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Big Impact in a Small Format

A New Wave in Retail

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After years of hype about "big-box" retailing, we see an increasing number of small-format success stories around the world. They range from convenience stores, such as JB Beaumont in Britain and Oxxo in Mexico, to discounters, such as Germany's Aldi and EKI Descuento in Argentina, which sell staples and key grocery items in a cost-effective neighborhood format. Although big-box retailers are doing well in key Asian markets such as China, so too are convenience stores, which target unmarried people, small families, and working people.

The renewed interest in small formats may soon extend to the United States as well, where big retailers, including Wal-Mart and Publix, are experimenting with the form. European retailers such as Britain's Tesco also are making pushes into the U.S. market with convenience-type stores, and if they are successful, they will ratchet up the pressure on American retailers to follow suit.

There are a number of reasons for the increased global interest in smaller formats. Primary among them is that the consumer experience in massive retail establishments is becoming increasingly unattractive. The time it takes to negotiate the seemingly endless aisles is a drawback to harried shoppers—and it's made worse by the crowds at the checkouts. The size of the store also diminishes personalized service and doesn't allow for a product assortment tailored to a particular demographic niche.

This is true both in more mature and in developing markets. Demographic changes in more advanced economies are resulting in more single-person and smaller households, whose members are less interested in a weekly trip to stock up and prefer to shop more often for fewer items. These more affluent shoppers are demanding more and more convenience. Europeans returning from work, for example, want to be able to buy their necessities at stores between the train station and their home, and don't want to have to travel to big-box stores that may be geographically remote. Proximity is king.

In less-developed parts of the world, lower-income shoppers find that they are not comfortable in large stores because the service is less personal and the broad assortment of products drives home how little they can afford. Furthermore, getting to large stores, which are often located far from city centers, is difficult for this group of shoppers, who have to spend money to get there and may even lose hourly wages if it's truly out of the way. Going farther to a bigger store is only a good value, in terms of the total cost of purchase, if the big store offers substantially lower prices—and even then, the resulting savings for a relatively small purchase are usually not enough to offset the cost of transportation and the hassle.

Quite aside from what consumers want, retailers and consumer goods manufacturers are finding that smaller formats are a necessary part of their retailing footprint for a variety of very practical reasons. They are learning, for example, that in smaller formats they are better able to tailor the assortment of goods and the display of those goods. This control allows for a greater sense of intimacy with their customers.

Simply through human contact, small-format retailers can detect shopping behaviors, which may lead them to offer new services, such as store credit or other financial services. Big-box retailers capture extensive data from shoppers' checkout baskets and combine that information with demographic data from the surrounding geographic area to make merchandising decisions. But if owner/operators have personal knowledge of shopper behavior and expectations, they can create a different interaction and improve their customers' shopping experience.

Governmental and economic forces also are at work. In some countries, smaller-format stores are necessary because of regulatory constraints. In Germany, for example, regulations prevent retailers from opening stores larger than 700 square meters (approximately 7,535 square feet) in residential areas. And the value proposition offered by smaller-format stores has shifted; they are no longer always saddled with higher prices or lesser quality. Savvy operators of chains of smaller stores are able to achieve efficiencies of scale in procuring their merchandise and then to use distribution channels that have been much improved by computerization and advances in supply chain logistics.

The Rise of the Small Format

As a result of this confluence of trends, smaller formats are being seen for the first time as offering great potential for cost-effective innovation. They are simply more flexible than their big-box counterparts. Owner/operators can quickly change the product offerings, the display of goods, the layout of the store, and the marketing materials, such as signs or flyers.

Smaller formats allow for far more business model innovation than do larger-format stores, which tend to be more expensive and more difficult to adapt to changing customer tastes. Consider how adaptable Aldi has been. It started out as what Germans call a "hard discounter" because it offered the lowest-cost goods, in many cases at prices 20 percent below those charged by traditional retailers.

That was fine for the initial stage of Aldi's expansion. But it discovered a demand for more upscale products and expanded and upgraded its selection. It also expanded into nonfood items such as household staples.

What makes the small-format trend so interesting is that it is gaining traction in Europe and Latin America, which differ greatly in both demographics and income levels, and it also is gaining in different types of smaller retailing environments. The distinction that retailing experts make between convenience stores and discount chains is that the former attempt to tailor the mix of products to the widest possible range of needs; price is not always the paramount consideration. Discounters tend to have slightly larger formats and concentrate on driving down costs in a narrower range of products for more cost-conscious shoppers. These distinctions are blurring in many markets but still provide a useful framework for analysis.

First, consider two examples of how convenience stores have been successful in these markets. JB Beaumont, a convenience store operator in the United Kindgom's East Midlands, saw less-than-stellar sales in its six stores—and recognized an opportunity. Changing demographics in the region, such as smaller families and more single-person households, were creating a valuable segment for a retailer that could provide a broad array of products in a format suited to these groups.

To cater to their needs, JB Beaumont began offering both takeout meals and meals that a family can prepare at home with minimal effort. It added cold beverages that can be consumed immediately; traditional grocery items, such as condiments, in smaller packages; and single-serving sundries, such as aspirin. In short, it moved into the middle ground between, say, a fish-and-chips shop that can provide a meal but not much else and a grocery store that can meet all of a shopper's needs but might also eat up an hour of her time. JB Beaumont's new format did so well that it attracted the attention of giant J. Sainsbury PLC, which acquired the smaller retailer in November 2004.

In Latin America, Oxxo has established around 4,000 stores in Mexico and is adding 300 to 400 stores there per year. Many stores function under a franchise-based model, usually operated by locals who are familiar with the micromarket in which the store is located and can customize service to the neighborhood's needs. Stores in neighborhoods where residents return home late at night remain open 24 hours; other stores deliver to nearby areas with high numbers of elderly or affluent residents. Oxxo is building on the region's traditional *changarros,* or mom-and-pop stores, by personalizing its service for its customers.

Oxxo, in fact, has created a new retailing business model. Store operators are not just employees; like franchisees, they receive a share of the store's profits. However, Oxxo frequently makes a large portion of the necessary capital investments to ensure consistency across the chain, such as purchasing standard shelving, microwaves, and refrigerated displays. Oxxo's store displays, layouts, and product assortment—with modern fixtures, lighting, and high standards of cleanliness—are much more appealing than those of traditional Mexican mom-and-pop stores. Oxxo's parent company also drives intensive promotional and bundled offerings by, for example, offering Marlboro cigarettes with a free lighter, or a bottle of Coke bundled with a discounted Powerade. The business model is novel—and effective.

In the realm of discount chains, German Aldi has experienced big success with its private-label merchandise. Private label, of course, refers to goods that are made under a retailer's brand name, in this case Aldi's, and sold at a discount to what the manufacturer otherwise would charge. Some shoppers don't care whether a drink is branded or has a generic cola name. They just want the best possible price. Aldi has adroitly addressed the market with private-label goods. As a result, Aldi has become the leading retailer in Germany in terms of growth rates and average spend per shopper, growing faster than hypermarkets and supermarkets.

The small discount format is also starting to flourish in Latin America. Argentina has led the charge with Dia, the chain of discount stores owned by the French supermarket giant Carrefour, which has been driving this format globally. EKI Descuento, an emerging local competitor with a similar discount format, has grown to around 150 stores. The format has two key differences from what is common in Europe: It is targeted at middle-income and lower-income consumers, offering a more basic assortment of staple products, and it stocks mostly leading brands, as opposed to private label. Interestingly, lower-income consumers value leading brands as a way of providing quality products to their families with their limited incomes.

The Future of Small

The common theme seems to be consumption "on the go." Small formats seem to be working in virtually all European market segments, and there is great diversity in those smaller stores; but in Latin America, the growth in smaller retailing is aimed at the low-income consumer, and there are fewer format types that are effective.

The big question is whether the U.S. market is ready for a shift toward smaller formats after so many years of emphasis on big-box establishments. In grocery, for instance, industry analyst Planet Retail and Booz Allen Hamilton have found that large-format stores capture 80 percent of retail sales in the United States, a number significantly higher than in the vast majority of other markets in the developed world.

European retailers, such as Tesco and Aldi, may be the first to test the U.S. market for its receptivity to smaller formats. Tesco, for example, plans to enter the U.S. market with 100 convenience-type stores of roughly 10,000 square feet under the Fresh & Easy Neighborhood Market brand. Those stores are slated to open in 2007 in Arizona, Nevada, and California. The company has conducted extensive research by sending a team to live in American homes and examine their purchasing patterns.

One major conclusion of that research, according to Tesco CEO Terry Leahy, is that “no one store gives [American shoppers] everything they want. You would think it is the home of the one-stop shop, but it’s not. I think they feel the one-stop shop—the big-box retailer—doesn’t quite do it on the food quality, the fresh food.”

We believe that for U.S. retailers like Wal-Mart, Target, and Publix to find the next leg of growth and escape the market saturation they are now suffering, they will also have to consider smaller formats as key channels in their overall retailing models. Wal-Mart is considering stores as small as 20,000 square feet, about one-tenth the size of its Supercenters; Whole Foods Market is experimenting with a concept called Whole Foods Market Express, which it is testing in Boulder, Colo.; and other large retailers are rumored to have similar projects in the works.

Just as retailers need to respond to the pressures for smaller-format retailing, so too do American consumer goods companies. Most consumer products companies have focused on big-box retailers—the most famous example being Procter & Gamble’s work with Wal-Mart to create a seamless flow of P&G goods to Wal-Mart’s shelves—and paid much less attention to small formats.

But they should give proper weight to small formats when engaging with their customers, which are the retailers. They need to improve their understanding of shopper demographics and behaviors for particular geographic micromarkets. They may have to adapt and tailor their business model, in such areas as how they go to market, how they price what’s offered, and how they deliver it. Consumer goods manufacturers are also learning about price points and price resistance. For them, small-format channels are an increasingly important part of their overall retailing “footprint.”

In emerging markets, we believe innovation in small formats will be the key wave of the coming years. Formats that allow chains to serve low-income consumers in a manner that is cost-effective and tailored to their needs will be winners: for example, new formats that allow the purchase of branded products in bulk, so the consumer can buy small quantities without the packaging.

The “next big thing” in retailing isn’t going to be big at all—it’s going to be small. That should restore a healthy balance in how retailers and manufacturers reach out and satisfy the ever-shifting needs and tastes of discerning shoppers.

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