

# Retail & consumer hot topics

## Uncovering hidden growth potential



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Since 2007 the world economy has been confronted with an unprecedented financial, economic and sovereign debt crisis which also hit the retail and consumer industry. Increasing and highly volatile prices for raw materials, declining consumer confidence, unemployment, and shrinking margins are some of the indicators which are accompanying this scenario.

Nevertheless, retail and consumer goods companies are very skilled in overcoming challenging times and adapting to changing market conditions. Over the last decades the sector has constantly demonstrated its creativity and flexibility. But given the persistently rough economic prevailing condition, companies will even need more agility and motivation to reach the next level of growth in the near future.

Entering new markets will continue to be a major objective for retail and consumer companies, in order to enable additional and profitable growth. In this paper we are focusing on two attractive destinations for retailers and consumer goods manufacturers: Central and Eastern Europe and India. PwC experts who are based in the respective regions will share first-hand industry insights and comment on recent trends with you.

When it comes to cutting down costs another “hot topic” for retail and consumer companies is to enhance effectiveness in operational processes. Thus, category management, store operations, procurement and supply chain management are strongly in the focus of management. Especially in highly competitive and saturated markets operational excellence is more and more the critical success factor.

Our new “Retail & consumer hot topics” provides you with in-depth insights and food for thought on the above-mentioned challenges. I would personally like to thank these PwC professionals for the hard work they have put into authoring these pieces: NV Sivakumar, Bogdan Belciu, Mihaela Mitroi, and David Kovačič.

I hope you will find these articles insightful and useful. If you have questions or would like to discuss any of the topics mentioned in the newsletter please feel free to contact me or one of the authors. PwC's retail and consumer experts are looking forward to continuing our dialogue with you around current industry trends.

**Gerd Bovensiepen**

*Europe, Africa and Near & Middle East  
Leader Retail & Consumer Industry*

# India's Retail & Consumer Sector— Opportunities abound

## Drivers, trends and issues to address in India's retail sector



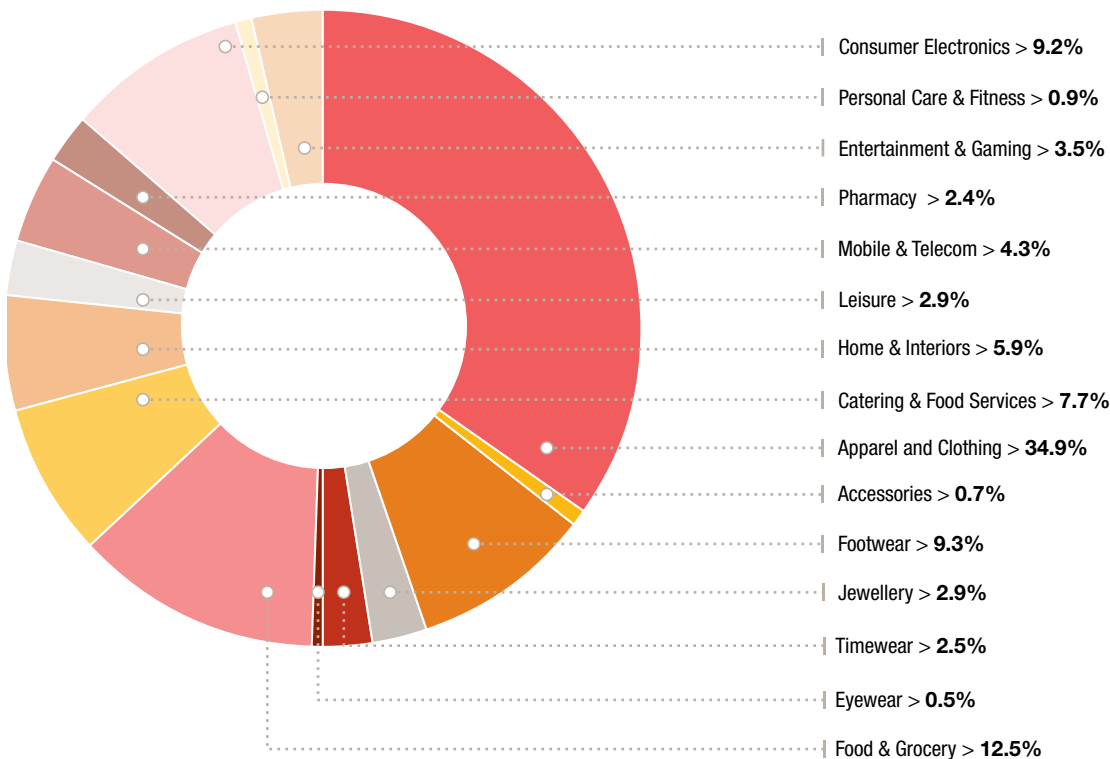
India's retail sector, worth over USD350 billion, differs from the retail sectors in most developed countries: it has a low organised retail penetration of 5 to 8% and is growing at a compound annual growth rate of 15 to 20%. The market is characterised by low penetration levels across most categories. Given its large market size and low organised retail penetration, significant growth opportunities exist across most categories.

The Indian retail and consumer sector has attracted the interest of the world's premier brands and many of them have a presence in India. *PwC's 14th Annual Global CEO Survey*, which covered 1,200 business leaders in 69 countries, indicates that 93% of retail CEOs surveyed believe that they will expand their Asian operations over the next 12 months.

Selected global retailers and brands with a presence in India include Cartier, Chanel, Marks & Spencer, Louis Vuitton, Metro, McDonald's, Swatch, United Colours of Benetton, Tesco, Walmart, Zara and others.

## India's organised retail market

Some of India's largest conglomerates have set aside billions of dollars to launch major, large-scale retail initiatives.



Source: Images Retail Report, 2011

## Investments of Indian companies

### Reliance Retail

USD 5.5 billion projected investment in food & grocery, leisure, apparel, accessories, gems and jewellery, hypermarkets, home and living, and eyewear

### Bharti Retail

USD 2.5 billion projected investment in cash and carry (agreement with Walmart) and food & grocery

### AV Birla Retail

USD 2.5 billion projected investment in food & grocery; market rumours suggest the retailer may launch an offering in specialty retail

Shopping in India used to be viewed as a functional activity; that is, buying only the essentials and not purchasing extra, or unnecessary, products. That said, increasing personal incomes, exposure to travel abroad, the Internet, growing aspirations, confidence in long-term career growth and the country's future economic progress have led to changing consumer behaviour. Indians are buying more non-essential products than before, switching between products, brands and categories, and experimenting with products.

The sector is not yet fully liberalised. Wholesale cash and carry, single-brand joint venture agreements (subject to riders), franchising, distribution and licensing are permitted. However, most retailers and analysts believe it is only a matter of time before the sector is further liberalised.

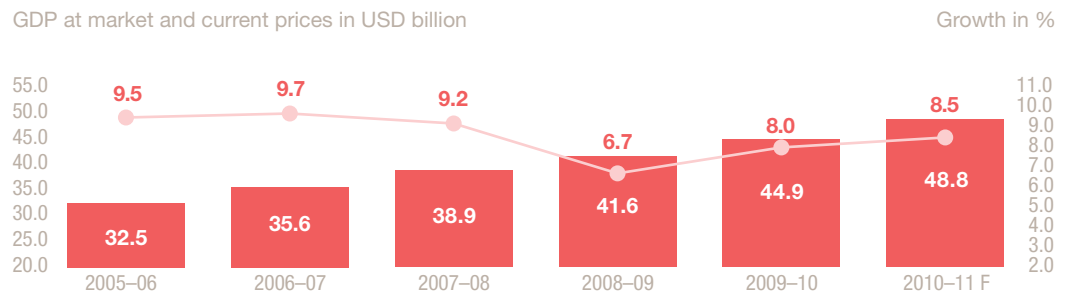
## India's twin growth drivers

Two major factors help make India one of the most exciting and dynamic retail and consumer sectors in the world:

### 1. Robust macro fundamentals

Since 2005-06, India has been growing at an average GDP of 8.6 percent. Foreign investment into India is increasing, Indian companies are stepping outside their national borders to acquire companies overseas, incomes are increasing and capital markets are buoyant. Also, studies have ranked Indian consumers as some of the most confident in the world. The more confident consumers are about the strength of the economy, their personal finances, and their career growth the more they will increase their consumption.

### India GDP growth trend



Source: Government of India

## 2. Demographic advantages

India's demographic advantages make it an extremely attractive market for companies that operate across a range of categories, among them: apparel, footwear, accessories, mobile phones, personal care, food and beverages, and hair care.

- > India has a large and aspirational middle class of 75 million households or 300 million individuals. Often referred to as the growth engine of the Indian economy, middle class consumers want products which are value-driven and offer value for money.
- > India also has 500 million Indians under the age of 25. Young India is driving purchases in mobile phones, fashion, accessories, food and beverage, and dining at quick service restaurants. Young Indians have access to more money than ever before and with this has come a sense of independence and a desire to be delighted and excited by products.
- > According to the *2010 World Wealth Report* by Capgemini and Merrill Lynch Wealth Management, the rise in the total number of millionaires grew almost 51% in India. This is the second-fastest in the Asia-Pacific region, after Hong Kong, which reported 104% growth.
- > The 700 million Indians residing in rural India present a future opportunity that retail and consumer companies cannot ignore. Agriculture technology has helped India improve its grain output, a boost to agro-based industries and rural incomes. Currently, the penetration levels for household and personal care products are very low in rural India, but those retail and consumer companies that localize products for this market, with appropriate pricing and packaging, can succeed.

The 700 million Indians residing in rural India present a future opportunity that retail and consumer companies cannot ignore.

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## *On the retail front: Evolution, expansion, excitement*

It is against this backdrop of business confidence, GDP growth and high levels of consumer demand that we consider retailers.

Retailers are moving beyond urban cities and are starting to establish a presence in other areas. While they are expanding operations, they are doing so in a manner which takes into account issues like retail real estate rentals and supply chain issues. Retailers are focused on growing their store networks and increasing same-store sales. Related to the idea of expanding operations is the need to hire more staff for sales floor activities. Some retailers have aggressive hiring plans; for example, media reports suggest that Reliance Retail wants to increase its employee size by 93,000. This would include all levels, such as middle and senior management and front-end staff.

As noted by PwC's thought leadership report "Strong and Steady—2011 Outlook for the Retail and Consumer Products Sector in Asia," hypermarket expansion is sweeping Asia, and India is no exception. The trick is choosing the size and product offerings of any particular hypermarket, according to local market tastes and real estate availability.

### **Launching private labels**

Not surprisingly, private labels appeal to the large number of value-driven consumers in India. Private labels, given their early-stage development, have yet to achieve the level of sophistication that we see in overseas markets in terms of quality of packaging, a wide presence across categories, and the creation of different tiers of products (no frills, premium, etc.). Regardless, any retailer setting up shop in India needs to consider establishing a private label suite of products.

### **The innovation imperative**

Rapidly-evolving customer demands, technology and competitor actions are just a few of the factors ensuring that product lifecycles are shrinking. Companies that continually innovate and launch new products will help ensure the longevity of their products and the product categories in which they operate. Establishing R&D and innovation centres enables consumer companies to create products that meet local market needs and identify game-changing products. In India new product launches have been occurring in hair care (shampoo, conditioners, styling products, hair masques, hair colorants), personal care (face wash, face masques, deodorants), skin care (anti-ageing creams, skin lightening creams, night creams, day creams), food (ready to eat meals, processed food, frozen food, noodles, cereals) and beverages (non-carbonated beverages, energy drinks, juice-based drinks, carbonated beverages).

FMCG companies typically face challenges with regard to supply chain and distribution systems. Distributing products to rural consumers is relatively expensive and to address this, companies can enter into partnership agreements or use intermediaries. Inadequate infrastructure, an absence of warehousing space, and large distances are some factors contributing to high distribution costs.

Indian consumers are making more informed choices in their food and beverage purchases.

### Health and wellness

“You are what you eat” is the mantra on which health-conscious Indian consumers are focusing. Today, Indian consumers are making more informed choices in their food and beverage purchases due to a variety of factors:

- > Better availability of healthier food options (imported, domestic) in modern trade stores
- > Increased promotional activities from brands that offer wellness products like zero-calorie artificial sugar sweeteners, juices without sugar and similar products
- > Commitments from food and beverage brands to create healthier snacking options, with lower levels of sugar, sodium and trans fats. New food and beverage products have been launched.

### Transactions

FMCG companies have been acquiring companies overseas that offer a range of products which include hair care, home care, and personal care. The trend seems to be continuing in 2011, with potential transactions occurring between domestic and global companies. India-based Jyothy Laboratories purchase of 50.97% equity shares from Henkel AG & Co KGaA, is subject to the receipt of regulatory approvals; Jyothy acquired 14.9% of Henkel shares in March 2011.

## Issues to address

### Workforce management

Hiring in the retail sector is projected to increase in the future due to several new global and domestic entrants and the range of formats they plan to offer. Growth in the Indian retail sector and the corresponding demand for talent has highlighted the need for effective workforce management systems. In general, human resource practices in workforce management are in the nascent stages of development in the Indian retail sector. Since organised retail is an emerging sector in India, experienced retail talent is somewhat scarce. The talent crunch in retail is exacerbated by the lack of the requisite training infrastructure.

### Infrastructure and supply chain

The main challenge in expanding outlets has been the absence of good retail space at the right price that opens at the right time. The major infrastructure required for moving goods in an efficient manner involves roads, freight, railways, ports and shipping, all of which are either managed or regulated by the government. Connectivity, quality of and costs incurred in developing infrastructure need to be improved. Streamlining and improving logistic services will improve productivity and reduce costs, thereby benefiting Indian consumers. As the market becomes increasingly crowded, supply chain expertise will be a critical enabler for overall competitive advantage (reducing costs, being more agile, moving goods efficiently to point of sale, and improving customer service through better prices and minimized stockouts).

### Retail benchmarks in supply chain

	Logistics cost as a % of price	Inventory turns	Stock-out %	Shrinkage %
Indian retailers	Approx. 10	3 to 14	5 to 15	3.1
Global retailers	5	Avg. 18	Below 5	Avg. 1

Source: Strategic Issues for Retail CEOs, PwC, 2010.

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## Critical success factors

Key factors for succeeding in the Indian retail and consumer market are:

### Understanding consumers

India is comprised of 28 states, but most retail and consumer participants believe that it is a country of 28 diverse markets. Consumers vary in terms of their education levels, attitudes, exposure and awareness levels, tolerance to price points, shopping behaviours, and buying patterns. Being able to understand a market of heterogeneous consumers and then adjusting supply chain requirements and merchandise mix are key success factors.

### Localizing products

Indian consumers, while they want to have access to the same products available overseas, also want to feel that a product has been created especially for them. Brands in quick service restaurants, apparel, luxury, food and beverage, and home goods have customized their offerings for the Indian market.

- > A global brand in the quick-service restaurant category created “Indianised” vegetarian offerings, using local flavours and ingredients, in order to appeal to the large number of Indian consumers. Most global quick-service restaurants that operate in India have localized offerings and operations (distinct cooking lines for vegetarian and non-vegetarian menu items) for the Indian market, keeping in mind cultural sensitivities.
- > One global luxury fashion and accessories brand launched a limited edition shoe model and handbag for the Indian market.

### Patience and deep pockets

Retail is a long-term play and requires patience and deep pockets. It takes between five and seven years to generate adequate returns. Retailers need to have sufficient capital strength to ensure operational continuity, until greater profits are generated. That being said, one of the arguments in favour of foreign direct investment is that it will usher in needed funds for expansion, new product launches, and supply chain development.

### Contact

#### **NV Sivakumar**

*Executive Director and Financial  
Advisory Services Leader India*  
n.v.sivakumar@in.pwc.com

#### **Rohit Bhasin**

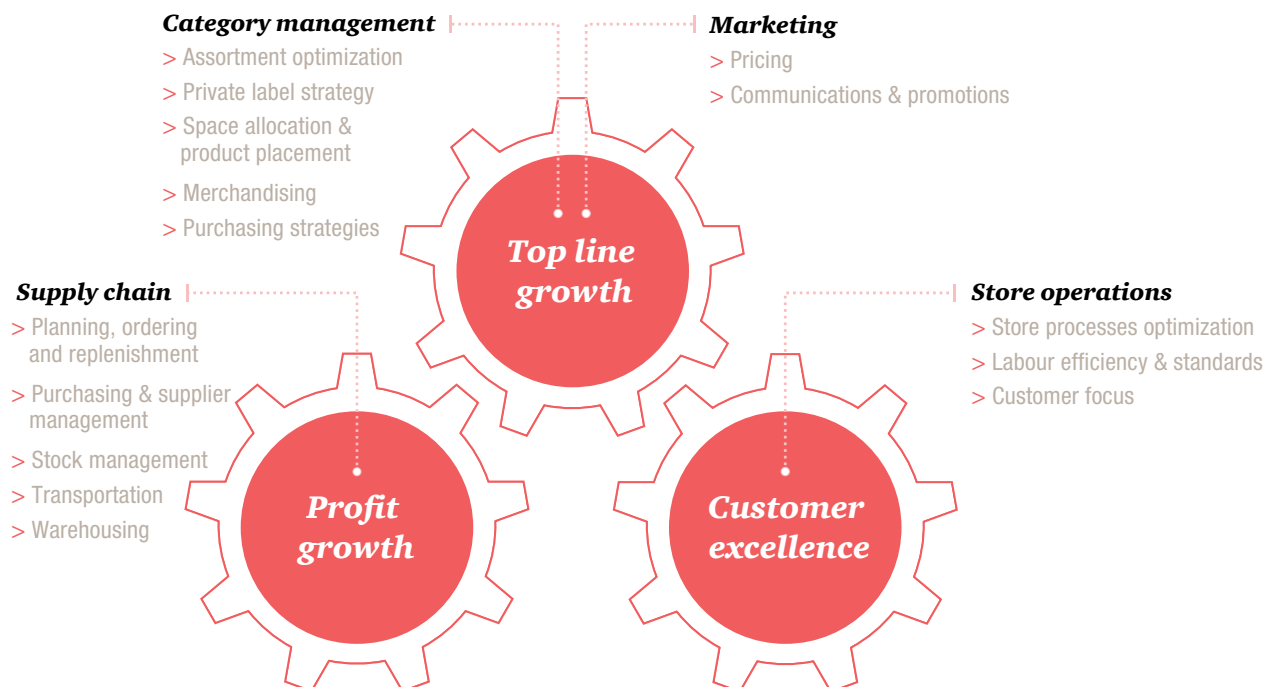
*Partner, Retail and Consumer  
Leader India*  
rohit.bhasin@in.pwc.com

# Fighting the margin pressure in retail

Retailer margins are under intense pressure in the current economic environment. First, decreasing disposable income leads to lower consumer spending, with direct impact on the bottom line. Second, shrinking margins in the FMCG industry make negotiations with suppliers of branded goods increasingly difficult. Last but not least, maturity in many markets leads to the introduction of new formats (including increasing numbers of convenience stores) and more discount retailers, generating fierce competition.

In order to address these challenges, retailers must proactively balance between top-line performance, profitability and customer excellence. We have identified several key areas which have a strong impact on operational and financial performance: **category management, marketing, procurement and supply chain** and **store operations**.

Several levers can be utilized by retailers in order to further improve their positioning



Our experience shows that, in many cases, **category management** is handled by buyers. But burdened with many operational tasks, they have limited time to dedicate to the more strategic aspects of category management. Also, in some cases, space allocation and planograms do not balance sufficiently between revenue and profit potential, while private labels do not follow a rigorous strategy. Hence, improvements in end-to-end category management can lead to important benefits in terms of sales growth and overall profitability improvements.

**Marketing** provides a complex set of tools helping to create value for customers, strengthen the brand, improve customer retention and maximize revenue potential. In many cases, pricing strategies are reactive rather than proactive and are insufficiently differentiated based on the strategic, competitive position of the retailer. With pricing being one of the most powerful levers for increasing operational profit, proactive demand-side pricing can significantly boost financial performance.

**Procurement and supply chain** encompasses the planning and managing of all activities, from sourcing to planning, ordering and replenishment, as well as the related logistics, including stock management, transportation and warehousing operations. In some cases, we observe that supplier negotiations are more operational than strategic, as the complexity of the analysis required in order to build a fact-based negotiation is high and time consuming; therefore results are often suboptimal. Moreover, forecasting and planning are complex tasks, especially in an unstable economic environment, leading to excessive inventory, write-offs and shrinkage in certain categories and unmanaged out-of-stock occurrences in other categories. Customer service levels that are mis-aligned with the importance of the category and turnover lead to additional complexity. Therefore, rigorous application of strategic procurement techniques can increase profitability by several percentage points, while optimizing supply chain can improve the balance between costs and customer satisfaction.

**Store operations** levers address areas related to daily retail processes and procedures in the network. Few retailers use demand forecasts for planning their store operations and staffing needs. Leveraging rigorous labour standards and flexible manning through advanced analytical techniques can generate important cost reductions, in parallel with improvements in customer satisfaction.

With pricing being one of the most powerful levers for increasing operational profit, proactive demand-side pricing can significantly boost financial performance.

*Several methodologies and tools are available to retailers in order to address these challenges and to improve operational performance. We will briefly describe below some of the more common techniques:*

### **1. Category management**

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- > Assortment optimization creates a strategic advantage for the retailer and focuses on three key areas: adding new products in order to align with the market trends and the strategic targets of the retailer; eliminating SKUs with low sales/low profitability if better commercial terms are not offered by the supplier; and creating a comprehensive private label strategy, especially in more commoditized categories.
- > Fact-based negotiations focus on building negotiation levers based on a comprehensive assessment of the category, in order to improve the commercial terms with underperforming suppliers and to boost sales for over-performing suppliers. Among the most frequently-applied tactics in negotiations are: consolidating volumes by delisting unprofitable SKUs; aligning shelf space allocation with total product profitability; and leveraging negotiation power with over-represented suppliers (compared with their overall market share).
- > Space allocation and product placement has the main objective of ensuring profits are maximized per available shelf space. Several factors need to be considered in optimizing the space allocation, including sales and profitability per square meter, sensitivity to shelf positioning, and consumer behaviours.

### **2. Procurement and supply chain**

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- > Planning, ordering and replenishment require a better alignment between processes, in order to optimize the balance between out-of-stock risks and transportation and inventory carrying costs.
- > Purchasing and supplier management focus on developing mutual benefits in the relationship with suppliers in order to build competitive advantage and to optimize service level agreements.

- > Stock management starts by setting the appropriate inventory target levels throughout the supply chain, based on multiple parameters such as forecasting accuracy, ordering and carrying costs, and involves the alignment of all planning and execution processes.
- > Transportation cost management requires total cost optimization through improved routing and load management, as well as rate negotiations with external service providers.
- > Warehousing cost management includes optimizing the physical network based on a total cost analysis, operational improvements in warehousing operations, and leveraging technologies such as RFID.

Store processes must optimize day-by-day store activities by eliminating redundancies, inefficiencies and non-value added activities...

### **3. Marketing**

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- > Pricing should balance between supply-side methodologies, be reactive to the moves of strategic competitors and to demand-side methodologies, as well as be related to price elasticity, regional and local dynamics and perceived product value.
- > Promotions and communications can be used by retailers to differentiate, increase brand awareness and enhance customer loyalty. Strategies should be based on detailed analysis of the impact of previous campaigns and should involve actively working with suppliers for cost sharing, exclusive initiatives and products, and coordinating marketing.

### **4. Store operations**

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- > Store processes must optimize day-by-day store activities by eliminating redundancies, inefficiencies and non-value added activities, and also by improving planning and staff allocation at all levels.
- > Labour efficiency and standards ensure that each activity is timed, standardized and optimized to enable efficient labour planning for all types of activities (fixed, variable and semi-variable).

Our experience shows that when retailers apply these strategies consistently and rigorously manage them, the strategies become competitive differentiators, resulting in above average financial performance.

Improvements in store operations can generate important benefits for customer experience

### Benefits

#### **Increased sales support**

- > Site focus on sales or customer service
- > Targeted sales improvement—managers have tools to plan
- > Ability to provide sales support for new opportunities

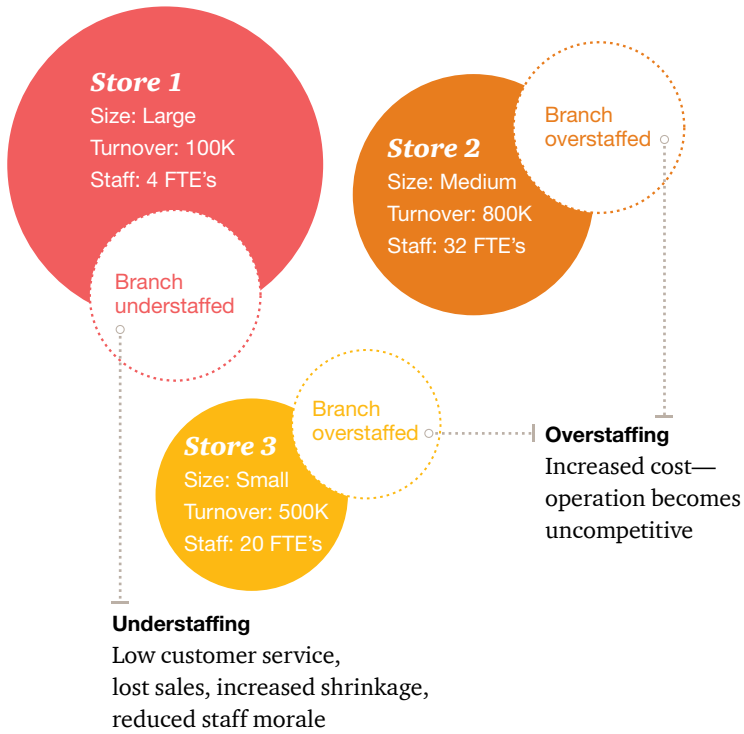
#### **Reduced costs**

- > Staff savings—model generated
- > Staff savings—process improvement
- > Increased control over costs

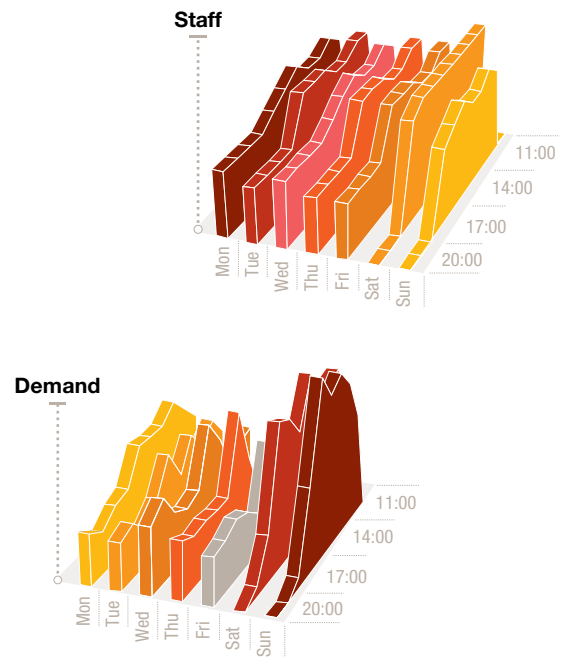


Typical mismatches in store operations result in reduced profits and customer service

**Staff not aligned with the store format/specifics**



**Staff not targeted at the right time of day or the right days of the week**



Illustrative; Disguised numbers

**Contacts**

**Bogdan Belciu**

Partner Retail & Consumer Romania  
bogdan.belciu@ro.pwc.com

**Iulian Circiumaru**

Manager Retail & Consumer Romania  
iulian.circiumaru@ro.pwc.com

# Time to re-think

With food prices rising and disposable incomes decreasing, retailers in Central and Eastern Europe will have to continue focusing on price-value proposition. To do this, incremental improvements within current frames might prove insufficient. At least for some retailers, a radical rethinking of value chain will be necessary.

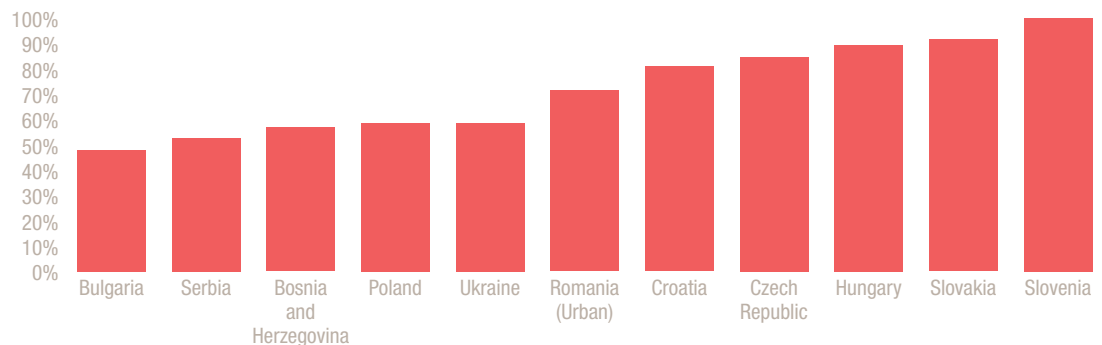
Transferring best practices from abroad to Central and Eastern Europe (CEE) is a complex task due to the fact that CEE is not a homogeneous region. Each country has a differing set of practices, laws, culture and geography.

According to The Economist food price index, food prices are up 30% from one year ago. Disposable incomes in most of the CEE countries are lower than they were a year ago and may get worse, due to high government debt. Fuel prices are also high, so people tend to shop closer to their homes. Companies are cutting labour, so people who still have work have less time to shop and purchase more prepared meals. The Internet is gaining ground with shoppers, often through mobile shopping. On the supply side, technology is increasingly replacing manual labour in distribution centres and in retail outlets. Recent incidents associated with the mass production of food have caused a fall in confidence in food safety and increased preference for local products.

## *CEE—mostly same trends apply, but with regional specifics*

Most of these trends are global trends in retailing; however, because of the regional specifics they tend to be manifested differently. Two major areas in which CEE differs from Western Europe are the structure of retail markets and the lower disposable incomes of its citizens.

Share of Top 10 grocery chains as the main shopping place in CEE (%), 2009



There are huge differences within the region. In Slovenia, for instance, the top 10 retailers account for almost 100% of revenue, while in Bulgaria they account for only 38%. On average, the grocery retail sector in CEE is less concentrated than in Western Europe. Furthermore, the share of traditional retail (open markets, small local vendors) in the whole industry is on average significantly higher than in Western Europe (in Romania for example, it is about 40%).

#### Expected development of consumption growth rates in CEE

	2011	2012	2013	2014
Bulgaria	1.5	2.8	3.2	3.3
Croatia	1.8	2.4	2.6	2.4
Czech Republic	1.7	2.8	3.1	2.8
Hungary	1.8	2.5	2.8	2.7
Poland	3.3	4.2	4.3	4.0
Romania	1.4	2.8	3.3	3.9
Russia	4.7	5.0	4.8	5.2
Slovakia	2.0	3.4	3.6	4.0

Combined with the fact that predicted growth figures for this region are on average significantly higher than they are for Western Europe, it can be predicted that these markets will go through many changes in the next few years. Since in the retail business size is one of the important factors affecting success, retailers will not be able to successfully do business in the region with present structures.

#### Consolidation expected to continue

Consolidation processes like Delhaize's takeover of the biggest Serbian retailer, Maxi, which created one of the biggest retail players in the region, are expected to continue. There will also be new market entries. Lidl is considering entering the Serbian and Lithuanian markets, and Carrefour plans to enter Albania.

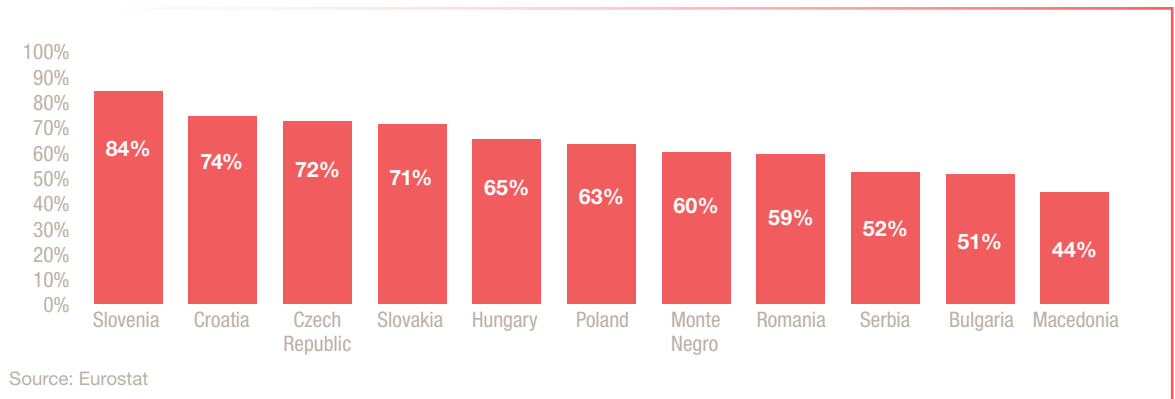
Then there's organic growth. Metro has recently announced that by 2012 it will invest 1 billion euro in organic growth in Russia, Ukraine and Kazakhstan. Auchan wants to triple its number of stores in Russia and grow substantially in Romania. In some CEE countries, where traditional mom-and-top type retailers still dominate the landscape, the expansion of international players will lead to a fight for the customer and increased price pressures.

Although online trading is not very developed in CEE, the battle for customers is expected to increasingly enter the digital realm. Online retail revenues are predicted to grow 30% in Hungary in 2011, albeit from a low basis. Tesco has announced it will begin online grocery retailing in the region, and Amazon is growing in the region as well, taking significant non-food (for now) revenues away from “brick-and-mortar” stores.

### Disposable income still below European average

Another area where CEE is significantly different from the West is disposable income. This is reflected in retail prices which, according to Eurostat, achieve only 51% of the European average in Bulgaria and 59% in Romania. This dynamic presents an unsavory scenario for retailers: rising purchasing prices due to the commodities boom but pressure to cut retail prices. The answer to this challenge must be clever category management with a focus on locally-sourced products on one hand, and operational efficiency on the other.

Level of prices for consumer goods and services as a percentage of average Europe level



### Perceived value for customers is crucial more than ever

History has shown that there is a particular retail model especially well-suited for this kind of environment: discount.

One main attribute of discounters is that category management focuses on a limited number of SKUs per category in order to achieve large quantities and low prices. In any case, efficiency is the main objective of the discount format: the design of every major cost driver (store equipment, logistics, labour, even marketing) is standardised as much as possible and therefore results in low costs. Typically, staffing costs at discounters are about half the level of other retailers (as a percentage of revenues). As long as the retail sector is still developing (which means lower market transparency and local monopolies) the low-cost level can be made up for with higher margins. Once competition increases, price pressure will begin to mount and margins will be under pressure. This is the situation in CEE right now.

This is not to say that every retailer should become a discount retailer. But the retail industry in CEE will go through a phase similar to the one aviation has gone through as low-cost airlines appeared. Their appearance has caused radical changes in the industry. There is a high probability retail will go through a similar transformation phase as well, where every benefit offered to customers will have to be re-examined. As the first step to compete with discounters, the executives of other retailers will have to understand the principles by which discounters are operating. Unfortunately, our experience shows that many retail managers have a very simplified view of discounters. In general, the prevailing opinion is that discount is all about low prices. However, if this were the case, competing with them would not be so difficult. Discount is not only about prices. It's about radically rethinking the value chain.

### *Rethinking the value chain*

The German discount giant Aldi didn't sell frozen products until 1998. Though this may seem as if they were unnecessarily forfeiting revenue, the company was, in fact, following its value chain definition very closely. The company estimated that even though frozen products would create additional revenue, the products would also create too many additional costs.

Though this may seem rather radical, such actions may be required. Faced with the aforementioned challenges, Like Aldi, retailers competing with heavy discounters will need to fundamentally examine what they should be offering their customers and perhaps even more importantly, what they will not. This means re-thinking the value chain and acknowledging that everything offered to customers creates costs. This, in turn, makes sense only if customers perceive this part of an offer as something valuable and are willing to pay for it. The reality is that consumer readiness to spend euros or dollars at the cash register is decreasing rapidly for all the things people find unnecessary, due to current economic conditions.

This does not mean every store should get stripped down to its basics. But this does mean some basic assumptions will have to be challenged and some fundamental questions have to be raised: Are customers willing to pay for keeping 100 SKUs of cereals in stock or would ten suffice, especially if they believe the retailer has chosen the best products for them? Is it necessary to have meat manually served in a store or would customers be satisfied with pre-packaged meat, provided that it is good quality? How should retailers free personnel from low-value repetitive tasks and use their time to increase sales? Is it an advantage to be placed in a large shopping centre or would it be better to be in a stand-alone, easy-to-reach building? Is it really necessary to offer margin-killing promotions to everyone or could we personalise the offerings and compensate those less price-sensitive with other benefits they would value?

There is no right or wrong answer to these questions. But these and many similar questions will have to be raised in order for retailers to find the right value proposition for their audiences. In today's environment, people just don't want to pay for something they don't see as valuable. Creating and presenting this value to them will be the main task for retailers in CEE in future years.

As the first step to compete with discounters, the executives of other retailers will have to understand the principles by which discounters are operating.

#### **Contacts**

##### **Mihaela Mitroi**

*Partner Retail & Consumer CEE*  
mihaela.mitroi@ro.pwc.com

##### **David Kovačič**

*Senior Manager Retail & Consumer Slovenia*  
david.kovacic@si.pwc.com

**For more information, please visit [www.pwc.com/r&c](http://www.pwc.com/r&c).**

**Europe, Africa and Near & Middle East Leader Retail & Consumer Industry**

Gerd Bovensiepen  
g.bovensiepen@de.pwc.com

**Austria**

Ian Murdoch  
ian.murdoch@at.pwc.com

**Belgium**

Filip Lozie  
filip.lozie@be.pwc.com

**Bulgaria**

Irina Tsvetkova  
irina.tsvetkova@bg.pwc.com

**Central & Eastern Europe**

Mihaela Mitroi  
mihaela.mitroi@ro.pwc.com

**Czech Republic**

Reinhard Langenhovel  
reinhard.langenhovel@cz.pwc.com

**Denmark**

Henrik Trangeled Kristensen  
henrik.trangeled.kristensen@dk.pwc.com

**Finland**

Ylva Eriksson  
ylva.eriksson@fi.pwc.com

**France**

Sabine Durand-Hayes  
sabine.durand@fr.pwc.com

**Germany**

Gerd Bovensiepen  
g.bovensiepen@de.pwc.com

**Greece**

George Balafoutis  
george.balafoutis@gr.pwc.com

**Hungary**

Peter Biczo  
peter.biczo@hu.pwc.com

**India**

Rohit Bhasin  
rohit.bhasin@in.pwc.com

**Ireland**

Jean Delaney  
jean.delaney@ie.pwc.com

**Italy**

Roberto Adami  
roberto.adami@it.pwc.com

**Lithuania**

Chris Butler  
chris.butler@lt.pwc.com

**Netherlands**

Dennis van Ameijden  
dennis.van.ameijden@nl.pwc.com

**Norway**

Petter Vold  
petter.vold@no.pwc.com

**Poland**

Agnieszka Ostaszewska  
agnieszka.ostaszewska@pl.pwc.com

**Portugal**

Jorge Costa  
jorge.costa@pt.pwc.com

**Romania**

Mihaela Mitroi  
mihaela.mitroi@ro.pwc.com

**Russia**

Dale Clark  
dale.clark@ru.pwc.com

**Slovakia**

Andrey Kolchin  
andrey.kolchin@sk.pwc.com

**Slovenia**

Francois D Mattelaer  
francois.d.mattelaer@si.pwc.com

**South Africa**

John Wilkinson  
john.wilkinson@za.pwc.com

**Spain**

Javier Vello Cuadrado  
javier.vello.cuadrado@es.pwc.com

**Sweden**

Jan von Zweigbergk  
jan.von.zweigbergk@se.pwc.com

**Switzerland**

William Wright  
william.wright@ch.pwc.com

**Turkey**

Adnan Akan  
adnan.akan@tr.pwc.com

**Ukraine**

Urmaz Kaarlep  
urmas.kaarlep@ua.pwc.com

**United Kingdom**

Mark Gill  
mark.gill@uk.pwc.com