Retail Functions

1

Abstract

This chapter explains the tasks of retailers within the distribution channel and recent trends surrounding these functions. This serves to demonstrate the complexity of retailers' activities and explain their general role as intermediaries between suppliers and final customers.

1.1 Introduction

Retailing refers to the process of purchasing products from other organisations with the intent of reselling them to the final customer, generally without transformation, and rendering services incidental to the sale of merchandise. However, this is a rather static and traditional definition. While traditional retail functions still dominate, retailers have developed into sophisticated and complex companies that often coordinate or even own value chains from the production stages right through to customer sales.

The retailing process itself is the final step in the distribution of merchandise. As with all services, it produces an intangible outcome. While the added value of a production company is obvious, it is – at least initially – less evident what value a retailer creates. Therefore, marketing and retail researchers have long tried to explain what added value retailers provide.

Butler (1917, p. 14) gave an early justification for the existence of retailers: "The middleman is the outstanding figure in modern marketing not because he has consciously set out to make a place for himself, nor because consumers have blindly permitted him to come between them and the manufacturers of the things they buy. It is because he has been forced

J. Zentes et al., *Strategic Retail Management*, DOI 10.1007/978-3-658-10183-1_1

into existence, on the one hand, by the necessities of specialised and large scale industry and, on the other hand, by the necessities of consumers equally specialised in their activities and constantly demanding more and more in the way of services which the distant manufacturer must usually rely upon the middleman to give."

A simple explanation for the potential advantage of using intermediaries (such as retailers) in a distribution channel is given by the **Baligh-Richartz effect** (Baligh and Richartz 1964). This effect is based on the fact that integrating an intermediary into the distribution channel (between suppliers and consumers) helps **reduce the number of necessary contacts** between the different actors in the system, where contacts include visits, payments, etc. If *m* different manufacturers (e. g., one for meat, one for bread, one for detergents, etc.) sell to *n* different households, the number of necessary contacts is m * n. Using just a single intermediary in this channel reduces the number of contacts to m + n.

In more recent economic analyses, **transaction cost theory** has often been used to explain the use of independent intermediaries in a value chain. This theory explains the existence of firms in general and the level of vertical integration with differing transaction costs in particular (Williamson 1985). From the transaction cost perspective, suppliers use intermediaries if the transaction cost of dealing with an independent retail channel is lower than the internal cost of coordinating these transactions internally. Transaction costs include, e. g., search and information costs, bargaining costs, monitoring costs and enforcement costs. Asset specificity, uncertainty and frequency of transactions influence these costs. Asset specificity refers to, e. g., the specific knowledge needed to sell a product or specific logistics infrastructure or specific equipment that may be required. As an example, for highly complex products, the cost of transferring the necessary specific product knowledge from the manufacturer to an independent retailer may be so high that a vertically integrated solution (i. e., direct selling) could be optimal. A more general case of asset specificity is the brand reputation that a manufacturer may have established and of which intermediaries may take advantage. In this case, verticalisation may also be beneficial (see Chap. 6). However, in many cases, for normal products, asset specificity is low and using independent intermediaries leads to lower transaction costs.

1.2 Traditional Retail Functions

1.2.1 Catalogues of Functions

To answer the fundamental question of why retailers exist, instead of, in the extreme case, every manufacturer selling their products and services to all the final customers who want to buy these products directly, different lists or catalogues of retail functions (or "distribution service outputs") have been proposed (Butler 1917; Alderson 1954; Sundhoff 1965; Bucklin 1966; Coughlan et al. 2006; Waterschoot et al. 2010; Zentes et al. 2012, pp. 57–59). The following explanation does not follow any of these specifically; instead, a list of functions is

derived that retailers usually perform in the value chain between producers and consumers as a synthesis of the abovementioned sources.

1.2.2 Creating an Assortment

One of the benefits a retailer provides in the value chain is goods sorting. This creates value, because manufacturers typically produce a large quantity of a limited variety of goods, whereas consumers usually demand only a limited quantity of a wide variety of goods (Coughlan et al. 2006, p. 6).

Retailers provide the customer with an assortment of products and services, thereby offering **variety** (Bucklin 1966; Waterschoot et al. 2010; Varley 2014, p. 7). They offer the customer a selection of products (the merchandise mix or product range), which they preselect from a very broad array of products offered by existing manufacturers and bring into association with each other (see Chap. 12). For example, an average supermarket offers a choice of about 10,000–15,000 items (so-called SKUs, see Chap. 12) from over 500 different suppliers. Home improvement stores may offer 40,000–60,000 items. *Amazon* offers millions of different products in its online shop and on its marketplace. Thus, while manufacturers can specialise in producing a very limited product range, retailers make a broad product range available for the consumer. This lets consumers

- choose between different products in a single category (e. g., between different power drills in a home improvement store) and
- combine their purchases and buy items across several product categories in the same store (e. g., buy a power drill and a screwdriver), fulfilling the increasing need for "one-stop-shopping".

In a way, creating an assortment is also a marketing function, since it facilitates the consumer's search process. For example, instead of selecting between printers from many different manufacturers by searching for them in different locations, a retailer's product range helps the consumer manage the product complexity, choose between preselected printer brands and models and easily compare them in a single store.

Chap. 6 will present manufacturers' emerging verticalisation strategies. Some manufacturers, such as *Dell*, *Apple*, *Esprit* or, in a few cases, even manufacturers of fast-moving consumer goods such as *Nespresso*, operate stores dedicated to their branded products. But this is clearly not an option for most manufacturers, as consumers prefer to shop for several products in a single location, and most manufacturers would be overlooked by consumers if retailers did not present their products.

1.2.3 Breaking Bulk

In addition, retailers offer customers different **lot sizes** than manufacturers usually prefer to ship (Bucklin 1966). To reduce transportation costs and transaction costs, manufacturers usually have the necessary infrastructure and systems to ship full truckloads, pallets or at least cases of products, while consumers only want to buy single packages of a product. Thus, retailers buy products in large quantities, then break down these large shipments ("break bulk") to offer quantities that fit typical consumption patterns.

It is noteworthy that the term for this institution ("**re-tailor"** vs. **"wholesaler**" in English, "commerce de détail" vs. "commerce de gros" in French, "Einzelhandel" vs. "Großhandel" in German) often refers to precisely this function, relative to the wholesale level.

1.2.4 Bridging Space and Time

The system joining manufacturers and consumers usually has geographic and temporal gaps that must be overcome. Closing these gaps is a further function of retailers.

Bridging Space

Manufacturers usually produce a specific product in a central location, while final consumption takes places in households across the country. Retailers help carry out this **spatial decentralisation** (Waterschoot et al. 2010, p. 6) by offering products in stores that are close to the customer. Large retailers have broad **market coverage** with a network of stores, so the consumer can easily reach one.

The added value retailers provide to this logistical function has drastically increased over time (see Chap. 18 and 19). Initially, the main advantage conferred was that of an intermediary, meaning the manufacturer's logistics chain did not have to extend to every single household, only to a specific retail store. In the past, it was common for stores to either receive direct deliveries from manufacturers or for small retailers to buy their products at wholesale markets, which also helped bridge a geographical gap.

However, with retailers setting up their own distribution centres, they now take responsibility for an even larger part of the journey from the production facility to the consumer. Modern retail logistics concepts even involve picking up products at manufacturing sites directly, meaning the full function of bridging space is handled by the retailer. In the interplay with manufacturers, retailers now often try to obtain **logistics leadership**.

Furthermore, in recent years, retailers are increasingly going one step further downstream. With the increasing use of online retailing, retailers manage the delivery of products to individual households (as catalogue retailers have long done), thereby bridging the final part of the supply chain. Sometimes they do so with their own truck fleet; sometimes the delivery is still carried out by logistics service providers and merely coordinated by the retailer.

Bridging Time
Consumers want to be able to buy (and consume) products when they wish, while production is often carried out in batches or at least not immediately before purchase. This temporal gap is overcome by retailers **holding inventory**. As a part of the logistics process, retailers stock products in their warehouses and on their store shelves. This makes products available to the consumer when they want them.

Here retailers expend a lot of effort on minimising the inventory in the supply chain while still ensuring products remain in stock in their stores.

1.2.5 Creating Demand

A further function of retailers is creating demand. This includes market analysis, evaluating and identifying consumer needs and providing this information to suppliers (or using this information to build adequate product ranges), etc.

Furthermore, retailers **present goods** to the consumer in their stores, mostly on shelves but often also in other display forms (see Chap. 15). For example, electronic devices such as home cinemas can be tested by the consumer, along with TVs, speakers, certain lights and so on. Or clothing collections can be displayed on mannequins. These measures increase demand and would be difficult for manufacturers to carry out without stores. However, online shops can also present products to create demand, provide customer-specific advice and set specific prices which stimulate the customer to buy products.

Retailers often have knowledgeable salespeople who can give advice to help customers choose. Brick-and-mortar retailers and online shops both carry out promotional activities and conduct many other activities to stimulate demand.

In more academic terms, a part of this function is sometimes labelled "informational market decentralization" (Bucklin 1966; Waterschoot et al. 2010), since it includes transferring knowledge about products, trends and technologies from the specific product manufacturer to the customer.

1.2.6 Carrying out Transactions

Every purchase transaction involves ordering, pricing and paying for goods and services (Sundhoff 1965; Coughlan et al. 2006). Retailers carry out these functions and typically reduce costs here through standardisation and routines. Products are offered in a physical or online store for a particular price (including price labels which help avoid price negotiations for every single purchase). Products are paid for at a (physical or virtual) checkout, where the purchasing contract is closed and product possession transfers from the retailer to the consumer.

However, full routinisation is not always possible. Certain cases still involve intensive negotiations in the purchasing process, e. g., in car or furniture retailing. Products may need to be tailored to the specific customer; prices may need to be fixed individually, etc. This is also part of the retail function.

For higher priced non-food items (such as furniture, cars or home appliances), it is also common for consumers to have the option to pay later or in instalments. Providing this option stimulates demand. For a manufacturer, being far from the consumer can make it difficult to provide this option, as evaluating a customer's creditworthiness can be difficult and sometimes costly. Thus, this **financing function** is often carried out (or at least coordinated) by the retailer.

1.2.7 Product-related Services

Even though the definition of retailing states that products are resold to the final customer "generally without transformation", retailers in certain sectors have long been involved in the final step of the production process, mainly final assembly. For example, retailers of expensive bicycles often assemble customised bikes for specific customers (Waterschoot et al. 2010, p. 20), while furniture retailers assemble kitchens in customers' homes.

While the delivery of goods to households has been discussed as part of the "bridging space" function, the installation, setup, maintenance and repair of products are additional functions. Indeed, the provision of such **customer services** by retailers is rising drastically. This can be observed, for example, with computer retailers, who not only deliver the computer to the customer's home but also physically set it up, configure it, install software, connect it to peripheral devices and the Internet, transfer data from old computers and so on. Another example is home improvement retailers, where the trend has moved from **"do it yourself"** to **"do it for me"**, and retailers now often provide the customer with craftspeople who assemble the product bought at the retailer. In food retailing, ready-to-cook and ready-to-eat products are prepared by the retailer for takeaway.

This function, however, still involves products which are bought from a manufacturer and resold by the retailer to a consumer. The services related to these products are often a means to differentiate the retailer's offer from that of a competitor by **complementing the product** with value-added services. A further integration of the retailer within the production function will be discussed in the next section.

1.2.8 Efficiency Benefits of Intermediaries

One criticism of catalogues of retail functions is that they merely reflect the functions currently carried out by retailers without justifying their existence. While the functions show different activities that must usually be performed in the system between manufacturers

and consumers, they do not necessarily need to be performed by a retailer. This leads to two considerations:

- Nowadays, retailers usually make many of these activities part of their domain. However, they often only manage the process, and the execution itself is carried out via **outsourcing**. For example, the transport function for distributing products to a store network increasingly falls under the domain of the retailer rather than the manufacturer, but retailers often use **third-party logistics service providers** to carry out the transport. Most online retailers ensure goods delivery to customers' homes, but they usually execute this via parcel services such as *DHL* or *UPS*.
- Manufacturers may carry out these functions themselves. This happens when manufacturers are verticalised (Chap. 6). However, if the manufacturer decides to eliminate the retailer as a middleman ("disintermediation"), these functions still need to be performed. Considering retail functions shows that eliminating the middleman does not eliminate the costs of intermediary functions.

From an economic perspective, retailers remain viable participants in the distribution channel as long as they can perform certain distributive functions more efficiently or effectively than other institutions in the channel. It is likely that different value-added functions (e. g., manufacturing, logistics and store operations) have **different optimal output levels** (Rosenbloom 2012; 2007), in which case vertical disintegration, where companies specialise in particular activities, can reduce overall production costs.

- Compared with internalised manufacturer activity, retailers can more easily achieve **economies of scale** for activities with high fixed costs (Rosenbloom 2007), e. g., providing a store, warehouses or a transport fleet.
- Furthermore, **economies of scope** are achieved because offering heterogeneous products from different manufacturers **smoothes the demand function**. A manufacturer of skiing equipment, for example, will often experience strong demand for a few months but no sales for the rest of the year. This leads to inefficient use of logistics capacity (such as warehouses) and in-store selling space (and salespeople, etc.). Idle costs will be incurred for the majority of the year. But if a sporting goods retailer takes over the functions, bundling products from summer sports manufacturers and winter sports manufacturers in their stores, they will reduce costs through steady use of the selling space and logistics infrastructure. Thus, a retailer can more easily compensate for demand fluctuations and generally employ capacity in a smoother, more cost-efficient way.
- Finally, bundling products from many different manufacturers into a product range can help reduce transaction costs for consumers (particularly search costs).

1.2.9 Flows in the Value Chain

Instead of catalogues of retail functions, other authors have focused on different channel flows that need to be performed between manufacturers and the consumer (see, e. g., Coughlan et al. 2006, pp. 10–13; Rosenbloom and Larsen Andras 2008). Usually, the literature mentions eight flows that have to be created and managed to link buyers and sellers:

1. Ownership
2. Physical possession of the product
3. Promotion
4. Negotiation
5. Financing
6. Risk
7. Ordering
8. Payment.

Ultimately, however, these flows can be associated with the retail functions listed above, so channel flows are simply another perspective on the same phenomenon.

1.3 Emerging Retailer Functions

The increasing power of retailers relative to manufacturers has led to more of the value chain being controlled by retailers. This partly applies to traditional retail functions in which retailers have taken over additional activities, e. g., in logistics. But it also applies to newly emergent functions traditionally not carried out by retailers. Retailers are increasingly using **backward integration** and partly or fully taking over the production function, a traditional domain of manufacturers.

In recent years, researchers have highlighted the changing value-added systems in the consumer goods sector (e. g., Zentes and Bastian 2010; Hertel et al. 2011; Olsson et al. 2013). These changes come as a result of the increasing relevance of store brands (see Chap. 12) and the rise of vertical retailers as new competitors (see Chap. 6). The reasons for backward integration are at least three-fold:

- First, it helps the retailer to differentiate itself from its competition if the company is involved in product development processes, since the company's offer then becomes unique.
- Second, coordinating the value chain helps the retailer ensure product quality and product supply, which may be crucial in the event of general supply shortages.
- Third, it helps the retailer acquire more of the profit margin in the value chain.

Coordinating the Value Chain

While retailers still hold a largely passive function for manufacturing brands, with product marketing mainly carried out by the manufacturer itself, this is different for **store brands** (see Chap. 12). Here, retailers are involved in R&D activities, mainly for product development, including design, packaging and so on. Quality standards are fixed and monitored by the retailer, including the necessary qualities of raw materials. In addition to selecting from different manufacturers' product ranges, the retailer actively coordinates the value chain.

Product specifications are developed by the retailer and the producer (often a specialised private label manufacturer), which is often merely a **contract manufacturer** that provides production capacity for the retailer. The retailer holds the rights to the product, product technology, recipes or construction plans and brand. Beyond coordinating production, the retailer also has to market these products entirely on its own, i. e., advertising and other marketing functions for these products are carried out by the retailer as well.

Examples of far-reaching value-added activities in the production process, in particular the development and design of store brands, include the sporting goods retailer *Decathlon* and the vertical fashion company *Zara*. For *IKEA*, insourcing the design function that was previously performed by manufacturers or independent design companies helped improve manufacturing and transport efficiency (Olsson et al. 2013, p. 1137).

Production Processes

Instead of merely coordinating production processes, some retailers go one step further and own the production companies as well. *IKEA* uses **contract manufacturing** but also owns factories around the world. This is sometimes also the case in food retailing; for example, the German market leader *EDEKA* owns more than 20 meat factories and more than ten regional bakeries. *Coop* in Switzerland owns a majority stake in Switzerland's largest meat and sausage manufacturer *Bell* as well as in many other production companies. *Migros*, a Swiss retailer that strongly focuses on store brands, owns *M-Industry,* which achieved sales of more than 6 billion CHF in 2014. *M-Industry* is a group of production companies with about 20 companies in Switzerland and further production sites in the USA, Canada, Germany and other countries. Its 12,000 employees produce a product range of about 20,000 different articles. From chocolate production to meat production, mineral waters, cheese, detergents and other product categories, *Migros* produces a large proportion of the products on its shelves. As well as being a supplier to the *Migros* stores, *M-Industry* is explicitly seen as a growth pillar for *Migros*, with the share of sales to external customers, particularly in other countries, expected to rise in the coming years.

Closed Loop Supply Chains

In recent decades, increasing importance has been attached to environmental protection and sustainable strategies (see Chap. 10). One consequence of this development is that supply chains are no longer just unidirectional, from the manufacturer to the consumer: **reverse processes** have become more relevant.

Closed loop supply chains try to close the product flows into a full circle with the aim of reducing waste. Instead of disposing of products at the end of their lifecycles, sustainable waste management reduces waste by collecting used products (and packaging material), separating (and in some cases disassembling) them, recovering the valuable parts (which can be the entire product, or components or material) and eventually reusing them through recycling or remanufacturing.

Retailers are taking over responsibility for this process. In many countries, retailers have to take back packaging material. They also have to take back used products or do so voluntarily as a customer service. From trading in used refrigerators or computers or returning used ink cartridges, returning cardboard boxes or bringing back empty glass or PET bottles, consumers can increasingly dispose of used products and packaging at their retailers. Together with manufacturers and third-party service providers, retailers are increasingly coordinating the accompanying reverse logistics processes.

1.4 Convergence between Manufacturers and Retailers

Today's retailers go far beyond their traditional distribution function and are establishing their own product development and production competence. This leads to an interesting phenomenon where the distinction between manufacturers and retailers is becoming blurred, and the characteristics of institutions at both ends of the value chain are converging.

Companies like *Migros*, *Decathlon* or *B&Q* are traditionally seen as retailers, even though their control over the production function is constantly increasing. On the other hand, companies such as *Apple*, *Boss* or *Montblanc* are traditionally categorised as manufacturers, even though they have made huge strides in integrating the retail function into their own systems and opening stores or at least controlling stores and other retail channels (see Chap. 6). The extreme cases are so-called verticals such as *Zara*, *H&M*, *IKEA*, *Dell* or *Nespresso,* where a vertically integrated exclusive system from manufacturing to retailing has emerged.

1.5 Conclusion and Outlook

Retailers add value to products and services by providing a number of retail functions. While these functions mostly do not create a tangible output and are thus not evident to everybody, they are still necessary in the value chain between manufacturers and consumers.

Retailers, as **specialists in distribution,** have a number of advantages in providing these functions more effectively and efficiently than other institutions, e. g., they can often achieve economies of scale and economies of scope in the distribution function. But with increasing size and sophistication, retailers have started to use their position as gatekeepers to the customer to acquire a growing share of the value chain and increasingly take over functions traditionally carried out by manufacturers.

Given the takeover of production functions by retailers and of retailing functions by manufacturers, both types of institutions are, in a way, converging. These developments clearly indicate that the classic conceptualisations of retail functions are not comprehensive enough to describe and analyse many modern retailers. It has therefore been proposed to revise and broaden them (Waterschoot et al. 2010).

Further Reading

- Coughlan, A., Anderson E., Stern, L. & El-Ansary, A. (2006). *Marketing Channels* (7th edn.). Upper Saddle River/NJ: Prentice Hall.
- Rosenbloom, B. (2012). *Marketing Channels: A Management View* (8th edn.). Mason/OH: Cengage Learning.

1.6 Case Study: Tesco

1.6.1 Profile, History and Status Quo

Tesco[1] is the fifth largest retailer in the world and the UK grocery market leader by a considerable margin (see Fig. 1.1). *Tesco* has seen impressive growth in recent decades, although the company has recently come under increasing competitive pressure, both at home and in some foreign markets.

The origins of *Tesco Plc* date back to 1919, when Sir Jack Cohen started to sell groceries from a market stall in London's East End. The name *Tesco* is derived from TES (from *TE Stockell*, a tea supplier Jack Cohen used) and CO (Cohen). By the 1960s, the company had established its self-service model and had developed a reputation as a value-for-money retailer, following its founder's "pile it high and sell it cheap" motto. During the 1970s, the company consistently lost market share to competitors, especially *Sainsbury's*. However, by 1995, *Tesco* surpassed *Sainsbury's* again to become the UK's market leader in food retailing, a position it has retained ever since.

In the mid-1990s, *Tesco*'s international expansion began. The company first entered Hungary in 1995, and in 1996, it entered other Eastern European countries, the Czech Republic and Slovakia. Shortly afterwards, *Tesco* entered Thailand (1998) and South Korea (1999). In the early 2000s, *Tesco* entered Taiwan (2000), Malaysia (2002), Japan (2004) and China (2004). The company then expanded into the USA (2007), Turkey (2003) and India (2014). However, not all its internationalisation efforts were successful. The business in Taiwan was never successful and was sold to *Carrefour* in 2005. In 2013, *Tesco* withdrew from its troublesome business in the USA, where it had operated about 200 *Fresh & Easy*

[1] Sources used for this case study include the websites http://www.tescoplc.com, various annual and interim reports, investor relations presentations and the explicitly cited sources.

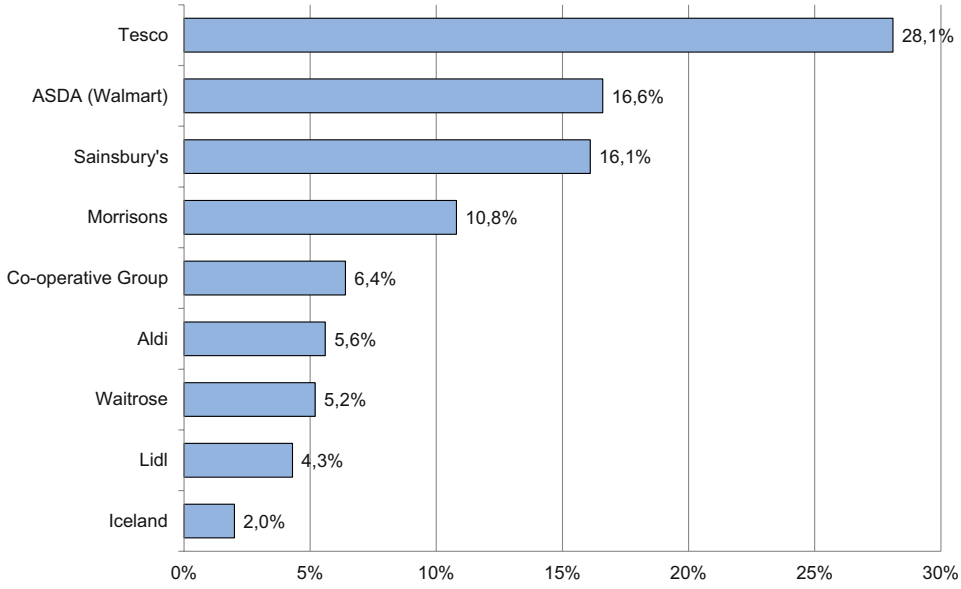

Fig. 1.1 Market shares in the UK grocery market (July–October 2015). (Kantar Worldpanel, cited from Statista 2015, p. 9)

supermarkets. *Tesco* also left Japan in 2013. And in China, where *Tesco* had ambitious plans, the company scaled back and sold a majority stake in its operations to a Chinese company.

In 2014, *Tesco* had global sales (incl. VAT) of 69.7 billion GBP, employing about 500,000 people in retail operations in 12 countries. But, as with most international retailers, the majority of Tesco's business comes from its home market. Therefore, this case study focuses on the UK. With sales (incl. VAT) of 48.2 billion GBP, almost 70 % of *Tesco's* sales come from the UK, where the company operates about 3500 stores in different formats, employing more than 300,000 people.

Even though it is the undisputed market leader in the UK with about 30 % market share, *Tesco* has been in a crisis for the past few years. Operating profit has fallen and like-for-like sales are down. The German discount chains *Aldi* and *Lidl*, who were not very successful in their first decade of operations in the UK, have recently gained acceptance among the British population, with resultant strong growth and aggressive expansion.

1.6.2 Tesco's Store Network

Tesco distributes products to customers throughout the UK via a number of different store formats (see Chap. 2 and 3) that cater to the needs of customers in different purchasing situations. All formats obviously help bridge the physical distance between supplier production sites and customers' homes, and they also help bridge the time between production and

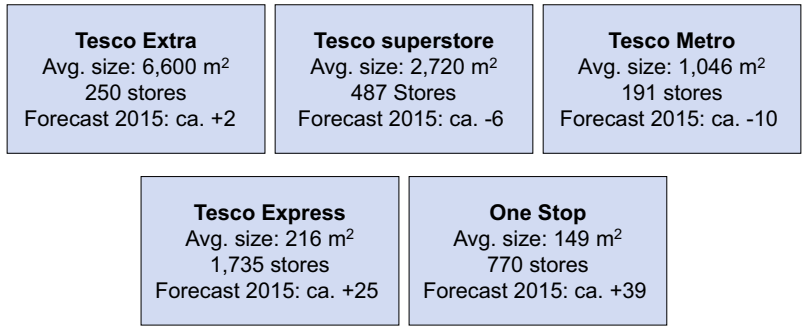

Fig. 1.2 *Tesco's* main UK store formats as of February 2015. (Tesco 2015, pp. 39–40)

purchasing. However, the different store formats do so in very different ways. Specifically, *Tesco* uses the following formats (see Fig. 1.2):

- ***Tesco* superstores** are large supermarkets with a focus on groceries but also certain non-food products. Their average size is about 2700 m². *Tesco* currently operates 487 of these stores but plans to reduce this number in the coming years. Usually, *Tesco* superstores are just labelled "*Tesco*". With 34 % of *Tesco's* overall floor space in the UK, superstores are a very important format. As with supermarkets in general, *Tesco* superstores are generally close to customers' homes and their merchandise mix is aimed at customers coming frequently to buy daily supplies.
- ***Tesco Extra*** stores are basically hypermarkets, mostly located out of town, with a broad range of groceries but also a high share of non-food products. Their average size is about 6600 m². *Tesco* has 250 of these stores and plans to keep their number relatively stable. With 42 % of overall floor space of *Tesco* in the UK, they are the most relevant store format (for this indicator). As is typical for hypermarkets, these stores are usually not frequented by customers for their daily shopping. Travel distances are farther (with "only" about 250 stores across the UK), but customers buy more at each shopping trip, stocking up their supplies for a week or two. *Tesco* plans major changes for the *Tesco Extra* format, because the stores are larger than new customer trends require. Therefore, selling space is being reduced and the released areas are being used as a type of shopping centre where, for example, *Tesco's* own clothing store brand F+F will have its own separate stores and other retail companies will be able to set up as tenants. Restaurants will be integrated and more space given to preparing fresh food, etc.
- ***Tesco Metro*** stores are inner-city supermarkets with a focus on groceries. They bridge the gap to the customer very successfully, with locations in cities and in particular on the UK's high streets. Their average size is 1046 m². With only 191 stores, *Tesco Metro* makes up only 5 % of *Tesco*'s overall floor space in the UK. In addition, *Tesco* plans to reduce this number in the coming years.

- ***Tesco Express*** stores are convenience stores with an average floor space of 216 m^2. This has been a growth format over the last decade, appealing to the growing demand for customer convenience. They focus on providing food products and prepared food. Margins are high due to this assortment, and market research has shown that prices in a *Tesco Express* are on average around 11 % higher than those for identical items in larger *Tesco* stores (Daily Mail 2013). *Tesco* already has 1735 of these stores and continues to open new locations. They already make up about 10 % of total floor space and there is clear expansion intent. This shows a trend towards fulfilling the "bridging space" function even better in the future, because customers have been observed to shop more frequently and invest less time in their shopping trips. Therefore, *Tesco Express's* inner-city locations along customer traffic flows, in train stations, petrol stations, business districts, etc., fulfil this customer need very well. They also provide a strong convenience store assortment of prepared food for lunches, etc.
- ***One Stop*** comprises small neighbourhood stores of only 149 m^2 on average. The chain is operated as a separate business with its own assortment. *Tesco* has 770 of these stores, which are often not known to be part of *Tesco* because they are not branded as such. A small number are operated by franchise partners and this number is expected to grow. Prices are higher than in typical *Tesco* stores. The *One Stop* format has seen great success due to its convenience, even in recent years, when *Tesco* in general has shrunk. Growth rates have been between 9 and 10 %, partially due to outlet growth. Therefore, *Tesco* intends to open more, with about 40 new *One Stop* stores due to open during 2015.

In recent years, *Tesco* has repeatedly mentioned that it sees its footprint of large stores (more than 70 % of *Tesco*'s floor space is *Tesco Metro* and *Tesco* superstores) as a burden, because the consumer trend is towards shopping online and shopping in smaller stores. In early 2015, the company announced the **closure of 43 stores** throughout the UK. While this was widely reported, it is, in fact, only about 1 % of its total store number. Still, the changes the company is making in its large stores, the move towards smaller stores and the increasing relevance of *Tesco*'s online retail site ***Tesco.com*** are a reaction to consumer trends. These changes are evidence of the problem of overstoring in the UK, with too much sales space to maintain sufficient productivity.

On a positive note, *Tesco* has been a global pioneer in online grocery shopping. It started its online shop 20 years ago (in 1994), and today it is the global market leader for online grocery shopping. This market is very important in the UK, which is the most important online market in the world. Compared to other countries, a very high share of UK retail is online. Even in grocery retailing, where most other countries do not see the relevance of online shopping, the UK online share in 2014 was about 7 %, according to the retail institute IGD. The market is estimated to be around 8 billion GPB today; *Tesco* has a market share of about 40 % in this market and it achieves impressive growth figures of more than 10 % annually.

From a retail function perspective, online shopping is a new paradigm for grocery retailers. In the past, retailers bridged the gap from suppliers to stores, before the consumer

took over the last part of the supply chain. With online grocery stores, *Tesco* offers to take over the troublesome last mile. With frozen food, ambient food, etc., this is a cost-intensive challenge. *Tesco* does this either by picking products from its existing store base and then delivering them to customers' homes or by picking products in so called "dark stores", dedicated to online order picking.

In addition, new options for consumers have emerged. Beyond just "store-based retailing" or "online retailing", *Tesco* increasingly offers cross-channel solutions (see Chap. 5). With "**Click+Collect**", *Tesco* allows customers to order their merchandise online and pick it up at a collection point (usually located adjacent to a *Tesco* store). While home delivery imposes a delivery fee of usually over 5 GBP, Click+Collect is free. In the UK, *Tesco* has 1750 Click+Collect collection points for general merchandise and over 260 grocery drive-throughs.

1.6.3 Tesco's Supply Chain

With its store network, online deliveries and the Click+Collect service, *Tesco* offers products to consumers where and when they need them. But the previous section describes only the final stage in this supply chain. To move products from manufacturing plants or farms to the store requires a complex logistics network of distribution centres (DCs). Previously, suppliers often delivered directly to stores. But retailers are increasingly developing their own logistics networks and have taken over large parts of this supply chain (see Chap. 18). *Tesco* has been one of the pioneers here. Initially, centralised warehouses were established, but later a more differentiated network of warehouses and distribution centres was established for different product groups. This network is continuously being optimised.

Tesco operates one of the largest distribution networks in the UK, delivering about 10 million cases per day to its stores (IGD 2011). About a decade ago, it had approximately 35–40 DCs in the UK and Ireland, but this number was reduced to 28 in recent years. Until 2006, each DC conducted separate planning. But this has since changed, with *Tesco* first grouping DCs into regional hubs and later centralising distribution planning to increase efficiency and ensure optimal asset utilisation.

Tesco's DCs handle different types of merchandise according to their logistical requirements, e. g.:

- **Ambient groceries** (such as cans of soup or beverages) see daily deliveries to all stores. However, some ambient items, like tobacco products, are still delivered directly to stores by suppliers.
- **Temperature controlled** groceries (e. g., chilled food like dairy products or frozen food like pizzas) are also delivered daily to all stores across the UK.
- **General merchandise products** (e. g., health and beauty supplies, electrical goods, etc.) are delivered to stores less frequently.
- **Clothing** is delivered to stores via different transport chains. A single DC in Daventry stocks all *F+F* clothing store brand products and delivers to stores throughout the UK.

While there are very few warehouses which stock frozen food and general merchandise, the groceries network is more extensive. The intention is to keep the DC network sufficiently close to the stores to reduce transport kilometres. **Consolidating the transport** of frozen food products and general merchandise products into the grocery product delivery network makes transport more efficient and reduces the number of trucks coming to the stores. Products from local suppliers or global deliveries enter *Tesco's* logistics network at the DCs, and from there *Tesco* distributes these goods to its stores.

1.6.4 Tesco's Assortment

A retailer must offer its customers an assortment of products. *Tesco* offers its customers a broad range of all different food categories and – particularly in its larger stores – also a broad range of general merchandise products, including electronics and clothing. In total, across its different formats, *Tesco* offers **90,000 different products** (SKUs). A recent UK study identified how superstores offer broad product assortments compared to discount stores (The Guardian Online 2015):

- **Ketchup**: *Tesco* offers 28 options, from its store brand to *GranoVita* organic tomato ketchup. *Aldi* only has one option: its store brand.
- **Dishwasher tablets**: *Tesco* offers 26 options, from *Tesco Everyday Value* dishwasher tablets to *Finish Quantum Powerball* tablets in apple and lime. Aldi has three options: its store brand in different pack sizes.
- **Rice**: *Tesco* offers 98 options, from *Tilda* steamed wholegrain basmati to *Yutaka* sushi rice. *Aldi* has six options, all store brands.
- **Coffee**: *Tesco* offers 283 options, from *Nescafé* to *Taylors of Harrogate Lazy Sunday* coffee beans. *Aldi* has 20 options: 5 types of *Nescafé* and 15 SKUs from its store brand.

While providing an assortment is clearly an important task, the question is what the optimal assortment is and what the optimal selection is for customers. While a supermarket customer clearly wants choice, too much choice can be confusing and delay purchase decisions. Furthermore, a broad product range is linked to high costs. While a broad range is a differentiation factor for superstores, it must not be too broad. Another reason why *Tesco*'s range has grown substantially over recent years is so-called **slotting fees**. Retailers like *Tesco* demand payments from their suppliers to put products on their shelves. With the increasing profit pressure on *Tesco* over the last years, listing new products has been a way to generate short-term income to improve profit and loss statements.

Dave Lewis, *Tesco*'s new CEO, has targeted reducing the assortment as another way to improve *Tesco's* cost situation without sacrificing customer satisfaction. Cutting out unnecessary products from *Tesco*'s product range will help cut prices, make shopping easier for customers, improve product shelf availability and make ordering and refilling shelves much less costly (The Guardian Online 2015). Therefore, *Tesco* has recently announced it will **reduce its as-**

sortment by almost 30 % of its SKUs. Instead of its current 90,000 SKUs, it has hired the Boston Consulting Group to decide which products will be eliminated. The final number of SKUs is expected to range between 65,000 and 70,000 (The Guardian Online 2015).

1.6.5 Store Brands

Compared to other countries, store brands in the UK have one of the highest market shares. Market leader *Tesco* strongly contributes to these figures. It is estimated that about 45 % of *Tesco's* sales come from its diverse store brand portfolio. In developing this store brand portfolio, *Tesco* has long been a role model for retailers around the world. For example, the company was the first to seriously launch a premium store brand ("*Tesco Finest*"), after which the premium store brands of many other retailers in Europe are modelled. *Tesco's* most relevant store brands are (see also Chap. 12):

- ***Tesco***: The standard store brand, which occupies a similar quality and price level to many manufacturers' brands and which covers very different types of food products. *Tesco* offers a choice of over 10,000 products with the *Tesco* brand.
- ***Tesco Everyday Value***: This is *Tesco's* budget store brand, offerings sufficient quality at very low prices, particularly for basic products.
- ***Tesco Finest***: This is *Tesco*'s flagship and premium store brand, which claims to be "best quality food", using specialist ingredients or recipes inspired by restaurants or celebrity chefs. The brand was launched in 1998, and while most other retailers' premium store brands see limited sales, *Tesco Finest* achieves more than 1.5 billion GBP in sales per year.
- ***Tesco Organic***: This is a product range for organic food, from fresh fruits and vegetables to organic ingredients in other food products, etc.
- ***F+F***: This is *Tesco's* store brand for clothing products. It sees sales of more than 1 billion GBP per year. As well as being sold in *Tesco* food stores, *Tesco* has also started to devote separate selling spaces to the brand (still within *Tesco* stores) to provide a more shop-like atmosphere.

Other store brands include *Tesco Free From*, *Tesco Healthy Living* and *Tesco Goodness*. In terms of traditional retail functions, this broad array of store brands allows *Tesco* to perform functions traditionally carried out by manufacturers. While *Tesco* brand products are still produced by independent suppliers, *Tesco* itself designs the products, plans the recipes, defines quality standards, etc. *Tesco* has developed its own food manufacturing standards that set requirements for suppliers of its store brands.

Sourcing the assortment

Retailers provide customers access to an assortment of products that they would otherwise have to source themselves. Retailers perform this sourcing globally, as the example of *Tesco*

shows (The Telegraph Online 2009). While many of *Tesco's* grocery products are sourced within the UK (except, obviously, fruits, spices and other products that do not grow there), most of its non-food products come from Asia. About 60 % of all clothing and 40 % of other non-food products sold in *Tesco*'s UK stores are procured via a *Tesco* sourcing office located in Hong Kong. *Tesco International Sourcing* uses more than 800 suppliers, mostly in China, with about 1000 factories. Together, every day about 200 containers full of clothing, TV sets, barbecues and other products are shipped from Hong Kong harbour to *Tesco*, mainly for sale in the UK (The Telegraph Online 2009).

Marketplace partners on Tesco.com
Tesco uses another measure on its online platform to expand the assortment it offers to its (online) customers. Similar to strategies by other large online retailers like *Amazon* or *Zalando*, *Tesco.com* allows third-party sellers to use its platform. This marketplace was introduced in 2012 and the number of partners has strongly increased since 2013.

1.6.6 Creating Demand

As well as placing an assortment in its stores, *Tesco* also contributes to creating demand for those products. For example, according to the market research company *Nielsen*, *Tesco* is the fifth largest spender on advertising in the UK consumer goods sector, behind only the consumer good giants *Procter & Gamble* and *Unilever*. Spending about 120 million GBP a year via different media (brochures, TV, radio, etc.), using the different methods described in Chap. 14, *Tesco* advertises its services and specific products to its customers. In addition, *Tesco* runs thousands of promotions each day, using many of the different promotion methods described in Chap. 13 to sell products from its diverse suppliers.

In 1995, *Tesco* launched a very strong loyalty scheme, the ***Tesco Clubcard***. This is one of the most effective loyalty schemes in the world, and it has been described in a number of case studies (see Zentes et al. 2011, pp. 309–317). With this loyalty card, *Tesco* tracks customers' individual purchasing behaviour, segments customers, uses strong direct marketing measures and offers customers precisely the right marketing measures (e. g., price discounts, special offers, etc.) to influence them to buy products from its range. In general, *Tesco* applies all the methods that loyalty programmes have been observed to use (see Chap. 16) and it has very early developed powerful data mining techniques and innovative methods to profile customers and link their profiles to the products they may be interested in.

1.6.7 Services

In addition to selling products, *Tesco* provides a number of services. For example, it obviously has sales staff to help customers in store. As part of *Tesco's* current restructuring measures, **customer satisfaction** with service and staff helpfulness is monitored. A number

of initiatives have been established to improve service. *Tesco* has increased staff numbers (investing in additional working hours for sales employees) and better aligned working hours to customer traffic (i. e., moving sales employees' working hours to busy times) via an improved staffing system. *Tesco* has also improved work processes to increase efficiency and free employees from unnecessary work so they are available for customers. With these measures, customer satisfaction with service has greatly improved over the last two years.

Tesco also sells products – both in store and online – that need home delivery, like large domestic appliances. *Tesco* provides delivery and installation services. Furthermore, *Tesco* has introduced **product recycling**, which customers can purchase as an additional service. Here, the *Tesco* delivery team will remove the old appliance when they deliver the new one.

In addition to product-related services, in recent decades *Tesco* has diversified its business into additional services. This diversification was intended to exploit the existing customer base. *Tesco* diversified into banking services in 1997 and later into the telecommunications market with *Tesco Mobile*, a mobile phone provider. *Tesco Bank* provides a range of financial services, including credit cards, insurance, etc. It has synergy effects with *Tesco's* core business, as customers can be provided – e. g., via the *Tesco Clubcard* – targeted offers for financial services. Furthermore, *Clubcard* points are awarded for *Tesco Bank* business. Recently, *Tesco* decided to sell its stake in *Tesco Mobile* as part of its effort to pin off non-core businesses.

1.6.8 Summary and Outlook

As well as fulfilling all the standard retailer functions, *Tesco* goes well beyond. For example, *Tesco* will deliver food and non-food items to customers' homes, and it offers the Click+Collect cross-channel services. It has a very efficient supply chain linking its suppliers' production sites to its stores. And it has a broad base of stores throughout the UK. As well as buying products from brand manufacturers, a large portion of *Tesco's* assortment is store brands, for which *Tesco* designs the products, develops recipes, searches for manufacturing options and coordinates the full value chain.

However, *Tesco* also shows how quickly the customer requirements for these different functions can change, and how quickly a retail success story can turn into a **crisis**. Discounters have suddenly become dangerous competitors – even though *Aldi* and *Lidl* have been in the UK since the early 1990s and never previously posed a threat. *Tesco*'s store network, which until recently was seen as a huge asset, is now perceived to be a burden, because too many of its stores are very large *Tesco Extra* and *Tesco* superstores. Re-structuring these stores to reduce their size and fill the remaining space with useful features is a huge challenge.

Globally, it has become clear that customer requirements for fulfilling retail functions are strongly heterogeneous (see Chap. 8). Store formats and products that worked very well in the UK (and in a number of other European and Asian countries) were not well received in the USA or in Japan, to name only two examples. *Tesco* withdrew from these

markets, a sign that the same functions have to be fulfilled in different ways for different customers around the world.

Questions

1. Using the catalogue of retail functions, describe *Tesco's* activities in terms of these functions.
2. Imagine if *Tesco* developed a strategy of building its own factories and further broadening its own brand range. What would this mean for its relationship with manufacturers such as *Nestlé, Unilever or Kellogg's*? Explain.
3. Assume a manufacturer such as *Tefal* (cookware, e. g., frying pans) decided to sell directly to the final customer. Considering the functions currently executed by retailers such as *Tesco,* what would *Tefal* have to do?

▸ Consider Chap. 6 on manufacturers' vertical strategies.

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