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Retailing in Britain: Traditional Retailers vs. Discounters

"IT'S not just the prices that are coming down on Britain's high streets: it's the share prices, profits and reputations of some of the biggest high-street retailers."[1]

"After enjoying boom conditions in Britain and America for far longer than other industries, retailers are finally facing recession."[2]

"Napoleon once stated, in derisory fashion, that Britain is a nation of shopkeepers. What he didn't expect was for the British to take this as a compliment."[3] British retailing industry stood true to its reputation for ages and by the turn of the 21st century, it grew to be one of the major sectors of the British economy. In 2001, sales from retailing industry accounted for 23% of the British GDP and employed over three million people, which translated to one in every nine employed[4] in Britain. By 2004, British retailing industry at $443 billion[5] was the second largest retailing industry in Europe after France. As the industry started maturing the traditional players faced difficulties, both, in terms of maintaining growth rate and market shares due to intensifying competition. Even iconic retailers like Marks and Spencer's, WH Smith and J Sainsbury became takeover targets by the end of 2004. Edward Whitefield, chairman of Management Horizons Europe, a retail consultancy in London, commented, "In a consumer economy where the rate of growth is tightening, the sheep will be sorted out from the goats."[6] Analysts opined that the traditional retailing giants, who contributed to the growth of the industry, were struggling to exist in the changing landscape of British retailing industry.

Retailing Landscape in Britain

The history of British retailing industry dates back to early 19th century, with small scale, independent retailers selling a limited variety of products in towns across the country. In the second half of the nineteenth century with urbanisation and development of mass production of consumer goods, particularly in consumer durables, led to the emergence of large-scale retailing – chain stores and branding of products. By 1860, such stores replaced the then existing draper[7] stores such as Shoolbred in London and JW Campbell in Glasgow, as product lines extended beyond the narrow range of drapery. This period also witnessed the emergence of food retailing activities due to the growth of Co-operative societies,[8] which originated in 1844. By 1862 there were 400 Co-operative societies which grew to 971 societies by 1881. Innovations in packaging dry foods in the last quarter of the nineteenth century resulted in the emergence of large department stores.[9] It had led to the development of regional and even national chain stores. The first chains were established by WH Smith and John Menzies, who were news paper agents.

1 "High Street woes", www.economist.com, July 26th 2001
2 "When you can't sell the goods, sell the shop", www.economist.com, January 16th 2003
3 Kalms, Stanley "Why the euro is bad for British retailers", www.ft.com, September 27th 2001
4 Ibid.
5 Cohn, Laura "Britain: The Battle For High Street Has Begun", www.businessweek.com, February 7th 2004
6 Ibid.
7 One who sells fabric and sewing materials in a shop
8 The Co-operatives emerged because of politics of sections of the working class movement which, after the defeat of Chartism, (the principles and practices of the movement advocating political and social reform in England between 1838 and 1848) led them to search for alternatives to capitalism rather than overthrowing it.
9 A large store that sells a wide range of goods through separate departments

This case study was written by G Saradhi Kumar, IBSCDC. It is intended to be used as the basis for class discussion rather than to illustrate either effective or ineffective handling of a management situation. The case was compiled from published sources.

Early department stores catered primarily to middle and upper class consumers, their location (in the heart of the large cities), size of store and product ranges ensured their vicinity to the target market. Department stores specialised in purchasing, displaying and merchandising specialised high quality goods. Selfridges or Harrods of London became synonymous with providing household goods to the rich in the late 19th century. The increasing wealth among the Britons encouraged the development and expansion of department store retailing. Vertical integration became the norm for these large-scale retailers. The manufacturers, who adopted mass production methods and the retailers, who undertook selling large quantities found the distributional networks of that time inadequate and were forced to create these networks themselves. Thus most of these early large-scale retailers had a high degree of vertical integration and also, as a result, specialised in the sale of only a very narrow range of their own-label goods.

The retailing industry in the late 19th century was characterised by formal agreements between retailers to limit price competition because of limited players operating and also because of Co-operatives whose focus was to fend off the impact of high food prices on the working class. Independent retailers and the privately owned chains restricted competition in two ways. Food retailers in urban areas like London, including chains such as Sainsbury's, entered into formal arrangements called 'pacts' to reduce price competition and horizontal competition, by restricting new stores in areas under the control of existing members. Under the pact, if any member wished to sell the stores, the existing retailers purchased it, in order to prevent new entrants from acquiring a valued site. Second way of limiting competition was restricting wholesale prices. Organisations were formed to monitor importing and wholesaling. These organisations, which included retailers with wholesaling functions, restricted vertical competition through fixing wholesale and retail prices. The Home and Foreign Produce Exchange in London, formed in 1888, and the Scottish Provision Trade Association, in 1889 were among those organisations, whose chief function was to disseminate information about other market centres in Britain and abroad and to issue weekly recommended price lists. These price lists were not mere guides to the members but were to be enforced. Reduction of competitive pressures ensured high margins and profit boosting, which in turn encouraged investments for developing distribution channels and other competitive advantages. Once these investments had infused new organisational capabilities to the big firms, the market environment could be altered to suit the competitive advantages.

The first quarter of the 20th century witnessed large-scale retailing organisations of Britain continuing with backward vertical integration into manufacturing and the manufacturers adopting forward integration to establish their own retailing outlets. "Thus by 1939 national grocery retail chains were established, such as Lipton's with its 449 stores, selling primarily tea from its own plantations, and the Maypole Dairy Co., with 977 stores, or the Meadow & Pearks Dairy Co., with 762 stores, supplied through their own dairy businesses."[10] Chains that were confined to a specific region also emerged, selling a wider range of goods. Sainsbury's, was one such retailer selling provisions under its own label with 255 shops by 1939. Sainsbury was vertically integrated in a backward direction encompassing wholesaling, manufacturing and even food production apart from warehousing and selling to customers. Other types of retailers also emerged who did not integrate, but depended on bulk purchases to derive economies of scale, such as Tesco, selling goods manufactured by other producers, utilising bulk purchasing, in order to create competitiveness. Marks & Spencer, on the other hand, depended on long-term relational contracting with suppliers to avoid the investment in clothes manufacturing. Unified relational contracting was a successful strategy for new retailing firms dealing in the narrow range of high volume goods. The manufacturers were guaranteed outlets for their output while retailers were guaranteed supply of goods to their stores. However, as retailing business increased in scale and scope, with larger stores selling a wider range of goods, the necessity for relational contracting diminished. Retailers' success depended upon the expansion of the range of products beyond what the unified relational contracting provided access to. Retailers, however, retained their control over the distribution channels – the most important ingredient in retailing. By 1950, it was estimated that 90% of groceries, which were sold throughout the nation, flowed through retailer-owned central warehouses or retailer-owned co-operative warehouses. Till the 1980s, the established retailing houses thrived in that environment, to become household names in Britain. The 1980s also witnessed an invasion of foreign retailers into British retailing which gave a tough competition to the incumbents. The foreign retailers not only challenged the traditional retailers on prices, but also challenged the way retailing was carried out by them in Britain.

[10] Morelli, Carlo "The Development of Chain Store Retailing in the US and Britain 1850-1950", http://www.dundee.ac.uk/econman/discussion/DDPE_148.pdf

Traditional Retailers Loosing the Turf

Nearly 200 foreign retailers[11] entered Britain between 1980 and 1994. Although foreign multinationals were late comers to the well-established British retailing industry, they had strong competitive advantages to oust the incumbents. For example, in cloth retailing, Gap – a cloth retailer from the US, Sweden's Hennes & Mauritz and Spain's Zara brought with them global fashions, just-in-time manufacturing and economies of scale that the home-grown retailers lacked. Leveraging on their advantages, foreign retailers redefined apparel business in Britain, as *The Economist* observed, "…….fashion is no longer all about pricey designer-brands. Gap, H&M and Zara prove that. Fashion has gone upmarket and downmarket at the same time."[12] The success of foreign retailers in the British retail arena was attributed to many factors, as Dr. Andrew Godley, Director of Centre for International Business History at the University of Reading, in one of his papers noted, "Foreign multinationals were, by definition, late-corners into the already developed British high streets. Where these new entrants were successful, they must have held some strong advantages to oust the incumbents. As noted above, these may have been superior economies in the supply chain, such as in purchasing, or logistics, or other management functions. Or they may have developed superior merchandising skills elsewhere and so simply imported better advertising or display activities and so on to a receptive British audience. Or, following the classic account of the motives for EDI in manufacturing, they may have invested in dedicated distribution channels because of some combination of genuine productivity advantages over competitors, the importance of strong presence in the important UK market, and of high transaction costs inhibiting either market entry or growth."[13]

By the 1990s, apart from the specialist foreign retailers, traditional British retailers had to encounter the domestic supermarkets[14] which moved into non-food offerings. Asda,[15] (a supermarket chain acquired by Wal-Mart in 1999), was the first to expand aggressively into areas like stationery, videos and CDs and clothes designed by George Davis.[16] The huge volumes and relatively lower range of supermarkets enabled them to undercut the price being offered by general retailers. A survey conducted by Goldman Sachs in April 2001 revealed that at Tesco, a basket of DIY (Do-it-yourself) prices of goods were 46% lower than the average DIY retail prices. At B&Q (a large DIY chain) prices for the same were 58% higher than average. The foray of supermarkets into the general retailing goods had intensified the competition. The supermarkets diversified from groceries into selling their own branded general household goods like shampoos, toothpastes, newspapers, magazines, books and everything from £30 DVD players to £4 denim jeans. To fend off the competition and to protect their ground specialised retailers improved their products. Boots for example, released its own range of 'natural' creams and soaps to counter the increased competition from Body Shop (which sells cosmetics made from natural products). Supermarkets' foray into general merchandising transformed the British shopping habits. In 1999 only about 8% of Asda's customers bought clothes, but by 2004 one third of them purchased apparels. At Tesco, by 2004, revenues from the non-food merchandising had doubled in ten years. Supermarkets, apart from expanding themselves, made sure that their customer service was superior, by installing modern technologies to enable their backrooms to know and respond quickly to the needs of customers at the front-end. Another important outcome of the timely information sharing was lowering of average inventory,[17] which in turn decreased working capital requirements leading to lower costs.

Observers analysed that the steady flow of customers was a built in advantage for the supermarkets, which was exploited to lure the grocery shoppers to buy household articles by offering them at low costs, as *The Economist* observed, "Stationery is cheaper in supermarkets. Newspapers and magazines, Smith's traditional staple, are the same price in supermarkets; but why go to WH Smith when you're in Tesco for your groceries anyway?"[18] Taylor Nelson Sofres (TNS), a market–information consultancy, estimated that by 2004, Asda was selling non-food goods (excluding petrol) worth over £2 billion a year, against £8.5 billion[19] of food and drink. The consultancy also estimated that by 2004 the big three Tesco, Asda and J. Sainsbury were selling 5% as much as the rest of Britain's retailers put together in non-foods items. They leveraged on their buying power to keep prices down. "Price cuts? Who needs them to beat Boots? Ten Gillette Blue-II razors cost £2.45 at Sainsbury, £2.49 (in a pack of 20) at Tesco, £2.69 (currently cut to £1.99) at Superdrug—and £3.52 at Boots."[20]

[11] Godley, Andrew "Foreign multinationals and innovation in British retailing, 1850-1962.(Industry Overview)", www.highbeam.com, (*Business History*), January 1st 2003
[12] "By George", www.economist.com, September 23rd 2004
[13] "Foreign multinationals and innovation in British retailing, 1850-1962.(Industry Overview)", op. cit.
[14] A large self-service retail store selling primarily food and grocery
[15] By 2004 Asda was the second largest super market chain, on the basis of revenues, after Tesco. Standing third was J Sainsbury.
[16] Renowned fashion designer and the founder of apparel retailing chain *Next*
[17] In Britain, the big supermarket firms cut the average size of their inventory from 5.1 weeks' worth of stock in 1980 to 1.5 weeks in 1996. They achieved this by providing sales data from their tills directly to their suppliers, so that timely deliveries could be made.
[18] "The grandees fall behind", www.economist.com, January 8th 2004
[19] Ibid.
[20] Ibid.

To meet the competition, traditional retailers relied on discount sales. However, market watchers believe that they cannot sustain on discounts in the long term due to their cost structures. They say that the trick in discounting is not squeezing as much as the retailers can out of their supply chain and cutting prices across the board, but the ability to decide where the prices must be cut. Market watchers advocate that people notice price changes in the products they frequently require, such as eggs or disposable nappies. For the goods that the customers pick up as a convenience while they step in to a store, like toothpaste or deodorant, are less price sensitive.

Besides the competition from the discounters, traditional retailers were hit hard in their staple apparel business in which prices started falling continually. By 2004 the real price[21] of a jacket, for instance, was 30% less than it was ten years earlier. As most of the appareal production moved to low-cost countries, there was not much to be saved out of the supply chain. In this scenario the retailing chains which operate globally, were benefited as they could charge a premium for their global fashion perspective and they also could leverage on their global networking to minimize costs. Further, the discounters, with their inherent lower costs, were undercutting the department stores by offering chic clothes at low prices. According to Kellogg's Professor Blattberg, another major factor favouring the discounters was the trend towards casual business wear. This trend had a huge impact on the sales of formal clothing, which had been a staple apparel line for traditional department store. "People simply don't buy as many suits or ties as they used to."[22]

One more factor that affected the traditional retailers was a sharp decline in overall spending of the customers (Exhibit-1). It was noted that as major chunk of customers who drove the markets traditionally had grown older, the spending got diversified into a variety of services like education of their children, vacations, healthcare expenses, insurance and other services. This reduced the household budget for general merchandising. Consequently, the customers moved towards discounters, meeting their budgetary constraints compared to the high streets.[23] Strong pound also played its part by adding to the woes of traditional retailers. On one plank, high value of the pound increased rents and services, on the other, it made imported goods cheaper, which lured customers.

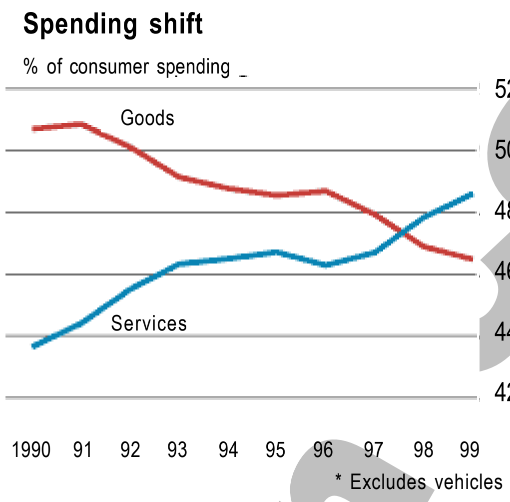
Mounting competition unearthed the weakness in traditional retail management. Many chains over-expanded, but, as some of the country's biggest employers, they could not close shops and fire people, fearing public backslash. As a result, profit margins dipped, even though sales increased. Gross margins in retailing fell from 30.1% in 1994 to 26.5% in 2000. The British retailers were ill-equipped to operate in such competitive environment, as the decision makers in British retailing industry who rose up the ranks from the buying departments, lacked customer perception. According to Richard Hyman of Verdict, a British retailing consultancy, "Old-guard retailers are a victim of their own success. They are not equipped to deal with this new focus on the consumer."[24] On-line trading started increasing in Britain in comparison with other countries (Exhibit-2), as price and convenience of buying round-the-clock attracted the customers.

Decreasing profits, which in turn reduced the share prices, made many British retailers vulnerable to takeovers. In 2002, Arcadia Group, which owned women's apparel stores such as Topshop and Dorothy Perkins, was taken private by retail entrepreneur Philip Green. In 2003, mass-market department store Debenhams, high-end department store Selfridges, and women's retailer, Oasis Stores were taken over by a consortium of private-equity firms called Baroness Retail, led by CVC Capital Partners and Texas Pacific Group; Wittington Investments of Canada; and Noel Acquisitions, owned by Baugur Group, Iceland's retail investment group. In the same year retail private equity deals in Britain amounted to $5.2 billion. The amount was 49% greater than the amount in 2002.[25] In 2004, till May, Britain had witnessed $2.2 billion worth of such deals.

Analysts predict that many other British retailers would fall prey to mergers and acquisitions. Commenting on the takeovers, Richard Hyman, chairman of Verdict Research Ltd., a retail consultancy in London, said "There will be quite a bit more of this, the environment is right, and it's ripe."[26] Bankers opined that possible future targets include Marks & Spencer Group PLC and Woolworth's Group PLC. Cost cutting through mergers and acquisitions is believed to be a means, in order to keep profits growing. Richard Hyman, observed, "The retail industry is maturing. Operating-cost inflation is outpacing retail-price inflation. The only response is to raise volumes, either by pinching market share or buying it."[27]

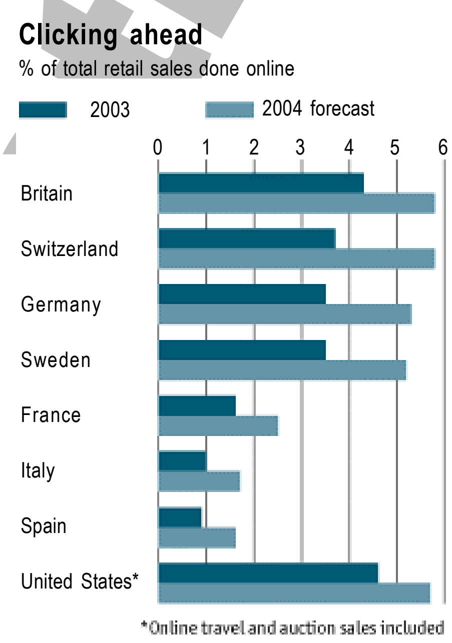
21 Existing Price adjusted for inflation
22 "Reinventing the store", www.economist,com, November 23rd 2003
23 In the United Kingdom, a principal street where the main stores are located is called high street. Traditional retailers have their stores in these localities
24 "High Street woes", op. cit.
25 Cohn, Laura "Reinventing British Retailers — The Hard Way", www.businessweek.com, May 10th 2004
26 Ibid
27 "When you can't sell the goods, sell the shop", www.economist.com, January 16th 2003

Exhibit-1
Spending Patterns in Britain



Source: "Shopping flopping", www.economist.com, January 11th 2001

Exhibit-2
On-line trading in Britain compared to other countries



Source: "Windows shopping", www.economist.com, January 22nd 2004