Commentary

Foreign Discount Grocers' Entry Into Canada Could Noticeably Intensify the Competitive Environment, but Will They Come?

Morningstar DBRS
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Key Highlights

- A foreign discount grocer's entry into Canada has the potential to noticeably intensify the competitive environment.
- Should a new entry result in significantly increased competition, especially if that new entrant also makes meaningful market share gains, it could ultimately even pressure the credit risk profiles of some incumbent grocers.
- Canada's large incumbent grocers are well positioned to face such a challenge, benefitting from their entrenched market positions, including their strong brands as well as their generally well-established discount banner footprints and/or private-label portfolios.

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There has been considerable public discourse on whether a foreign discount grocer, such as Aldi or Lidl, could come to Canada and what impact this might have on the competitive landscape. We believe such an entry has the potential to noticeably intensify the competitive environment. Should a new entry result in significantly increased competition, especially if that new entrant also makes meaningful market share gains, it could ultimately even pressure the credit risk profiles of some incumbent grocers. This is particularly true for smaller regional independent grocers. That said, we view an entry by Aldi or Lidl as unlikely, at least over the near to medium term, given their current focus on expanding in other geographies and considering that the Canadian marketplace represents a challenging and already competitive operating environment. Additionally, we believe that Canada's large incumbent grocers—Loblaw Companies Limited (Loblaw; rated BBB (high), Stable); Sobeys Inc. (Sobeys; rated BBB, Stable); METRO INC. (Metro; rated BBB (high), Stable); Walmart Inc. (Walmart; rated AA, Stable); and Costco Wholesale Corporation (Costco; rated AA (low), Stable)—are well positioned to face such a challenge, benefitting from their entrenched market positions, including their strong brands as well as their generally well-established private-label portfolios and/or discount banner footprints.

Aldi and Lidl Taking Market Share Globally

Aggressively Expanding Their Footprints

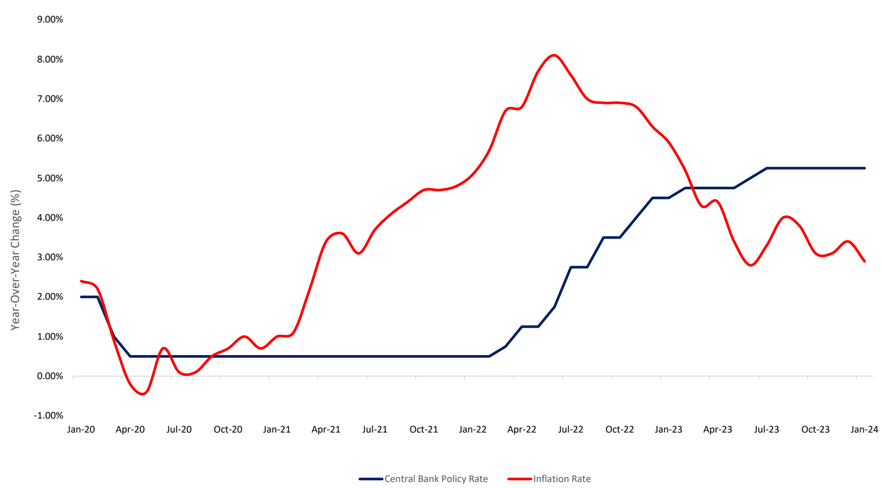
Aldi's and Lidl's growth has largely been fueled by their respective efforts to aggressively expand their footprints over the last few decades. Collectively, the two companies have grown to approximately 25,000 stores in more than 30 countries. In the United States, for example, Aldi is the country's fastest-growing grocer; it has more than doubled the number of its stores in the country since 2011, to more than 2,350 at the end of 2023. In the UK, where Aldi and Lidl opened their first stores in the early 1990s, the two have opened approximately 2,000 stores in aggregate and have grown their combined market share to approximately 17%.[1] Similarly, in Ireland, where Aldi and Lidl opened their first stores in 1999 and 2000, respectively, the two have grown their combined footprints to approximately 350 stores and have expanded their consolidated market share to more than 20%.[2] Their growth has not been limited to Europe and the U.S.; Aldi entered the Australian market in 2001, growing its store base to close to 600 stores and market share to approximately 10%.[3]

1. Kantar, Grocery Market Share data.
2. Kantar, Grocery Market Share data.
3. Statista, Market share of grocery retailers in Australia in financial year 2023.

Growth Amplified by Recent Changes in Consumer Behaviour

Aldi's and Lidl's longer-term growth trajectory aside, discounters in general have benefitted from recent changes in consumer behaviour. The compounded effects of inflationary pressures and aggressive interest rate increases (see Exhibit 1) have squeezed consumers' purchasing power (see our commentary *Global 2024 Food Retailer Outlook: Grocers Are Set to Weather Macroeconomic Challenges*, January 4, 2024). In an effort to reduce their overall spending, consumers have been allocating more time to visiting different stores to search for promotional discounts, substituting branded offerings with private-label products, trading down to more affordable alternatives within the same category, and buying smaller quantities.

Exhibit 1 Canadian Inflation and Central Bank Policy Rates



Source: Bank of Canada.

Discount grocers, which consumers generally perceive as offering relative value and which typically have higher private-label penetration, have benefitted from the aforementioned changes in consumer behaviour (see our commentary *Price Check: Discount Grocery Stores Set to Largely Outperform Their Conventional Peers Worldwide in 2023*, January 23, 2023). In the UK, for example, Aldi and Lidl averaged sales growth above 20% through 2023, approximately more than twice that of the more conventional market share leader Tesco.[4] This has translated to discount grocers making notable market share gains over this period. Aldi and Lidl have grown their combined market share in the UK by almost 300 basis points since 2022 (see our commentary *UK Discount Grocers Taking a Bigger Slice of the Pie as Food Inflation Remains Stubbornly High*, June 1, 2023).[5]

Private Company and Scale Advantage

Aldi’s and Lidl’s private ownership enables them to endure more pain to gain market share through price investments and take longer-term strategic views. This is because, unlike some of the public peers they

4. Kantar, "Record numbers hit the shops as supermarkets experience busiest Christmas since 2019," January 3, 2024.

5. Kantar, Grocery Market Share data.

compete against in other markets, they can place less of an emphasis on immediate results and continuous improvement in shareholder returns. Furthermore, through the scale of their international operations, they have the ability to spread price investments in one particular market over their other markets. Additionally, particularly as it relates to some smaller regional grocers, Aldi and Lidl benefit from global sourcing capabilities and overall more diversified and flexible supply chains.

International Expansion Hasn't Always Gone Smoothly

While Aldi and Lidl have been largely successful in their aggressive pursuit of growth, this has not been without challenges and setbacks. Lidl, which opened its first store in the U.S. in 2017, has been struggling with its entry into the North American market. Since 2017, the company has gone through four country heads, closed a number of underperforming stores, and let go of hundreds of its corporate staff. This was largely the result of intense competition from incumbent grocers, including Walmart, that have heavily invested in private-label offerings, as well as dollar stores that are increasingly focused on food offerings. Lidl also has to compete against Aldi, which has been operating in the market since 1976. Similarly, Aldi entered Greece in 2008 with aggressive plans to open 100 stores by 2009. Just two years later, Aldi left Greece after having opened less than 40 stores because of intense competition, including from Lidl, which has been operating in Greece since 1999.

Canada a Tough Market to Enter

Challenging Operating Environment

The Canadian marketplace represents a relatively challenging operating environment. Particularly compared with European countries, Canada has a substantially larger landmass with relatively low population density (for context, Canada is approximately 40 times the size of the UK with only about 60% of its population). This can make it significantly more difficult and costly to set up a profitable national store and logistics base compared with other markets. That said, we note Aldi's successful entry into Australia, a country with a population density even lower than Canada's and a geographic location far away from Aldi's European roots. This was accomplished by focusing on more densely populated areas. Additionally, Canada has a patchwork of federal and provincial regulations, including bilingual and other labelling requirements, and is home to a multicultural population with demand for a variety of niche products. Both of these factors could increase operating costs for a new entrant relative to other markets. As such, even leaving competition from incumbent grocers aside, foreign discount grocers could consider Canada a less attractive target market than others from a return on invested capital perspective.

Canada a Graveyard for Foreign Retailers

While Walmart and Costco have defied these challenges and been very successful in establishing themselves in Canada by making notable market share gains, many other retailers have not been successful. This is evidenced by the retreats of foreign retailers over the years, such as Target; Lowe's Companies, Inc. (rated BBB (high), Stable); Nordstrom, Inc. (rated BB, Stable); Bed, Bath & Beyond; and the Body Shop.[6, 7, 8, 9, 10] Even Walmart's Sam's Club announced it would be leaving Canada in 2009; this was partly because of competition from well-established Costco, which had already been operating in the country for close to 20 years when Sam's Club arrived in 2003. While these retreats are certainly not only the result of Canada presenting a challenging operating environment, they could negatively factor into a foreign discount grocer's decision-making process when determining whether or not they want to enter the Canadian market.

Canadian Grocers Benefit From Existing Discount Banner Footprints and Private-Label Portfolios

Unlike other markets that Lidl and Aldi have entered in the past, Canada's large incumbent grocers have generally well-established discount banner footprints and/or private-label portfolios. In its 2023 Retail Grocery Market Study, Competition Bureau Canada noted that all the foreign grocers it spoke to commented on the strength of private-label grocery products sold in Canada and highlighted that they believe these are high-quality products at good prices. Canada's national grocers—Loblaw, Sobeys, and Metro—all have well-established discount banners, while Walmart and Costco have a unique positioning that is challenging to compete with. Furthermore, these grocers are continuing to heavily invest to improve their competitive positioning, including through continued investments in their private-label offerings and discount footprints.

Difficult to Dislodge Canadian Grocers From Entrenched Market Position

Their private-label and discount banners aside, Canada's incumbent grocers' entrenched market positions also benefit from strong brands, prevalent loyalty programs, and supply chains with long-term supplier relationships. Furthermore, they have well-established store footprints in high-traffic locations that are difficult to replicate, especially when considering lease agreements and real estate ownership that can prevent other grocers from operating in the same location. Additionally, some of Canada's incumbent grocers benefit from the added size and scale offered by their auxiliary businesses, such as drugstores, or, in the case of Walmart and Costco, international operations. As outlined in the aforementioned Competition Bureau Canada report, all of the foreign grocers it spoke to said that they would face tough competition from Canadian grocers if they entered Canada, with at least one stating that it could be difficult to compete on price. The foreign grocers also noted that it is easier for them to continue to expand in their current regions than to come to Canada. As such, while a foreign discount grocer's entry into Canada certainly has the potential to noticeably intensify the competitive environment, we view an entry as unlikely at least over the near to medium term given the challenging and already competitive operating environment.

6. Morningstar DBRS, "DBRS Morningstar Comments on Nordstrom, Inc.'s Announcement of Winding Down Its Canadian Business," March 3, 2023.
7. Morningstar DBRS, "DBRS Comments on Target's Announcement to Exit Canada," January 15, 2015.
8. Morningstar DBRS, *Lowe's Announces Sale of its Canadian Retail Operations; No Immediate Impact on Credit Risk Profile*, November 8, 2022.
9. Morningstar DBRS, *Bed, Bath & Beyond Inc. Throws in the Towel—Key Business Risk Weaknesses To Watch For In Other Retailers*, May 4, 2023.
10. Morningstar DBRS, *The Green Cosmetics Retailer In The Red: Subsidiaries of The Body Shop File For Bankruptcy And Cease Operations*, March 5, 2024.

Related Research

- *Delayed Closing of Kroger and Albertsons Deal Highlights Regulatory Risks Associated with Megamergers*, January 17, 2024.
- *How McKesson's Potential Disposition of Rexall Could Have a Notable Impact On Canada's Retail Landscape*, January 16, 2024.
- *Global 2024 Food Retailer Outlook: Grocers Are Set to Weather Macroeconomic Challenges*, January 4, 2024.
- *Battle of the Brands: Private Labels Filling Grocery Carts…For Now*, October 25, 2023.
- *UK Discount Grocers Taking a Bigger Slice of the Pie as Food Inflation Remains Stubbornly High*, June 1, 2023.
- *Price Check: Discount Grocery Stores Set to Largely Outperform Their Conventional Peers Worldwide in 2023*, January 23, 2023.
- *Global 2023 Food Retailer Outlook: Grocers Largely Immune to Macroeconomic Challenges*, January 5, 2023.

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