how Tesco will try to capitalize on them in the U.S. marketplace.

Consolidation. The U.S. retail landscape continues to consolidate, but the rate of consolidation is slowing dramatically. From 2000 to 2003, the top 10 U.S. retailers were responsible for approximately 50 percent of all the growth in its retail landscape. Forecasted forward between now and 2010, that number will be almost cut in half.

The most important factor is Wal-Mart's marked growth slowdown. By 2011, Wal-Mart will have a higher share of total US retail sales than it will of U.S. retail growth. We expect Wal-Mart to continue to grow from 2007 to 2012, but at a rate that is not significantly higher than its share.

This leads to a present-day U.S. retail landscape where there is *no correlation at all between a retailer's existing size and its ability to grow*. The implication with respect to Tesco is that a small retail company can be beautiful. The U.S. has become a landscape where smart retailers, not big ones, grow.

Fragmentation. The U.S. marketplace continues to increase in diversity — ethnically, demographically, and from an income-distribution perspective. This seems to be fueling diversity in format growth — particularly when we look at forecasted U.S. channel growth over the next five years.

The quieter — but more significant — change in the U.S. retail landscape has come from the regression of channel growth rates toward the mean large-chain average growth rate.

According to our proprietary global retail database, from 2002 to 2006 the U.S. retail landscape saw four channels growing more than 50 percent faster than the U.S. large-chain average growth rate of 5.3 percent: Supercenter; Club; Discount (small box, limited assortment discount); and Non-store (online, catalog, direct).

From 2006 to 2010, only one format (non-store) should grow more than 50 percent faster than the large-chain average. In addition, formats that were significantly underperforming (supermarket and department stores) have seen a marked uptick in performance.

Individual retailers in those “slow growth channels” (*i.e.*, JC Penney and Kohl's in department stores; Publix and HEB in supermarkets) have shown far above-average growth rates that help re-establish channel parity in growth.

The distinguishing characteristic of growth retailers is how they *leverage this fragmenting opportunity*

in a scalable way. We have identified three core focus areas to accomplish this:

- **Demographics.** Focus on a core segment. Target is a great example of a retailer relentlessly focused on a core demographic.
- **Psychographics.** To sharpen its assortment and marketing message, Wal-Mart is working to focus on three core types of shopping behavior: 1) strong value orientation; 2) brand aspirationalists; and 3) price-sensitive affluent shoppers.
- **Shopping Trips.** Running a portfolio of formats to meet shopper needs based on trip types. Historically, this has been Tesco's strategy in the U.K. Kroger is probably the closest U.S. retailer to this today.

Meanwhile, *store sizes* are becoming more polarized. When you aggregate stores that are more than 100,000 square feet and stores that are less than 15,000 square feet, both are actually growing markedly faster than the market average.

Tesco capitalizes on key trends to conquer America.

Tesco is taking a “small is beautiful” approach with a format that is aimed at key niches of a market that can and should continue to grow. Format is actually only one way to tackle shopper segments. A number of retailers are working hard to get their stores to appeal to different types of shoppers depending on trading area.

We predict that Tesco will dramatically change its assortment and strategy by demographics to meet the diverse needs of its trading areas.

In particular, watch how Fresh & Easy manages some of its more “hardcore urban” locations, where its competitive set may not be a large-chain retailer, but a series of urban bodegas and independent markets.

Focus. The continued proliferation of the U.S. retail landscape into a variety of formats is leading to what we call a “portfolio theory” of shopping behavior. A typical shopper might visit a combination of club store, supermarket, specialty grocer and chain drug store to fulfill a variety of specific needs based on which format meets each need best.

The key factor is that a number of markets (notably Nevada, Arizona, and California) have seen a real change among shoppers in terms of their “anchor store.” Wal-Mart has rapidly expanded in these geographies with its Supercenter, which has had a consistent effect across the U.S., putting pressure on “center store” in the supermarket.

However, the most interesting variable in Tesco’s chosen geographies isn’t Wal-Mart, but Costco. Costco as an “anchor store” may change the shopper’s other portfolio of formats more than any other store—particularly when Costco is combined with a small, premium grocery format (e.g., Trader Joe’s or a Whole Foods) and a convenient drugstore (e.g., Walgreens or a resurgent CVS, in those markets).

As the number of “grocery” items on a shopper’s list gets significantly smaller, you can argue that a Costco, combined with a store like Fresh & Easy, can eliminate the need for a trip to the supermarket altogether!

Fresh & Easy might be the most interesting choice

to round out a Costco member’s shopper portfolio—a quick in-and-out shopping trip for grocery needs and a destination for prepared foods, organic/natural foods, and wine.

Green. Obviously, the time has never been better for a retailer committed to bringing natural and organic sensibilities to a broader audience. Tesco is committed to making sure that shoppers who don’t feel like paying a Whole Foods “premium” can still get access to that type of offer.

Wal-Mart has put tremendous work into building its credibility in this area through its sustainability efforts. However, Tesco appears to have a great opportunity to bring a “clean slate” to affordable retail—allowing its brand to stand for affordable environmental responsibility.

A GROWTH OPPORTUNITY

Tesco’s research into the U.S. appears to have positioned it extraordinarily well for growth. Our conservative forecasts have the retailer reaching approximately 450 stores by the end of 2010, with an annualized sales rate of approximately U.S. \$4 billion.

As Tesco continues to scale, its growth could accelerate significantly—and do not assume that it will remain limited to the Fresh & Easy format. Tesco is a multi-format operator in every market it cares about.

That said, we don’t expect Tesco’s entry into the U.S. market simply to be a run-up to Tesco buying a conventional supermarket chain. For all of the reasons above, Fresh & Easy is a well thought out and unique approach to U.S. food retailing. *Any* format developed by Tesco can be expected reflect that same uniqueness! ■



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