

Strategic corporate development at tesco



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The food and retail sector represents the biggest industry in the United Kingdom, providing employment to more than four million people in production, manufacturing, retailing and distribution. Retail sector accounted for 9% of the GDP of the country in 2003 (Datamonitor, 2003). In last few years, UK's supermarkets have been under increasing scrutiny in regard to their treatment with suppliers, in own-label products, still the development of supply networks in the country had been an integral part of supermarket strategies in the past decade.

Tesco is the third largest food retailer in the world, employing more than 400, 000 people. The company also provided online services by a channel operated by its subsidiary, Tesco. com. United Kingdom has been the company's largest market, in which Tesco operates under the names of Superstore, Metro, Express and lastly Extra. The report below gives the insight into the strategic development of the company from the past, in the present and for the future. The report also emphasis on resource analysis and external environment analysis with the view of getting the insight into company's strategic scenario.

Part 1: Strategic Corporate Development History

The first store of the Tesco was opened in North London in 1929. Since that time, company had grown with reflection towards changing in retailing.

Tesco began listing on the stock exchange in year 1947 with initial price of 25p per share. Since then company had started becoming familiar name in the streets of United Kingdom and Tesco was able to take added advantage of operating economies of scale by purchasing bulk of the supplies. The

company also used strategies to for building customer loyalty along with the usage of stamps that were exchanged for cash and goods.

Tesco chose to pursue SBU structure across all its business areas for maximizing the degree of competitiveness along its individual market areas. The Strategic Business Unit covered the strategic foundation; scope of operation; products and services sold and their variety; strategic thrust; service quality; brand identification and image for products and services; functions performed by Tesco; distribution outlets; geographies served and financial targets.

The company operated within four SBU's namely, Core UK, handling UK's grocery operations, International, handling international holdings, Non-food, handling sales of electronics items, home goods items and other non-food items in the Tesco Extra and other company stores, and Retailing Services, managing financial services, the website Tesco. com along with Tesco Telecoms services.

Strategically analyzing the company from 1992, it is noticed that the Tesco faced following difficult conditions in UK market in 1992

Lower population growth

Lower food price inflation

Saturated and well-developed supermarkets market in the United Kingdom

Increased difficulty towards getting permission for big Greenfields sites

Strong competitors within UK (Asda, Safeway and Sainsbury)

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Market position of number two (16. 7%) after Sainsbury (19%)

The launch of 2 new store formats i. e. Warehouse clubs and limited assortment stores.

Also going through the tough time of above said problems, the company turned on dramatic growth spurt, with total group sales compound growth rate of 12. 9% per year till 2004, adding £24. 4 billion in sales within the period.

The above graph shows Tesco's sales over the period of 14 years from 1991 to 2004. Despite going through so many challenges in 1992, the company emerged as an industry leader in UK and world's number three retailer. The sales of the company grew from £7. 1 in 1992 to £30. 8 in 2004. Tesco is an international grocery retail chain that is based on the United Kingdom. It is the fifth largest retailer in the world, with over \$80 billion in sales and 2, 800 stores in 13 countries. Tesco originally specialized on food but later on expanded to selling clothing, electronics, and internet and financial services (TESCO)

Mission

Tesco aims to “ create value for customers to earn their lifetime loyalty”[9]. The company claims that their success depends on their consumers and their employees. This is the reason why Tesco is making a regular effort to understand the needs and wants of their customers and staff, and learning to respond onto these.

Positioning

Low Price Strategy: Tesco believes that consumers want value for their money, and this is the reason why they try to keep their prices as low as possible, without sacrificing product quality. Between 2000 and 2005, they were able cut their prices down by 15%. The company claims to sell its products based on a national price list which is available on their website.

Customer relationship management

Tesco claims to make a regular effort to understand the needs and wants of their customers, and learning to respond onto these. This strategy has helped them tailor their products and services to changing consumer needs, such as an increasing concern for health, a growing number of working mothers, etc. They are able to do this by having annual forums which they call “ Customer Question Time”. Twelve thousand customers attend these yearly meetings and give their comments and views on Tesco’s products, services, pricing, and quality. Also, they have a customer service help line that consumers can call for important matters.

Five Store Formats

Unlike the “ one size fits all” strategy of Tesco’s main competitor Wal-Mart, Tesco appeals to upper, lower, and middle income consumers, calling it, “ an inclusive offer”. Tesco offers five different store formats, each tailored to fit their various consumer needs and complement their lifestyles. These include Extra, Superstore, Metro, Express, and Home plus. These stores are 60, 000 square feet in size. They aim to be a one stop destination store and so they sell food and other items such as electronics, clothing, beauty products, seasonal products, and hardware. · Superstores. These traditional-sized

supermarkets (20-50, 000 square feet) emphasize on food, but also sell various products. The store's product line is extended on a regular basis. · Metro Stores. These small sized supermarkets (7-15, 000 square feet in size) sell ready-made meals. They are located at the center of the city and cater to busy customers. · Express Stores. These convenience stores (3, 000 square feet in size) emphasize on produce, alcohol, and fresh-baked goods. The stores are located near residential places and corporate offices, aimed to offer convenience to nearby residents and employees home. These stores are 35-50, 000 square feet in size and emphasize on non-food products, including clothing. (TESCO)

Traditionally, local players tend to dominate in their home markets. Wal-Mart, the world's leading retailer, has about 8% of the US\$ 2, 350 billion market in the USA. Similarly, Tesco has a market share of about 13% in the US\$ 406 billion UK market. The main value propositions that most large retailer posses are a combination of low price, ' all-under-one-roof' convenience and ' neighborhood' availability. Globally the grocery portion accounts for close to 40% of all organized retail sales. In the global scenario grocery also includes items like fish and meat. (Planning a Retail revival)

The US\$ 9 trillion Retail industry is one of the world's largest industries and still growing. 47 of the Global Fortune 500 companies & 25 of Asia's Top 200 companies are retailers. Even as the developing countries are making rapid strides in this industry, organized Retail is currently dominated by the developed countries with the USA, EU & Japan constituting 80% of world. (Global retail Business) Retail is a significant contributor to the overall economic activity the world over: the total Retail share in the World GDP is <https://assignbuster.com/strategic-corporate-development-at-tesco/>

27% while in the USA it accounts for 22% of the GDP. The share of organized Retail in the developing markets ranges between 20% to 55%.

Part 2: Current Strategic Situation

Tesco is a company with superior management skills, market positions and asset quality. However, over the last two years management have been concerned about 1) Tesco's ability to confront improved competition in the UK, 2) the risk that the UK would follow other markets into deflation and 3) the high capital intensity both in the UK and International, the latter becoming more apparent as LFLs weakened.

Over recent months these three risks have abated or disappeared:

- The UK has escaped from deflation, contrary to our expectations six months ago.
- Tesco has fully closed the gap in sales growth with the other Big 3 after two years of underperformance
- International LFL is stabilizing as the base eases and the local economies recover. We believe LFL was already positive at the end of the year in countries such as Ireland, Korea, Thailand, Turkey, China and Poland.
- Analyst expect UK capex to fall significantly from 2010, boosting free cash flow generation after two years of no free cash flow in the UK. This will allow the group to reduce net debt by about £1bn per annum

Tesco has been underperforming the other Big 3 for most of the last two years. In a couple of instances in 2008 it closed the gap but it widened again

later on. On the current situation analyst believe that the recovery can be attributed to the doubling of the loyalty card rewards and the advertising initiatives around it.

A key question is whether Tesco will maintain its double Clubcard points beyond the summer. When the loyalty card points were doubled last 17 August, the company didn't specify if the offer would be temporary or permanent. The company now says that the double points have been extended until the summer. There is a believe that the offer has helped lift LFL growth by 150-200bp, but estimates suggests that this is below the 300bp estimate which is needed to make the investment profitable ceteris paribus. Tesco funded the majority of the cost with cost savings including £100m in energy, c£100m supply chain productivity and c£100m in store labor productivity.

Current Competition Analysis

In the last couple of years Tesco's LFL performance has been solid in absolute terms, particularly in the context of the depressed growth by peers on the Continent or the US, but its growth has fallen behind that of the other big 3. Does this create a problem? Analyst thinks not, unless the underperformance was to continue. Despite the limitations covered in the previous section in terms of population penetration and normalization of competition, it is believed it is important that Tesco does not let its key competitors fully close the sales density gap it has built over those 15 years. Management believes that sales densities are the main lever of value creation and also the main lever of competitiveness in bidding for new sites. Sales productivity in summary allows companies to bid more for sites and

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sell groceries for less. It is ultimately what has allowed Tesco to sustain a superior ROIC in the UK at 17-18% pre-tax for many years while other players were not matching the cost of capital. Analysts believe that the superior ROIC will not be sustainable without the superior sales productivity.

The main factors distorting the comparability of sales densities across the different players are petrol and non food. So my analyses have attempted to exclude petrol sales and non food sales and space from the calculation.

The main highlight from the rapid catch up of Morrison, which has gone from selling 30% less food than Tesco per sq ft in 2003-04 to just 10% less at present. Sainsbury has also made good progress – over the same period, it has narrowed the gap from 20% to an estimated 12.5%. From one estimate that Asda is roughly at the Tesco level, based on publicly available sales and space data. As mentioned, analysts think that it was inevitable that this gap would narrow at some point. However, it is important, in management's view that it doesn't close much further as it is the foundation for higher ROIC and higher margins. In conclusion, Tesco has best in class sales densities, best in class margins and best in class ROIC in the UK. The differential versus peers has inevitably narrowed in the last few years, but it is important that it maintains superior sales densities and operational excellence if it wants to maintain its high margins and ROIC. In this respect, it is important and positive to see that Tesco has stopped underperforming the other Big 3 in the UK.

The working capital inflow of £700m would be particularly impressive and, if confirmed, can be attributed to the impact of CFO Laurie McIlwrie and his

useful logistics background in bringing down inventory levels. Management understands that the back rooms are emptier than ever and that this is somehow related to Tesco using the top of the shelves to stock the product (there has also been an unexpected benefit in availability and employee productivity). The reduction in inventory levels can also be explained by the ongoing experience and learning in non food management. Analyst believes Tesco would like to regain the balance sheet flexibility it used to enjoy until the acquisitions of Homever and 50% of TPF and it will aim to continue reducing net debt by c£1bn again in 2010/11.

During 2009, everyone was concerned about Tesco's international sales, which were affected by macro factors in Ireland and Eastern Europe mainly. LFL sales have been falling by c6-7% between calendar 4Q08 and calendar 2Q09. In 3Q09 LFLs improved to -3.7% and in the more recent Christmas trading update analyst estimates LFLs improved further to c-2%, on a lower base. However, as LFLs improved, the contribution of new space to sales has come down, partly explained by the fact that space growth in 2009/10 is particularly weighted to the end of the year. Management estimates that the contribution of new space opened in the last 12 months to total sales growth has fallen from 15% in 2008/9 to 6%. Of this, analyst estimate that 6 points is related to the cycling of the Korean acquisition but there is still an underlying slowdown, partly related to the phasing of the openings, as mentioned earlier.

According to TNS Kantar, the Company had gained the market share in Ireland at the Christmas while the Dunnes Stores, that had an exceptionally strong 4th quarter in FY08 based on the intensity of an aggressive value club

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promotion, became the biggest loser. The twelve-week period saw a significant 6% drop in the total value of the country's grocery market to €2.1bn however, based on TNS comments, analysts believed Tesco had ended the year with positive LFLs. Aldi and Lidl increased their share from 7.3% to 8.3%. The average household in the country spent €1,355 in the market on the twelve-week Christmas period, a dropdown of €139, or 9.3% considering the same period an year ago. Of this 9.3% of reduction, TNS estimated that 5.9% was directly linked with a fall in the prices of products with the remainders due to customers buying cheaper alternatives. Cross-border shopping had also seen a slight reduction.

Part 3: Strategic Decision for the future

Company is quite realistic about the fact that it cannot grow food sales at the pace of the last decade. Tesco's growth during the last 15 years has to be seen as exceptional as it was possible to a great extent thanks to the consistent failure of other companies such as Sainsbury, Safeway and Somerfield/ Kwik Safe. However, these companies are now either well managed or in the hands of well managed companies, and are no longer the easy source of market share they used to be, rather the contrary. Analysts also believe, based on the experience in other markets, that in large markets it is difficult (costly) to grow market share above c33%. Tesco already reaches c90% of the UK population compared to Morrison and Sainsbury in the 60-70% range. It is becoming more difficult to grow without cannibalizing sales. Increasingly, the way to grow profitably is to sell other stuff (non food and services) to existing customers rather than by attracting many more new customers, which the company obviously acknowledges. Tesco is

growing sales not by capturing many new customers but rather by selling more to existing customers. This can be done via store openings, which can lead to some cannibalization, and by selling non food (via extensions and online) and services, which is the primary focus of Tesco's growth.

In my view, Tesco is already market leader in a majority of the countries where it operates and the profile of its LFL growth (and those of its competitors) in countries such as Ireland, the Central European ones or Korea and Thailand, where over 80% of the capital invested is concentrated, is not typical of immature countries. The infrastructure can indeed be diluted by expanding the network but LFLs do matter because growing sales densities is the most effective way to dilute fixed costs, better than opening stores. Weak LFLs also matter when other competitors perform better. LFLs matter because when a business expands space rapidly, it should have positive LFLs just to avoid a decline in sales densities. For example, a business expanding space by 15% analysts believe should report LFLs of at least 3% just to keep sales densities as the space opened the year before should be enjoying LFL growth of c20% through the typical maturity curve. In addition, LFL growth is normally needed to match cost inflation and keep profitability. A decline of ROIC is not so concerning if it affects all players in the sector. Analysts believe that the profitability of most players in Ireland and Central Europe has come under pressure. However, there are some exceptions such as Biedronka in Poland and BIM in Turkey, the respective market leaders. These companies have continued to report very solid LFLs and expand aggressively.

Tesco chose the traditional hypermarket (French style) and supermarket formats for its international expansion versus the German type of limited range discount. One can argue that the wide range traditional hypermarket and supermarket model can become a bigger business and that the limited range discounter is more of a niche type of model. Management in future would of course agree that a hypermarket covers more consumer needs and allows you to sell a lot more than just food but analysts would disagree with the view that a discounter cannot become large. In Germany, discounters (mainly three players) account for over 40% of the food sold in the country. In Poland or Turkey, the market leaders are limited range discounters. Management is of the view that the different levels of discounter penetration across countries is not so much a matter of differences in tastes but rather mainly explained by the ability of a given company to build a competitive advantage at an earlier stage. Most of the analyst agree that the size of the discount segment as a whole will always be smaller than the non-discount altogether but a dominant discounter can be the market leader, like Biedronka or BIM are. Tesco does recognize the need to accelerate asset turns and has the ambition to shift its growth in Central Europe in favour of LFL and not just space. In this context, Tesco's new space in the region is increasingly driven by smaller formats, which achieve better returns.

Analysts view Tesco's expansion in the United States with a different format as a positive. At this stage management are not 100% sure about how well adapted the concept is to the local markets and whether Tesco will succeed or not in the end but analysts applaud Tesco's out of the box thinking and its decision to use a differentiated, capital light, limited range format, which has

proved quite successful in Europe in its different versions (Colruyt, Mercadona, Pingo Doce).

International sales were perhaps slightly below market expectations, up 11.9% on a reported basis and 5.3% on a constant currency basis. This included, however, some considerable disruption in Asia due to the curfew in Thailand as well as the Korean situations, both of which impacted sales over a prolonged period and resulted in slightly negative LFL sales over the quarter. Sales are believed to have since recovered and the exit rate is positive. A similar adverse impact was seen in Europe in Poland during the two weeks of mourning for the President, but a strong recovery in Ireland helped to deliver a slightly positive LFL over the quarter. The US business reported Q1 growth of 37.8% (+40.6% constant currency). This is below the stated 50% full year target, but management has reaffirmed that the US is on plan.

A key question is whether Tesco will maintain its double Clubcard points beyond the summer. When the loyalty card points were doubled last 17 August, the company didn't specify if the offer would be temporary or permanent. The company now says that the double points have been extended until the summer. Analyst believes that the offer has helped lift LFL growth by 150-200bp, but it is estimated that this is below the 300bp analyst estimate is needed to make the investment profitable ceteris paribus. Tesco funded the majority of the cost with cost savings including £100m in energy, c£100m supply chain productivity and c£100m in store labour productivity. Management also assume that Tesco reallocated promotions and other marketing budgets to fund this investment, hence it is very difficult for us to

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say if the initiative has been worthwhile or not. But there is believe that it is probably too expensive for it to become permanent and the question will be how sticky the incremental sales captured will prove.

In conclusion, Tesco has best in class sales densities, best in class margins and best in class ROIC in the UK. The differential versus peers has inevitably narrowed in the last few years, but it is important that it maintains superior sales densities and operational excellence if it wants to maintain its high margins and ROIC. In this respect, it is important and positive to see that Tesco has stopped underperforming the other Big 3 in the UK.

Some commentators in the market are of the view that Tesco's international ROIC will go up because the operations are immature and, as scale continues to be built, the company will be able to dilute the large investments made in infrastructure. Some people also believe that international LFL is not the best indicator of underlying health given the large expansion being undertaken by the different players. A decline of ROIC is not so concerning if it affects all players in the sector. Analysts believe that the profitability of most players in Ireland and Central Europe has come under pressure. However, there are some exceptions such as Biedronka in Poland and BIM in Turkey, the respective market leaders. These companies have continued to report very solid LFLs and expand aggressively.

Committing less capital allows a company to operate with a lower EBIT margin and still make a satisfactory return. Lower build costs should also mean lower maintenance costs. Furthermore, because of its limited range, Biedronka concentrates its purchasing power into fewer SKUs (c800 SKUs or

€4. 6m sales per SKU in 2009 against Tesco which may sell 30, 000 SKUs or €0. 07m per SKU). Tesco does recognize the need to accelerate asset turns and has the ambition to shift its growth in Central Europe in favour of LFL and not just space. In this context, Tesco's new space in the region is increasingly driven by smaller formats, which achieve better returns.