Despite the recent failures of Tesco’s Fresh & Easy and Walmart's Marketside in the U.S., the small grocery store format - roughly defined as between 8,000 and 20,000 sq. ft. in total size - is becoming increasingly significant in the U.S. supermarket industry. However, its future continued growth will inevitably be “messy” as time goes by.... messy in terms of acquisitions, mergers, site selection mistakes, store closures, and outright failures.

There are obviously two (2) main genres of small grocery store formats:-

1. Natural/Perishables Stores, e.g. Earth Fare and Sprouts
2. Limited Assortment Stores, e.g. Aldi, Grocery Outlet, and Save-A-Lot

In addition, there are cross-over and blended formats, such as Bottom Dollar, PriceRite, The Fresh Market, Trader Joe’s, and Walmart Express, and the still-untapped potential for European-style convenience stores (not to be confused with the gasoline-oriented American version).

Small store format growth in the U.S. continues to be encouraged by at least ten (10) factors:-

1. **Demographic trends**, especially the aging population (and their distaste for large stores) and the increased attractiveness of urban living where large-scale retailing is less feasible or necessary.

2. **Falling real incomes** are stimulating a multi-store shopping pattern including the use of Limited Assortment Stores and other price formats.
3. The effects of declining real incomes - and the resulting increased opportunities for Limited Assortment Stores - are being reinforced by cut-backs to the Federal SNAP and unemployment benefits programs.

4. Political and social concerns about the food deserts in deprived areas of major U.S. cities.

5. Increasing health awareness in the case of Natural/Perishables stores.

6. Increasing time pressures and disorganized lifestyles which are resulting in more quick fill-in shopping trips which favor small format stores.

7. The continuing real estate glut - soon to be re-fueled by the inevitable fall-out of the Office Depot - Office Max merger.

8. The mediocre perishables standards of many traditional supermarkets, as exemplified by the former Dominick's stores in the Chicago market.

9. Technological change - specifically the growth of online retailing - is encouraging the development of small store formats as pick-up points and reducing the need for, and attractiveness of, large store formats offering wide - but never comprehensive - selections.

10. Growing grocery competition from "small format" Drug and Dollar Stores. In the case of the latter, their rapid development has been enabled and encouraged by the continued shortage of Limited Assortment Stores.

The growth of the Natural-Organic/Perishables store format will inevitably pressurize margins at Whole Foods - supplemented by strengthened natural-organic competition from "traditional" chains such as Kroger. By capturing high-margin perishables sales, their growth will also accelerate the down-sizing of the still-substantial middle-market supermarket segment.

However, in my opinion, the growing Army of Natural-Perishables start-ups (included in Figure 1) is arguably getting excessive attention in the media in relation to Limited Assortment Stores. Many of the former will close or be acquired in coming years because of operational failures, localized over-storing, and the chronically weak site selection that this segment appears to
“specialize” in. While usually picking the right general locations in an urban area, many of the operators apparently never see a site they don’t like and are setting records for the briefest times from store opening to closing!

In our view, Limited Assortment Stores should – and will – be of greater significance over the next 5-10 years, despite Aldi’s previously slow, deliberate and profitable expansion since its U.S. launch in 1976. Presumably stimulated by the much-reported and delayed arrival of arch-rival Lidl, Aldi has just announced an acceleration of its store openings from 80 to 130 annually over the next five (5) years….which will take it to over 2,000 U.S. stores and over $15 billion in annual sales by 2018.

With exceptions, such as Price Rite, most "domestic" Limited Assortment Stores have performed indifferently because of inadequate operational disciplines, especially excessive SKU counts which have inflated labor costs and other expenses. As a result, their price differentiation has been inadequate and has stunted the overall growth of the format to far below where it “should” be – in terms of store counts and market shares - given the needs of an increasing proportion of American grocery shoppers.

Like Clubs, Limited Assortment Stores have very fragile economics but, unlike the three (3) remaining Club chains, they do not have the membership fee revenues, sales volumes, and non-food margins. Further, they obviously have even fewer SKU's: 1,200-1,500 versus 3,500-4,000. Their relatively low volumes and profits have unfortunately encouraged excessively fast rollouts and sloppy site selection by domestic operators - worsened by the desire to reduce Site Research costs in line with the perceived lower investment risks of the format.

The numbers and significance of Limited Assortment Stores will grow, however, as some of the U.S. operators “get it right”, Aldi ramps up its U.S. expansion program, and - assumedly - Lidl eventually develops a meaningful presence on the U.S. East Coast (plans for 100 stores are rumored). In addition, Dollar General may also “formally” enter the Limited Assortment Store fray after carefully fine-tuning its Dollar General Market format and converting, expanding, or re-merchandising "standard" Dollar General stores.

Central to the success of small store retailing - of whatever format - is powerful competitive differentiation on at least one or two key dimensions. The latter are - most obviously - extremely low prices or superior perishables quality and/or selection….coupled with locational convenience and the convenience of small store shopping. Trader Joe's is the obvious stand-out example of
clear-cut positive image differentiation - featuring unique products and superior service, as well as the convenience of a small footprint and value pricing.

Despite Tesco’s failure with Fresh & Easy - which was “driven” by inadequately interpreted market research, poor site selection, and transaction-limiting self-service checkouts - the small grocery store format is definitely a “wave of the future” in American grocery retailing. In large part, this is being driven by domestic innovators, such as Sprouts and Trader Joe’s. However, America’s grocers also need to learn from the “Best in Class” discount and small store retailers from Germany and elsewhere in the world. These are the retailers who have made life hard for the Hypermarkets in France, drove Walmart out of Germany, and are now pressurizing the “Big Four” supermarket chains in the U.K. The same trends are now taking place in the USA.
Figure 1
SMALL STORE FORMAT POSITIONING

| Higher Pricing | | | Balducci’s Earth Fare Mrs. Green’s New Seasons The Fresh Market |
| | | Natural Grocers/Vitamin Cottage Valuland Trader Joe’s Walmart Express |
| Lower Pricing | Aldi Dollar General Market Grocery Outlet/Amerlia’s Ruler | Save-A-Lot Bottom Dollar | PriceRite |

Limited Selection Perishables Selection Wider Selection

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