

# Evolution or revolution?

## How to respond to consumers' demands for value



We have all seen the evidence: consumers are responding to the recession by reining back on their spending. Value operators have seized the opportunity this presents, positioning their offer as a way to maintain the same standard of living at a lower cost. Given the current economic conditions, this is no great surprise; the more critical question is whether these changes in consumer behaviour are likely to be permanent.

During summer 2009 we interviewed over a thousand consumers, and some of the leading CEOs in the retail, consumer goods, and leisure sectors. We wanted to look behind the headline figures and media stories to identify whether the trends in consumer behaviour we are seeing now are temporary, or indicative of a far more enduring step-change in the way we spend our money.

Our research into consumer and corporate behaviour suggests there have been some structural changes. Consumers have traded down and often liked what they have found. The value sector is developed and here to stay. A continued polarisation between value and premium will force companies to adapt and remodel their businesses for the new consumer.



## Introduction

'easyJet see sales soar', 'Cash-strapped consumers turn to discount supermarkets'; 'Primark is the new black'. The value sector may be making hay at the moment, but its competitors in the mid-market are banking on people returning to their previous purchasing habits when times improve. But will they prove to be wrong?

The value sector did not exist in the same form as today before the early 1990s. Many of its most successful operators grew rapidly following the pressures of the last recession. Will the current recession herald similar structural changes? If so, what can mainstream businesses do? Is competing on price alone a viable option, or are there other strategic alternatives? And will the changes some mid-market businesses are already making prove to be merely short-term survival tactics, or are we seeing the start of an evolutionary shift in the whole mid-market?

Having done our research, we are convinced it is the latter. In fact we believe consumers are developing a whole new understanding of what value means. If mainstream businesses are to survive the recession – and thrive in the upturn – they will need to understand this new dynamic, and identify what 'value' now means for their own products and services. This may mean stripping out costs that do not add value, or even 'unbundling' what they currently offer, focusing on those elements customers really value. The good news is that doing this will open up new commercial opportunities across the retail, consumer and leisure sectors and allow the smarter players to create a new and sustainable competitive advantage. The last recession gave rise to the modern value sector. What will be the legacy of this one?



## Is there a flight to value?

One of the catchphrases of the current recession is the so-called 'flight to value'. Most journalists and commentators use this as a straightforward synonym for 'trading down', as consumers switch from upmarket stores to discount chains at the expense of their more established (and expensive) peers. But our research suggests that what 'value' really means is rather more complex than this. In fact, consumer perceptions of the relationship between price and value can vary significantly depending on the economic conditions at the time.

In good times consumers feel wealthier and are therefore more relaxed about the correlation between price and value, but in a recession this relationship comes under intense scrutiny, and people become far more willing to make



"What we have seen in the grocery sector is that consumers have been switching more than they did before. They're visiting more types of supermarkets than they ever have before in the UK."

Marc Bolland, CEO, Morrisons plc

the extra effort to compare prices and look elsewhere. They put a new priority on getting a bargain, but they still want the quality they have grown used to in a boom. You can see this very clearly in our research, which suggests that trading down is only one of four distinct strategies consumers are employing to get better value for money and maintain their standard of living in the current recession.

The strategies we identified are:

- Trading down – buying cheaper types of products or services
- Switching – buying from cheaper stores or leisure channels
- Buying clever – spending more time getting the best price – for example by checking prices on the internet or hunting for promotions
- Buying less – simply buying less than before.

Interestingly, behaviour is different across grocery, clothing, restaurant and travel – largely driven by the degree to which the spend is discretionary. In grocery, the majority of consumers are buying clever and trading down, whereas in clothing and restaurants



the key behaviour is buying less. Recessions provide the breeding ground for substantial changes in market share as customers shop around for the best retail and leisure deals. Retaining new customers through delivering a positive experience is what allowed the value sector to grow rapidly after the last recession.

We expect the value sector to do better this time around, starting from a much stronger position.



“We have certainly seen a change in the customer base that’s coming into New Look. We see a flight to value from the mid-market players”.

Carl McPhail, CEO, New Look



“Customers want good value, but they want great quality. They’re choosing where they wish to shop to get good value.”

Robert Schofield, CEO, Premier Foods plc

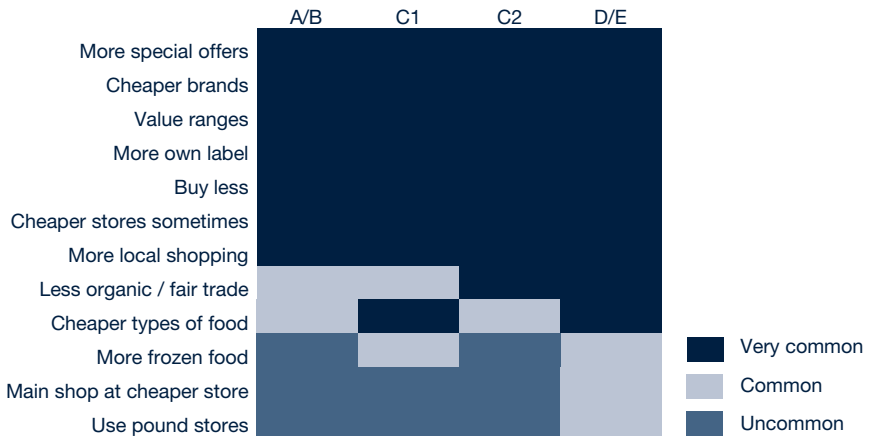
### Changes in consumer behaviour



\*Travel is not applicable



### Changes in grocery buying behaviour by socio-economic group



Interestingly, this behaviour is visible across traditional socio-economic boundaries. As the chart shows, when buying groceries, people from all socio-economic groups have been behaving the same way. This holds true in all the sectors or segments we researched and is one of the aspects of the current downturn that distinguishes it most markedly from those we saw at the end of the last century. Consumers simply cannot be segmented into nice neat boxes anymore which makes mass market targeting much less effective.

For example, 17% of those who shop at premium supermarkets regularly buy clothes at discount stores, while 11% of those who opt for mid market or value grocers also shop for clothes at designer outlets. Consumers are less homogenous and increasingly complex and difficult to segment. The future focus has to be more on how to enable a product, service or retail offer to be tailored more closely to individual consumer needs.



Furthermore, over half of those we questioned who said they would not go back to their old shopping habits put this down to the fact that there is no longer any stigma attached to being seen in cheaper retailers. Indeed, newspaper pictures of celebrities shopping in some of these stores and even starring in their advertising campaigns has given them a cachet of their own. But will consumers go back to their old behaviour?

Unsurprisingly, the value end of the market is hoping the answer will be no, while premium and mid-market companies hope that consumers will revert to more conventional buying patterns, and trade up once the recession is over. Although the answer will vary from consumer to consumer, and sector to sector, our research strongly suggests that some of the changes we are seeing in the retail, consumer goods, leisure and travel industries will prove to be long lasting for a significant number of consumers.



“Once the recession is over, I think consumers will continue to up trade again. Why? Because that is what has been happening historically, first point. Second point, we’ve had recessions in the past, which have been quite severe in certain regions, and what we’ve seen is once those recessions are over, consumers go back to their historic purchasing behaviour which is to up trade.”

Paul Adams, CEO, British American Tobacco plc

Last time around the value sector was characterised more by ‘cheap’ or ‘discount’ offers characterised by a sacrifice of the quality of experience of product, with few national or well known brands. Today the value sector is thriving, with nationally recognised businesses. This sector is in many cases outpacing the retail and leisure markets in which they operate. As discussed before, value in this context does not necessarily mean lower price – it means better value for money at lower prices. Cheap does not have to be nasty anymore.



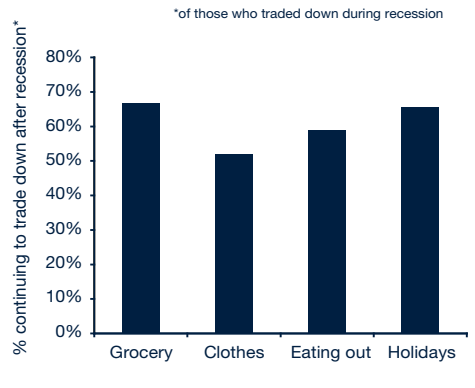
## Is this a temporary tactic or structural shift?

We believe we are witnessing a structural change.

Nearly 70% of our respondents who have traded down for some or all of their groceries say they will continue to do this once the recession is over. Similarly half of those who have switched to cheaper options for their clothes shopping will continue to do so once the recession is over. At a product level, trading down behaviour is likely to be permanent in brand led FMCG categories such as toilet paper, washing powder, and soap. Consumers are more likely to trade back up to higher-priced products in perishable categories such as meat, fruit and vegetables. Of the products surveyed, people are most likely to trade back up in chocolate where indulgence clearly comes at a premium. The same patterns are seen in travel, with 68% claiming they will still look for cheaper accommodation, flights and destinations when the recession is over, even though a surprisingly high proportion (48%) will revert to holidays abroad rather than the UK.

So what is driving these decisions? Why will some purchasing choices

### Changes in consumer behaviour: will they be permanent?



revert to pre-recession patterns, while others look likely to stick? At one level this is about long-term macro trends. The share of total household spending absorbed by groceries and clothes has been falling over the past 25 years, and this is likely to continue as consumers choose to spend more on leisure and technology or are forced to devote more of their income to housing and fuel. This is likely to make many consumers – especially those on lower incomes – reluctant to revert to spending more on food and clothing unless they see substantial tangible benefits in doing so.

This takes us back to the whole idea of what 'value' really means.



## What does 'value' mean to consumers now?

From the grocery element of our research, we asked people who had traded down what they thought of what they found. Nearly 78% of them believe they got the same or better value, driven by the 90% who believe the quality was as good or even better.

But can this really be the case? We decided to carry out our own research into the relationship between price and quality, focusing in particular on clothing. We bought five different



“I think once people discover value for money they will stay with it and why shouldn't they; they're smart.”

Alan Parker, CEO,  
Whitbread plc

types of garment ranging from T-shirts to jeans, from ten different retailers covering the whole spectrum from value to designer stores. We then performed industry standard textile tests (for example on colour fastness and performance after washing) and compared the outcomes with the retail price.

The results show that it is no longer the case that cheap clothes are sub-standard – in fact many of the cheaper clothes performed better in the tests (see below). Some might be surprised that the best performing garments were from a leading value retailer. Obviously we could not test subjective quality such as fit and style, but clearly price is not necessary correlated with product quality – no wonder many customers say they will continue to shop at the value stores.

### Results of PwC product testing

		Price	Quality			Price	Quality
T-shirt		£2 Lowest	8th	Polo shirt		£4.50 Lowest	= 4th
		£5	1st			£12	1st
		£39 Highest	4th			£85 Highest	5th

Source: PwC textile testing, 50 garments from 10 retailers



Our research suggests that most UK consumers have traded down in one form or another, and many of those who have done so like what they have seen. They do not want to go back to paying the old prices, and this is unlikely to change even in a sustained upturn. That said, consumers are still prepared to pay more if they can see clear benefits from doing so – they are just getting a lot more astute about what those benefits are, and how much, exactly, they are willing to pay for them.

Some commentators have christened this new trend ‘scrimp and splurge’ – in other words, the same consumer is often willing to spend quite significant amounts on products and services that they perceive to have genuine value, while focusing ruthlessly on finding the lowest prices for goods they perceive as more commoditised. The challenge for all companies is to understand how this dynamic is working in their own sector, so that they can start competing with the low cost operators on value, not price.

After all, competing on price alone has rarely been a successful option for most mid-market businesses, because the

operational changes required are simply too sizeable. Becoming a successful low cost operator in retail, consumer goods or leisure, is about far more than merely maintaining low overheads. In fact, it is generally far easier to build a low-cost business from scratch than transform a higher-cost one, because the two operating models diverge so dramatically. Our research suggests that the lowest cost operators have a cost advantage of 10 to 15% of sales versus more traditional players in grocery, clothing and leisure sectors, driven by their operating models, cost base and culture.

Using a price war to force your low-cost competitors out of business is a dangerous undertaking, because they are often more likely to survive than you are.



“I think value retailers are here to stay, I think over the past 20 years we’ve really established ourselves in the High Street, and consumers want us.”

Hussein Lalani,  
Commercial Director and Co-founder,  
99p Stores



This is why the conventional wisdom for mid-market operators has always been to differentiate their own offering by adding value rather than cutting price.

However, the insights we have gained in our research suggest that this is now a more challenging strategy than it once was. In fact, some of the products and services provided by mainstream businesses are no longer prized as much as they once were – at least for those where consumers perceive the price to be out of line with the benefits the product or service brings. Moreover, in some cases this may be a permanent rather than a temporary change of preferences and priorities.

This means that upgrading these products or services by adding new (and expensive) benefits may not be the answer. The focus instead should be on assessing which of the existing product or service benefits customers do value, and which they do not, then matching the proposition more closely to individual consumer needs. In some cases it means lowering prices, in others it means adding benefits, however, in most it means providing more for less.



“I think lowering operating costs is going to be a continuing focus for the industry over the next few years, and I think what the recession has done is it’s woken everybody up to the opportunities that exist to do that without compromising the guest experience.”

Andy Cosslett, CEO  
InterContinental Hotels Group plc

This may seem like a recipe for lower profits, however, this is not necessarily the case. Our research suggests that over time, customers get used to many of the ‘benefits’ that have been added and ascribe no value to them, even though they may be costly to deliver. For them, less can mean more.

In addressing this new consumer challenge, it is therefore critical as a first step to be as efficient as possible, to eliminate wasted or non-value adding costs and to remove anything the customer does not value. The second step is to reassess the business proposition to match it more closely to consumers’ individual needs and get them to pay more for what they really value.



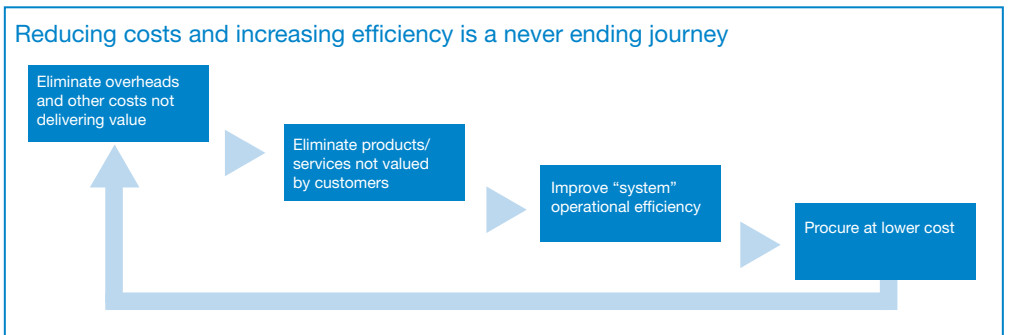
## Reducing costs and eliminating waste is back top of the agenda

During the good times, many businesses reduce their focus on costs. This is being reversed now, especially with respect to cutting out the costs that deliver no consumer benefit. All the CEOs we interviewed are reducing overheads, maximising procurement savings and eliminating redundant product and service features: in fact, rationalising anything that costs more to deliver than customers are prepared to pay – or reducing the cost to an economically viable level. This renewed focus is about identifying good costs, and bad costs – those that generate value for the customer, and those

that do not. For example, a number of the CEOs we interviewed cited the example of hotel concierge support. With so many businesspeople carrying their own blackberry or laptop, they no longer value, or want to pay for, these services, which means hotel operators can remove them and their associated costs without having a negative impact on guests. This brings costs down and ensures that any price premium is associated with services that people value, rather than something they no longer need.

This is an iterative process that can sometimes be neglected in the good times – opening the door for the low cost operators to enter the market.

### Reducing costs and increasing efficiency is a never ending journey





## Match the proposition much closer to customers' individual willingness to pay

Customers do not necessarily want to buy the cheapest product on offer. It is human nature to want to trade up. Furthermore, consumers recognise that higher service or convenience can come at a price. The challenge is to clearly signpost why customers should pay a premium over the lowest cost option.

There are four models we have seen businesses use to get customers to pay more for products and services – each one gives the customer added choices about how much to spend, or what to spend their money on. They are:

- Product ranges – quality choice
- Channel – location choice
- Yield management – timing choice
- Unbundling – attribute choice

The first three are well-trodden paths:

### Product range

We have seen the development of sophisticated product range hierarchies within the grocery, clothing and leisure sectors – this can be either within a

store (e.g. good/better/best in grocery and designer/diffusion in clothing) or by using different brands (e.g. tour operators or restaurants). The last recession saw Tesco and ASDA launch value ranges to combat the arrival of the hard discounters. This time, we have seen round pound pricing and “discounter ranges” launched. Going forward, ranging will remain a key tool in targeting value better at specific customer needs.

### Channel

Channel used to be about giving customers choice about where to shop – e.g. in the high street, out of town or in the neighbourhood. Now, the online channel and home delivery can also be added. New technology and the internet are changing the way consumers shop – how they research, where they buy, who delivers it, the choice is theirs. Pricing differentiation can be effectively introduced to reflect greater channel costs e.g. location or delivery costs. A multi-channel strategy can be an effective weapon against lower cost operators who tend to have a fixed and inflexible operating model.



## Yield management

Long established within the travel and leisure industry, yield management gives the consumer a timing choice. Customers are rewarded for booking early or using under utilised capacity whereas they have to pay for last minute travel or highly valued time slots. This is as true for flying and hotels as it is for grocery home delivery. We expect to see some interesting developments in this area, especially as the population switches from cash rich/time poor to time rich/cash poor.

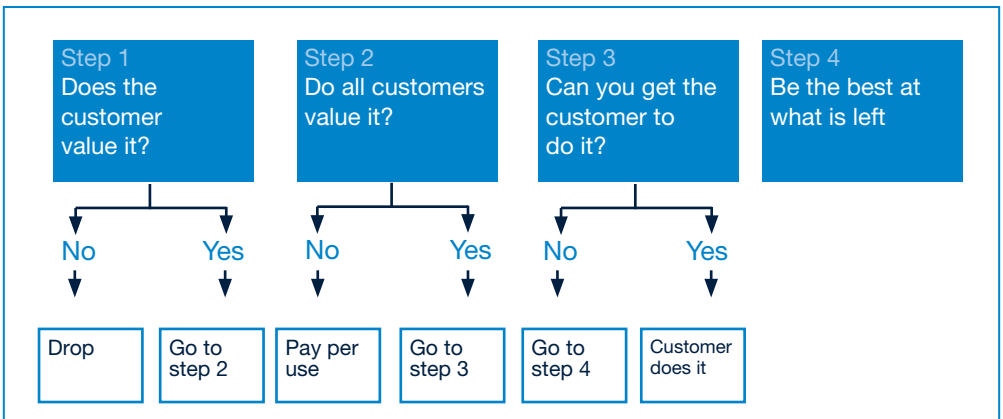
## Unbundling

Unbundling is about stripping down a product or service to its component

parts, then reassembling it in a way which gives consumers more choice about which product or service attributes they want to buy and about how and when to consume them.

It allows companies to unbundle what they are offering, so that they can evaluate exactly which elements people value, and at what price they are prepared to buy them. They can then use this insight to deliver better value to consumers and over the long term, higher profits to themselves. The diagram below shows how the decision making process might work:

Clearly, if consumers don't value a particular element of the product or





service then it should be dropped altogether if possible. If some customers value it, then there is an opportunity to make them pay appropriately for it, so that prices can be reduced for the rest, and the majority does not have to subsidise the minority. Even if all consumers value the proposition, there may be ways to get them to happily undertake some of the work for themselves: that is a clever win-win that effectively reduces costs, and therefore enables price reductions. Finally there are the benefits that everyone values, but customers will not or cannot do for themselves. These therefore become critical as brand, product of service differentiators and need to be a source of real long-term competitive advantage.

Low cost airlines are far further down this route than many other sectors. There has been a good deal of media coverage about their charging structure but as the diagram shows, the disaggregation process has gone much further than this, with some services dropped altogether, most being on a pay per use basis, and customers even taking part of the responsibility for cleaning the plane, which not only reduces costs, but cuts turnaround time on the ground. Interestingly we are now seeing additional charges being levied by some carriers for ‘premium’ services and suggestions that onboard facilities may not be ‘core’ – clearly we have not reached the end game yet.

#### Unbundling and personalisation in action - airlines

	‘Low cost’	Full service carrier
Check-in	Pay per use	✓
Baggage	Pay per use	✓
Lounge	Pay per use	Premium
Allocated seat	Drop or pay per use	✓
Food/drink	Pay per use	✓
Onboard toilet	Core	✓
Clean plane	Customer	✓



## Unbundling and personalisation in action - restaurants

	Fast casual dining	Full service
Greet & seat	Core	✓
Tablecloths	Drop	✓
Food order	Customer	✓
Serve drinks	Customer	✓
Lay table	Customer	✓
Serve main course	Core	✓
Serve dessert	Customer	✓
Clear table	Core	✓

There can be a limit to the unbundling, which will turn away some customers. These customers can often however be the higher cost-to-serve population who have historically been subsidised by other customers.

A parallel example from the hospitality industry are the fast casual dining operators (such as Nandos), where the core proposition has been refined down to greet and seat, food service, and table clearance. Everything else is either eliminated or done happily by the customer in return for lower prices.

There are far fewer examples in retail but the recession and new technology may change that. IKEA, for example does not have conventional shelves, and makes an additional charge both

for optional extras like delivery and assembly, and for elements that are still core to a traditional retail business model, like paying by credit card. At one low cost extreme you can pick your own product, pay by cash, take it home and assemble it yourself. At the other, you can pay online by credit card, have it delivered and IKEA will organise a third party to assemble it for you. You pay your money and make your choice. Further retail examples include self-service checkouts, stores without stock to take home and personal shoppers. This will be an area of real future innovation.

Unbundling works best where elements of the product or service can be easily separated from the underlying offering, and costed accordingly.



For most businesses, it will be an iterative process, testing in the market where an element needs to be part of the core product and where it can be unbundled. Nonetheless, the approach can allow businesses to target efforts on what customers want, eliminate unnecessary costs, and remain competitive where it really counts.

But can unbundling be an effective weapon against the value sector? We think it can be. The difference between a mid-market and value operator is likely to be which elements of products and services become core, offered to all at no extra charge, and which become 'pay per use'. While mid-market and premium players may never unbundle basic aspects of their products or services as the value operators have done, they may allow customers to 'personalise' their products, enabling those who wish to purchase additional elements to do so without imposing the associated costs on those who do not want them.

The CEOs we interviewed agreed that this 'personalisation' approach could offer significant potential for some mid-market and premium businesses

allowing customers to access a basic level of service for a lower price and paying more for additional features which low cost operators often cannot afford. British Airways has announced that it is introducing charges for some customers to pre-book certain 'premium seats'. TUI Travel UK also see further potential for personalised itineraries, allowing customers to add additional elements to their holidays, without driving up prices for other customers.

Clearly there are those who will choose to remain bundled and develop the 'all inclusive' nature of their products as a key differentiator, especially the more premium operators where the brand or experience drives the perception of value. 'Value' and 'premium' will co-exist; the undifferentiated mid-market is dangerous territory.



"I think there's a real opportunity in the future to look at unbundling some of the core product offering... an example of that is lounge access...but I don't think you'll see full service, quality brands like British Airways unbundling to the same degree as the no-frills carriers have done."

Willie Walsh, CEO, British Airways plc



## Where next?

Our research clearly shows that consumer behaviour has fundamentally changed in the course of this recession. The value sectors across retail, consumer goods and leisure are now well established. As we move towards an upturn this sector is likely to continue to thrive, because customers have sampled what it has to offer, and they have liked what they have seen.

This means that tempting them to switch back to their old habits will be harder than it is ever been before. In a market where consumer behaviour is increasingly fragmented, this may be a real challenge, especially for the mid-market operators. In the face of this new customer behaviour, all businesses will need to rethink their business models, both by reducing their cost bases, and re-aligning what they offer to what their customers really value, and what they are prepared to pay. Some products and services will be dropped, others may be charged for. It will be all about offering a very personalised product which delivers better value to each customer.

One thing, however, is clear. History teaches us that evolution in business follows the same rules as evolution in biology: it is crises that bring about the most significant change. This recession is now driving the evolution of new thinking, new technology, and new business models for the consumer sector.

The customer has changed. As ever, the winners will be those who evolve furthest and fastest to meet their new and more individual needs.

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