



Aldi's decidedly Germanic expansion strategy continues to eat into Woolworths' earnings. AAP/Lukas Coch

Australian companies have just finished reporting their half year results, so our experts are measuring up how these businesses are fairing on a number of fronts: domestic competition, international strategy, business sentiment and weathering changes in the Australian dollar.

In this piece John Rice and Nigel Martin discuss how retail sector companies that have long enjoyed little competition are responding to new threats.

Several pressures are emerging in the Australian economy that are making business competition more unpredictable and challenging. Three examples in the retail sector, as evidenced by recent half-year financial results, are the emergence of new competitors, Australia's changing tastes, and disruptive technologies.

More investment extending overcapacity?

Incumbent firms, when confronted by agile new entrants, face some tough choices. In some respects the best way to counter new entrants with better business models is to change and expand the way you operate. For myriad reasons, this is usually impossible.

What firms generally do is try to replicate the new entrants' approaches within their own business. Qantas pulled this off fairly well with Jetstar: it built a low-cost airline to counter Virgin's emergence in Australia. But large grocery retailers Coles and Woolworths, facing a similar threat in their sector, are struggling to counter the threat posed by new entrants.

One of these new entrants is Aldi. Its decidedly Germanic expansion strategy continues to eat into Woolworths' earnings. [In Woolworths's](#) near-A\$19 billion food business, sales were up by more than A\$500 million while earnings declined by around A\$130 million in the half-year

to December 31, 2016.

One interesting statistic in Woolworths' results was the decline in sales per square metre for the Australian food division from A\$16,251 to A\$15,927. This is a decline of just over 2%.

In the context of higher real sales numbers, this shows Woolworths is growing its retail space quickly. There's evidence of this by the growing number of smaller inner-city stores, and new stores in the capital cities' urban fringes.

This can be contrasted with Aldi's smaller stores and relatedly simpler and more agile logistics arrangements. This particular measure shows how Woolworths' legacy store structures and leases continue to hold back any fundamental turnaround in profitability – and why perhaps Woolworths' landlords should be worried.

The conundrum for the likes of Woolworths, Metcash (supplier to IGAs) and Coles is that they are driven to lease new, generally smaller-format, stores to retain customer patronage, but moving out of their older sites is rarely feasible. As such, by trying to refresh their retail locations they are also adding more and more floorspace to a business where floorspace is driving less in sales.

The problem is that Woolworths is adding more retail capacity to a sector that is approaching saturation, with a rapidly growing competitor in Aldi. As such costs are increasing and margins are declining.

This is a classic economic imbroglio: firms see such innovative expansions as a means to solve their problems, but in many ways it makes those problems worse.

Changing tastes upend value chain arrangements

There is more to the story of a tougher retail environment than Aldi. Changes in what Australians are buying at the checkout is impacting supply chain arrangements significantly, and tilting profits to producers of higher quality and more healthy foods – and away from retailers.

As our national average girth expands, there is evidence that Australians are starting to change their ways in relation to heavily sugared grocery mainstays like soft drinks, sweet biscuits and the like.

This is evidenced by [Coca-Cola Amatil's tough result](#). Its sales volumes were down by 2.1%, while revenues were down by 3.4%. This shows Australians are drinking less and paying less for their products. The squeeze was more acute for "sparkling beverages": its volumes were down 4.7%.

While better-quality and healthier food is great news for Australia's health, it is not so great for our grocery retailers. The decline of high volume consumer staples like chips and soft drinks is bad news for retailers, which use such products to draw in customers. This means retailers have to be more cost competitive and margin-sensitive across the complete business, not just in the drawcard products.

The flipside of this can be seen in the listed fruit-and-vegetable producer Costa Group, Australia's largest grower and packer of fresh fruit and vegetables. [Its results](#) showed sales up by 9% and earnings up by 26.6% year on year.

Since its listing in 2015, Costa's share price has increased from A\$2.25 to more than A\$3.50. Its stronger margins since listing is a sure sign that, as a supplier to grocers, it is getting a stronger share of the food value chain – at the supermarkets' expense.

Innovation is disrupting business models

Technological innovation [drives waves](#) of creative destruction in economies allowing firms to continually revolutionise and competitively recreate themselves. Economist Joseph Schumpeter noted that economies progress through such innovation, albeit at the expense of firms left behind by the new innovators.

This is nowhere better illustrated than among Australia's pizza retailers, where [Domino's](#) ascendency is [close to complete](#). In its recent [results](#)

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, profits were up by more than 30% year-on-year.

As a retailer, Domino's has taken command of its market segment through innovation, IT development and marketing in an unprecedented manner.

Illustrative of this is [its 3/10 project](#), which aims to have pizzas for pickup available in three minutes or home-delivered in ten. Innovations such as this have left Domino's competitors in its wake.

Even this market hero, however, has clay feet. Domino's share price has declined sharply recently, in part due to a series of [scandals](#) ranging from alleged immigration fraud to widespread [underpayment of workers](#).

In terms of technology-based disruption, more is on the way. Innovators like Amazon have signalled an interest in moving heavily into the Australian economy, expanding its e-commerce model into groceries.

Its [Amazon Go](#) technology and business model, where customers walk in, take what they want, and walk out (with goods billed automatically to the customer's account) is intriguing.

Innovations such as this promise to disrupt retail as much as platform-based innovators like Uber have [disrupted taxis](#).

Amazon's mainstay is general e-commerce. In the [US](#), e-commerce accounts for 8.3% of retail sales, while in [Australia](#) the figure is around 6.8%. In both markets e-commerce is experiencing double-digit percentage growth. It is chipping away at the fundamental economics of traditional retailers like Myer, which continues to struggle.

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Taken together, the retail sector will continue to be a tough place for incumbents to thrive.

Innovators entering without the legacies of outmoded business models and with the benefit of new technology will continue to usurp incumbent firms.

For consumers, choice and convenience will continue to emerge. For incumbents unable to deliver on these outcomes, the future is bleak.

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