

JOE BERRY AWARD 2023

ENTRY – JBA23-016

Topic: 4A - Optimizing Retailer Pricing Strategy

Presentation # 4

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Executive Summary

Though the pandemic concerns are receding, we still face numerous factors⁷⁸ that will continue to exert pressure on cost, margins, and wallets. With another 12-18 months before prices stabilise,⁷⁹ the IMF predicts that by the end of 2023, a third of the global economy will experience recession.⁸⁰

Although Australia might escape economic downturn, the Reserve Bank forecasts unemployment to rise, real wages to lag behind persisting inflation⁸¹ and the economy to stagnate.⁸² This is a perfect opportunity for discounters (Davids) to challenge traditional retailers (Goliaths), as after all, a weekly shop is where customers have more control over their budget.

This paper explores some of the unintended consequences of changes to retailers' pricing strategies:

- Why low-price is not the only consideration for customers.
- How short-sightedness now, can cost Goliaths in the future.
- Why losing the value-equation equilibrium could be the death knell for both consumer brands and Goliaths.

A multi-pronged approach, tailored to customers' unique value needs, is key to optimising pricing strategy that maximises the "three-way win". The following strategies must be combined for success: Key Value Items, Value-Based Pricing, and a Loyalty Program.

Three factors are critical to implementing the recommendation:

1. Pricing must be part of a wider customer value strategy.
2. Goliaths must be able to execute the plan.
3. Long-term partnerships and evolution from item to portfolio management.

⁷⁸ <https://hbr.org/2021/07/how-b2b-firms-can-price-with-confidence-as-inflation-rises>

⁷⁹ <https://www.mckinsey.com/industries/retail/our-insights/how-retailers-in-europe-can-navigate-rising-inflation?stcr=F85F5D2CBAD04EF4803415B3654CC98D&cid=other-eml-alt-mip-mck&hlkid=4c8b0d7223b3453f93c25dbd56aa8520&hctky=1770917&hdpid=3a008426-d931-4e0a-9eb8-b032f5d8a80e>

⁸⁰ Chalmers, J 2023, 'Resilience needed for challenging future', *The Australian*, 9 January, p. 9.

⁸¹ <https://www.abc.net.au/news/2022-11-04/reserve-bank-statement-on-monetary-policy-nov-2022/101616336>

⁸² <https://www.westpaciq.com.au/economics/2022/12/video-csi-bill-dec-v2>

Introduction

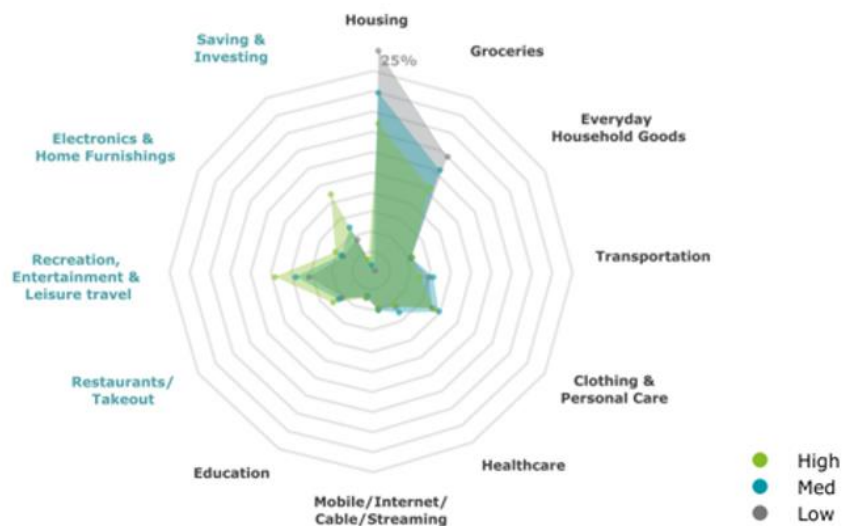
Like in the biblical story of underestimated David vs dominant Goliath, when Aldi and Lidl (Davids) entered the UK in the 90s, British supermarkets (Goliaths) neglected their own operational inefficiencies, entry-level range gaps and wide disparity in price, while branded suppliers perceived private labels as inferior and low-quality. Then, during the 2008 financial crisis, by operating a low-cost model and aligning with changing customer expectations through low-prices, Davids forever revolutionised the UK retail landscape.

History repeats itself in Australia, where decades-high inflation and recession-low consumer sentiment,⁸³ present an opportunity for the Davids, while the adage of ‘adapt or perish’ has never been truer for the Goliaths.

The unique aspect of current inflation is sustained high-aggregate demand,⁸⁴ driven by historically low unemployment⁸⁵ and increased post-pandemic household savings.⁸⁶ The resulting strong demand has allowed businesses to pass-on rising costs to customers,⁸⁷ thereby contributing further to inflation.⁸⁸

Due to declining real wages compounded with fast-rising interest rates, housing and groceries will take a disproportionately larger portion of lower-income consumers' budgets (Figure 1).⁸⁹ With the cumulative impact of the “lag effect” yet to hit the grocery market mid-year 2023,⁹⁰ it's a “tale of two cities”,⁹¹ where premium customers keep spending, while mainstream ones face increasing pressure, and budget customers are forced to choose between necessities and wants.⁹²

Figure 1 Share of Wallet by Income, Australia, December 2022



⁸³ <https://www.roymorgan.com/findings/anz-roy-morgan-consumer-confidence-virtually-unchanged-at-87-7-in-second-week-of-january-highest-since-september-2022>

⁸⁴ Johnston, E 2023, 'CEOs speak out: five big lessons of profit season', *The Australian*, 27 February, p. 13,17.

⁸⁵ <https://www.abs.gov.au/statistics/labour/employment-and-unemployment/labour-force-australia/latest-release>

⁸⁶ <https://www.ft.com/content/837c3863-fc15-476c-841d-340c623565ae>

⁸⁷ <https://www.forbes.com/sites/erolschweizer/2022/12/18/why-the-federal-reserve-cant-solve-food-price-inflation/?sh=60328a563bbb>

⁸⁸ <https://www.theguardian.com/business/2022/oct/16/us-inflation-federal-reserve-interest-rate-hikes>

⁸⁹ <https://www2.deloitte.com/us/en/insights/industry/retail-distribution/consumer-behavior-trends-state-of-the-consumer-tracker.html>

⁹⁰ <https://mozo.com.au/online-shopping/aussie-retail-spending-surges-over-holidays-but-what-s-next>

⁹¹ <https://www.afr.com/chanticleer/what-27-ceos-taught-me-about-the-economy-and-profits-20230224-p5cngb>

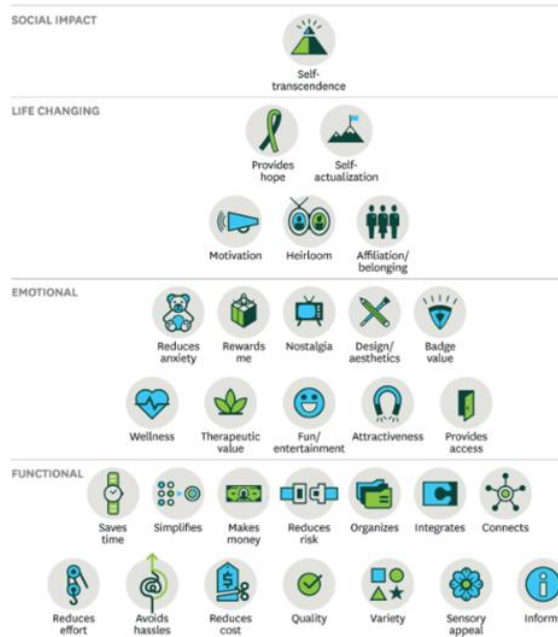
⁹² <https://www.mckinsey.com/featured-insights/sustainable-inclusive-growth/future-of-america/rise-of-the-inclusive-sustainable-consumers>

Value-Equation – Are all Customers at Risk?

Price will gain importance across all income segments, being a particularly dominant factor for lower-income households. Like Maslow's hierarchy, higher levels of value become less significant for customers who struggle to fulfil basic needs (Figure 2).⁹³

Figure 2 The Elements of Value Pyramid

Products and services deliver fundamental elements of value that address four kinds of needs: functional, emotional, life changing, and social impact. In general, the more elements provided, the greater customers' loyalty and the higher the company's sustained revenue growth.



Values, such as access to healthy and sustainable living, convenience, quality of service or frictionless experience are still part of customers' aspirations.

Value is not solely defined by price, regardless of income, and a broader set of variables must be factored. To remain relevant, brands and retailers must understand what value means to customers, especially as budgets shrink and consumer bifurcation accelerates. Targeting the right segment with the right value proposition is crucial for tenable pricing.⁹⁴

For Goliaths, all customers are at risk, be it trading down within the category (sales and profit risk), shopping across retailers (share of wallet risk) or trading out of the retailer (customer-loss risk). Goliaths must ensure that the difference between the value they offer and the price they charge exceeds the next best alternative, the Davids' (Figure 3).⁹⁵

Figure 3 Customer Value Relativity

$$(VALUE_G - PRICE_G) > (VALUE_D - PRICE_D)$$

G – Goliaths D – Davids

⁹³ <https://hbr.org/2016/09/the-elements-of-value>

⁹⁴ https://www.bain.com/about/media-center/press-releases/2020/its_not_all_about_the_money_amid_growing_ranks_of_lower_income_households_consumer_centric_companies_need_to_improve_their_value_for_price_proposition/

⁹⁵ <https://hbr.org/1998/11/business-marketing-understand-what-customers-value>

*“Loyalty in retail is simply the absence of something better.
When they find it, they’re gone.”⁹⁶*

The Hidden Price of Pursuing Perfect Prices

To remain relevant, Goliaths and brands need to address the enduring change in customer value expectations rather than the temporary margin squeeze.

Navigating the Present while Securing the Future

In times of business stress, companies may resort to cost-saving measures or investment cuts. However, Goliaths must not compromise the unique selling value proposition, such as choice and quality, or impair the customer experience, like convenience and availability. If implemented ineffectively, they risk greater exposure to the dimension Davids do best, no-frills, and low-price.

To ensure enduring success, Goliaths should draw a lesson from the 2008 financial crisis by focusing on medium to long-term market-share growth and investing in transformation, rather than cut spending.⁹⁷ The ever-changing market conditions will require Goliaths to develop new competitive advantages directly translating to additional customer value or enabling sustainable investment in future value expansion. Examples of both include affordable sustainability,⁹⁸ supply chain and online fulfilment efficiency improvements,⁹⁹ leveraging existing assets through B2B channels¹⁰⁰ or creating new revenue streams like retail media.¹⁰¹ The latter initiatives not only provide better customer experiences but also unlock monetization of the entire ecosystem.

The Tug-of-War between Balancing Cost and Value-Equation

To stay viable, businesses are forced to pass the cost-pressures to customers. But to maintain customer value equilibrium, a price change should be followed by an addition of value. Due to the imbalance, 66% of consumers have forsaken brand loyalty in favour of purchasing the cheapest option available¹⁰² and 56% of customers believe that companies are taking advantage of the situation.¹⁰³ Views on whether customers are right or not are irrelevant. The ultimate decision on the fairness of prices rests in their purchasing choices. And that’s a key factor for both brands and Goliaths to consider.

⁹⁶ <https://www.pymnts.com/news/retail/2022/walmart-us-chief-to-nrf-loyalty-in-retail-is-the-absence-of-something-better/>

⁹⁷ <https://www.mckinsey.com/industries/retail/our-insights/how-retailers-in-europe-can-navigate-rising-inflation?stcr=F85F5D2CBAD04EF4803415B3654CC98D&cid=other-eml-alt-mip-mck&hlkid=4c8b0d7223b3453f93c25dbd56aa8520&hctky=1770917&hdpid=3a008426-d931-4e0a-9eb8-b032f5d8a80e>

⁹⁸ <https://www.bain.com/about/media-center/press-releases/2022/retail-sustainability-strategies-lag-as-inflation-threatens-to-pause-investment-and-slow-consumer-interest--bain--company-analysis/>

⁹⁹ <https://www.ocadogroup.com/our-solutions/what-is-osp/>

¹⁰⁰ [https://www.mckinsey.com/industries/retail/our-insights/beyond-retail-why-retailers-should-think-services-and-ecosystems?stcr=1CD05795CEED482FBBBBAD1899B56283&cid=other-eml-dre-mip-mck&hlkid=e37164ff395944a787bb57a727f067db&hctky=1770917&hdpid=2f694d5c-fc02-44c4-bdf3-b9e36390e09f#/#/](https://www.mckinsey.com/industries/retail/our-insights/beyond-retail-why-retailers-should-think-services-and-ecosystems?stcr=1CD05795CEED482FBBBBAD1899B56283&cid=other-eml-dre-mip-mck&hlkid=e37164ff395944a787bb57a727f067db&hctky=1770917&hdpid=2f694d5c-fc02-44c4-bdf3-b9e36390e09f#/)

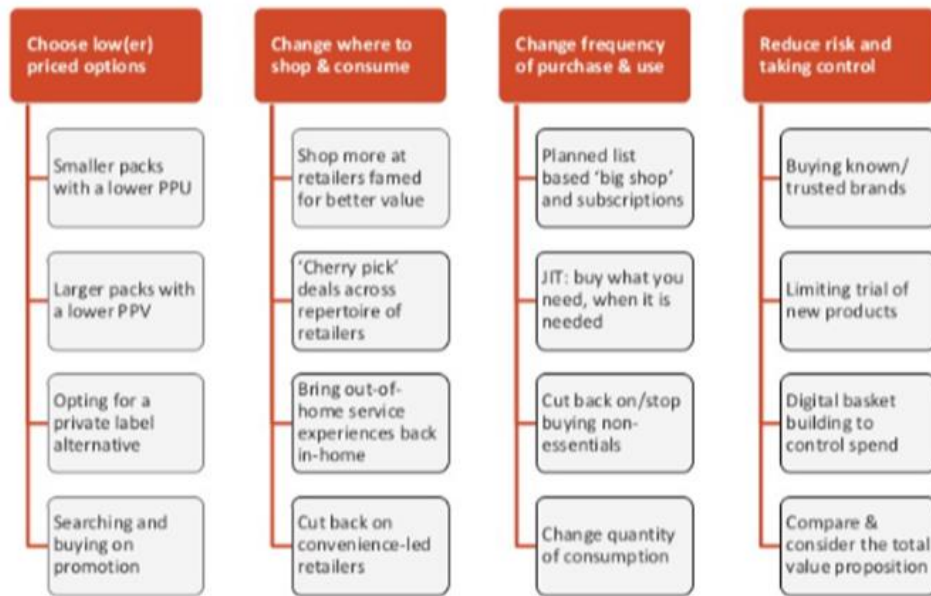
¹⁰¹ https://www.ey.com/en_gl/consumer-products-retail/retail-growth-through-alternative-revenue-streams

¹⁰² <https://www.afr.com/policy/economy/as-inflation-bites-brand-loyalty-falls-away-20221111-p5bxeg#:~:text=Australians%20are%20paying%20about%20%24136,prices%2C%20according%20to%20new%20research>

¹⁰³ <https://www2.deloitte.com/us/en/insights/industry/retail-distribution/consumer-behavior-trends-state-of-the-consumer-tracker/price-gouging-and-rising-us-inflation.html>

On the back of increased at home consumption, customer frugality might not lead to a drastic, retail-wide volume decline,¹⁰⁴ but come down to how much more customers are ready to spend on staples as they try to stretch their dollar further (Figure 4).¹⁰⁵ Those who fail to get their value-equation right,¹⁰⁶ risk either overpromotion or volume-leakage to other brands, alternatively private labels. As the latter occupy a greater portion of consumers' baskets, it removes branded products as a barrier from switching retailers all together.

Figure 4 Four Themes for Anticipating Inflationary Influenced Behavioural Change



Pricing Recommendation

Depending on the market context, the importance of purchase driving attributes and customers' distribution along the Value-Equation Line will change (Figure 5).¹⁰⁷ Goliaths must adjust their holistic customer value strategy to factors impacting their price perception, the economy and competitors' price and value positioning.

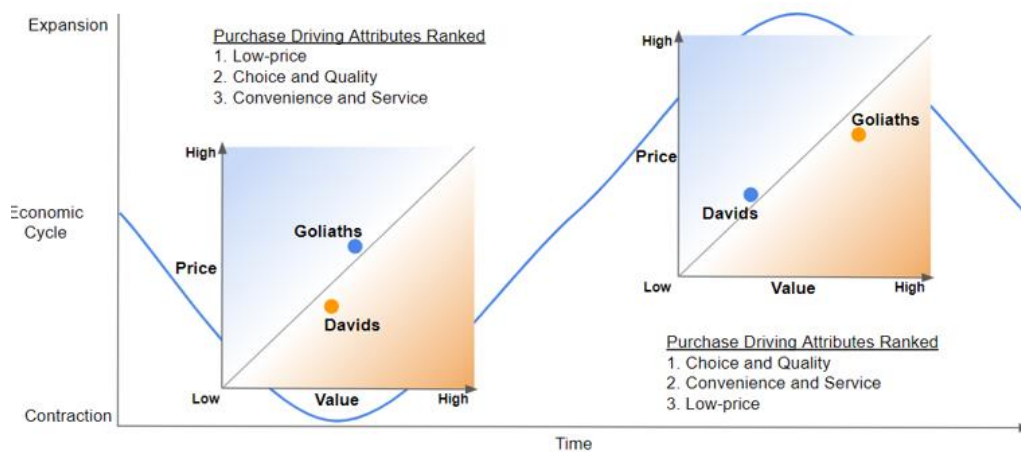
¹⁰⁴ <https://www.mckinsey.com/industries/consumer-packaged-goods/our-insights/uneven-impacts-australian-consumers-and-inflation?stcr=A973388E14F94B0394423B1728748BF5&cid=other-eml-alt-mip-mck&hlkid=6fb6256d7738452aa0e6688446bf8a63&hctky=1770917&hdpid=30a50a1e-fff2-4f18-8dd3-8ef6d72b6f2b>

¹⁰⁵ https://retailworldmagazine.com.au/retail-world-magazine-annual-report-2022-email-non-tob/?utm_source=Retail+World&utm_campaign=91d195432e-EMAIL_CAMPAIGN_2022_12_15_12_34_COPY_01&utm_medium=email&utm_term=0_-

¹⁰⁶ <https://hbr.org/2022/03/talking-to-your-customers-about-prices>

¹⁰⁷ Adapted based on: <https://www.mckinsey.com/capabilities/growth-marketing-and-sales/our-insights/setting-value-not-price>

Figure 5 Example of Value Position Changes through an Economic Cycle

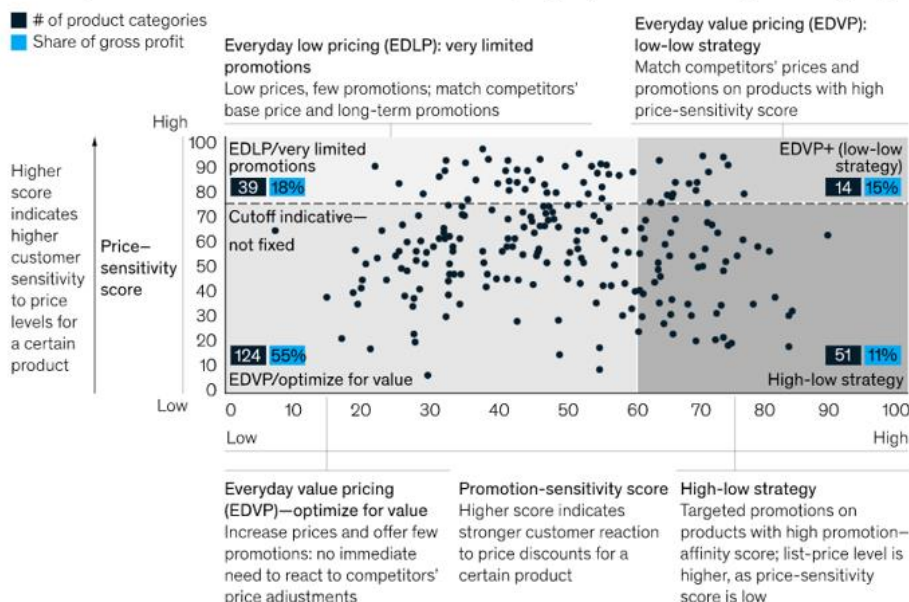


The recommended strategy, optimised for market resilience and delivering the “three-way win”, consists of three components:

Key Value Items (KVI)

Through KVI Goliaths will stay laser-focused on providing a competitive offer across ~20% of ranged products with the greatest impact on price perception. The KVI can be identified by high frequency of purchase, known-price and high price elasticity.¹⁰⁸ Goliaths’ must actively manage their price perception, by offering competitive, seasonally-relevant everyday low prices (EDLP) mixed with a low-low promotional strategy on products with high promotion elasticity (Figure 6).¹⁰⁹

Figure 6 Example of Price-Promotion Matrix Identifying Optimal Pricing Strategy by Product



¹⁰⁸ <https://www.mckinsey.com/industries/retail/our-insights/how-retailers-can-drive-profitable-growth-through-dynamic-pricing>

¹⁰⁹ <https://www.mckinsey.com/capabilities/growth-marketing-and-sales/our-insights/pricing-and-promotions-the-analytics-opportunity>

By providing the same value through price on the range that is most meaningful to customers, Goliaths successfully neutralise Davids' greatest customer promise, low-price.¹¹⁰

Value-Based Pricing (VBP)

VBP strategy expands the value proposition beyond price through additional product attributes. However, Goliaths' prices should still be competitive enough to avoid any negative impact on customers' price perception.¹¹¹ Effective combination of everyday value pricing and high-low promotional strategy across the remaining ~80% of the range (Figure 6)¹¹² will unlock the investment needed to balance the usually lower-margin, traffic-driving KVI strategy.¹¹³

Goliaths offer a range that low-cost models cannot match. By leveraging greater price-coverage and right-price pack architecture (PPA), Goliaths unlock the opportunity to capture premium customers trading down from specialty stores. Furthermore, they slow down the negative implications of the "disappearing middle", by providing customers with more options to trade-down while retaining them in the store.¹¹⁴ For that, Goliaths have two options:

- Partner with a branded supplier on delivering a more comprehensive tiered-PPA with low-priced options.
- Develop a tiered private label range (Figure 7).¹¹⁵

Figure 7 Example of Tiered Private Label Strategy, ASDA, UK



¹¹⁰ <https://www.bain.com/insights/the-pricing-is-right-lessons-from-top-performing-consumer-companies/>

¹¹¹ <https://www.mckinsey.com/capabilities/growth-marketing-and-sales/our-insights/pricing-and-promotions-the-analytics-opportunity>

¹¹² Ibidem

¹¹³ <https://www.mckinsey.com/industries/retail/our-insights/how-retailers-can-drive-profitable-growth-through-dynamic-pricing>

¹¹⁴ <https://www2.deloitte.com/us/en/insights/industry/retail-distribution/consumer-behavior-trends-state-of-the-consumer-tracker/price-gouging-and-rising-us-inflation.html>

¹¹⁵ <https://www.asda.com/about/own-brands>

Loyalty Program

"Incentivised loyalty" is on the rise in Australia, with discounts and rewards being key motivators.¹¹⁶ Goliath's broad customer base makes increasing the above-the-line promotional plans unsustainable nor tailored enough to drive customer satisfaction. Through loyalty programs, Goliaths can offer customers personalised value and the most relevant combination of price, product, and service. Goliaths should keep their loyalty programs as below-the-line, targeted offers, making it more challenging for Davids to measure or create a competitive response.

Interestingly, 60% of customers are willing to pay a premium for enhanced loyalty status.¹¹⁷ Provided being matched with sufficient incentives, the recent introduction of subscription-based tiered loyalty programs that utilise value of the ecosystem¹¹⁸ is another way of tightening the bond with customers.

Critical Factors

The recommended strategy hinges on three components:

Holistic Customer Value Strategy

When in 2010 Coles launched their "Down-Down" program, the retailer's market-share skyrocketed. Meaningful price reductions drive short-term performance but on their own are also relatively easy to copy by competitors. Customers are clear that value through price is a ticket to the game and what they expect "is way beyond low-price".¹¹⁹

Pricing strategy needs to stay true to the retailer's brand and overall customer value strategy. Without a clearly defined value proposition that aligns with customers' expectations, pricing strategy alone will not be able to salvage Goliaths' market-share.

Price perception is as important as the pricing strategy itself and is influenced by factors beyond just price, such as marketing or in-store execution. Goliaths need to ensure that they serve and communicate with customers more broadly through a unified approach and simple messaging across all parts of the organisation, including supplier partners.

Execution Capability

To execute the recommendation, Goliaths will need to exhibit a real customer centricity, by taking an integrated and data-driven approach to pricing. That involves investment in advanced capabilities like promotional effectiveness, competitive benchmark data, insights on customers' value expectation, and a solid reading of consumers' price perceptions (Figure 8).¹²⁰

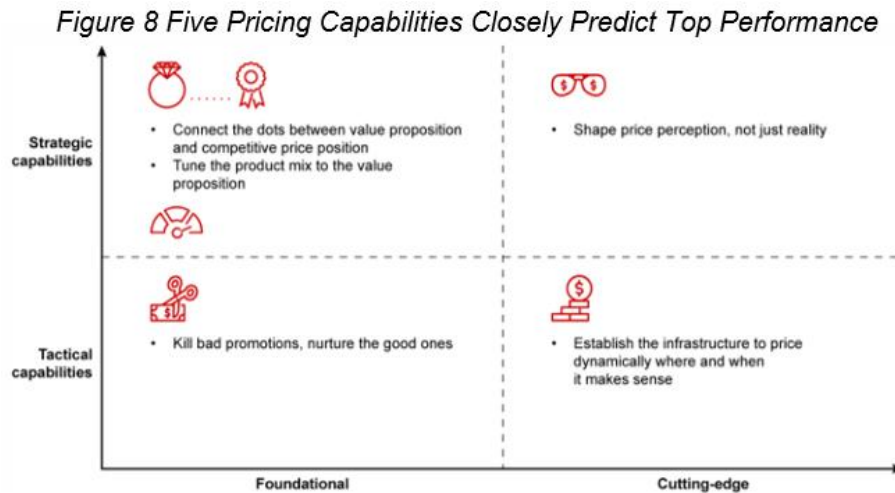
¹¹⁶ <https://www.afr.com/policy/economy/as-inflation-bites-brand-loyalty-falls-away-20221111-p5bxeg#:~:text=Australians%20are%20paying%20about%20%24136,prices%2C%20according%20to%20new%20research>

¹¹⁷ <https://www.mckinsey.com/industries/retail/our-insights/introducing-the-australian-consumer-loyalty-survey?stcr=A463D3EF7D0E4DE7AD8A4C6D9728BCEE&cid=other-eml-alt-mip-mck&hlkid=2982e224b03e45bcb88a5ab5fb4c5084&hctky=1770917&hdpid=30a50a1e-fff2-4f18-8dd3-8ef6d72b6f2b>

¹¹⁸ <https://www.woolworthsrewards.com.au/extra.html>

¹¹⁹ <https://www.smh.com.au/business/companies/down-down-but-not-out-coles-thinks-it-s-onto-a-good-thing-with-new-ads-20180306-p4z31b.html#:~:text=%22Down%20Down%22%20launched%20in%202010,at%20the%20expense%20of%20quality>

¹²⁰ <https://www.bain.com/insights/the-pricing-is-right-lessons-from-top-performing-consumer-companies/>



To fortify their position further, Goliaths should develop business intelligence that would proactively target customers based on competitive vulnerability, be it through new KVI proposition, above-the-line promotion or targeted loyalty offer.

By embracing advanced analytics, Goliaths will not only increase their revenue and customer loyalty, but also provide their suppliers with data-based volume certainty, and transparency on marketing and promotional spend effectiveness.

Long-Term Partnerships

Today's UK Goliaths lost their brand identity focusing too much on replicating Davids. Relying solely on private labels (20-30% of the range) to compete with Davids is a missed opportunity. Australian Goliaths should follow Edeka and Rewe, successfully leveraging a mixed strategy using competitive private labels and variety through brands. Meanwhile suppliers will have to manage - the temptation of short-term job buy volume certainty with Davids, who range 80-90% own labels and long-term sales risk from 70-80% branded portfolio of the Goliaths.

To implement the recommendation, Goliaths must form a number of long-term partnerships focused on matching their holistic value proposition with evolving customer value expectations, whether through new product development, EDLP, promotion or customer activations. However, those strategic partnerships must be mutually beneficial, involve greater transparency and evolve from siloed item performance management towards a total vendor portfolio management. That applies to both suppliers and Goliaths and involves balancing key performance indicators across the whole supplier's portfolio, be it branded or in some cases also private label.

Conclusion

The multi-pronged approach to pricing forms part of a holistic customer value proposition. The recommended strategy will increase **Goliaths'** revenue on top of improved customer satisfaction and loyalty. Diversification of the strategy will unlock **customer** value through price, greater range-coverage, personalization, and innovation, while driving volume through low-priced ranges without eroding long-term brand value of higher product tiers for the **supplier**.

Despite rising cost-of-living, if brands and Goliaths work together to create mutually beneficial partnerships, they could effectively prevent damaging customer relationships and market-share loss. Now is the time to join forces and dive into the customer data to understand the 'why' behind each customer purchase decision. This could be a step forward towards establishing a culture of collaboration that will last well beyond this or the next inflationary cycle.