McKinsey Global Institute

Sweden's Economic Performance: Recent Development, Current Priorities

Retail

May 2006

McKinsey&Company

The Swedish Retail Sector

EXECUTIVE SUMMARY

The Swedish retail sector has experienced very strong productivity growth since the early 1990s. The productivity gains are due to decreased labor input rather than increased value-added. Product market conditions have improved and today it is barriers to job creation that need attention.

In 1990, Swedish retail productivity was 16 percent lower than the US benchmark and slightly behind European peers. The main reasons for the low productivity were identified as product market barriers – e.g. low competitive intensity due to price co-operation, zoning policies, and strong position of less efficient voluntary chains – rather than labor market barriers.

Since 1990, labor productivity has increased 4.6 percent annually, which is on par with the US and higher than European peers. In absolute productivity levels, Sweden has passed France and Germany but is still significantly behind the US. Several factors combine to explain the positive labor productivity development. The factors include: eased application of zoning laws, increased competition from category killers and new entrants, growth of integrated chains on behalf of less productive voluntary chains, and growth of large highly efficient store formats.

Job reduction, rather than job creation, accompanied the strong productivity growth since 1990. In relation to peers, Swedish retail is worst-in-class in job creation with a net job loss of 0.5 percent of working age population. The main factors behind the weak performance are low labor flexibility, high cost of labor and weak demand. Together these factors inhibit growth, innovation and employment in service-intensive retail concepts. Since 1990, few actions have been taken to improve the situation, with the notable exception of setting the probationary employment period to 6 months.

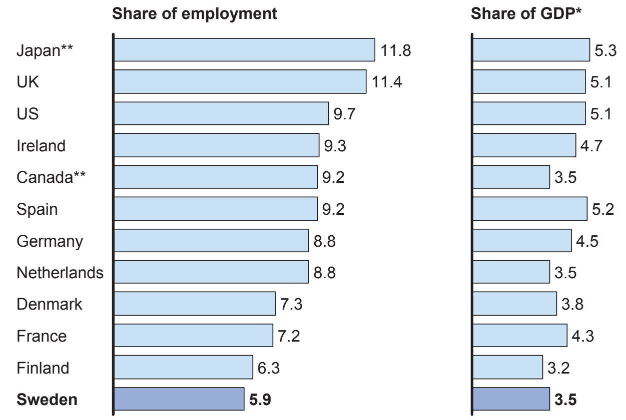
In the future, three key trends will shape the retail sector. First, the industry restructuring will continue with the growth of integrated chains and large, highly efficient store formats as well as increased polarization due to parallel growth in both premium and low-price segments. Second, the importance of private labels will increase especially in premium/niche products. Third, the international influence will increase in Swedish retail as additional international chains enter either organically or through acquisition.

The most important actions for policy makers are to further ensure availability of retail premises and, even more importantly, remove barriers to job creation by addressing the labor market and demand conditions. Companies need to consider their strategic position and improve their operations to meet the increasing competition. The unions should actively support job creation in retail by allowing labor flexibility to increase.

PERFORMANCE IN THE RETAIL SECTOR

The retail sector[1] is one of the largest sectors in developed economies, typically representing 3-6 percent of a country's GDP and employing 5-10 percent of all employees. However, in relation to other countries, the Swedish retail sector is small, both in terms of share of employment (5.9 percent) and share of GDP (3.5 percent) (Exhibit 1).

Exhibit 1



The retail sector is smaller in Sweden than in peer countries, both as share of employment and contribution to GDP
Percent, 2003

* Value add at current price
** Canada and Japan 2002
Source: Groningen Productivity Database, February 2005; McKinsey analysis

The retail sector is important to study for several reasons:

- *Potential driver of economic growth.* The retail sector is important to a country's economy not only because of its size, but also as it represents a significant portion of private consumption and thus affects the daily lives of all persons in the country. As evidenced by the US retail phenomenon of the last two decades, it can also be the driving force in economic development by promoting productivity in wholesale and manufacturing sectors, such as food

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[1] Defined in this study as excluding cars, gas, alcohol and pharmaceutical/medical products unless otherwise stated. Occasionally and always explicitly stated, retail sale of alcohol and pharmaceutical goods are included in the macroeconomic data to permit cross-country comparisons

processing. The increased productivity comes from both increased pressure on suppliers as well as more sophisticated integration and use of information and communication technology. In retail, value is added either by creating an efficient business model for the goods sold, or by adding value with services.

- *Potential source of significant job creation.* As Sweden loses jobs in manufacturing, it will be important to replace the lost jobs with service sector jobs. Retail is a large sector that in many other countries employs significantly more people per capita than in Sweden. If Sweden can accomplish the manufacturing-to-service-sector transition, many new jobs will be created.

- *Dynamic sector directly affected by policy decisions.* Sweden, together with most other developed economies, has experienced a shift in the retail industry structure during the last decades. The overall trend, driven by scale advantages, is towards increased competition with the growth of integrated chains and large store formats, which often take over market shares from smaller independent stores. Policy makers play a very important role in this development. Some countries, like France, have chosen to try to counteract the development while others, like the US, have chosen to embrace it.

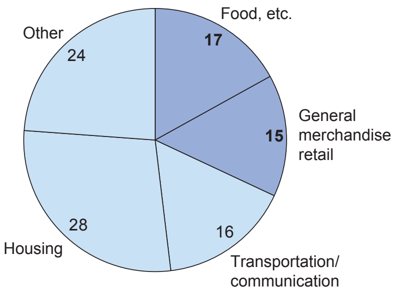
THE RETAIL SECTOR IN SWEDEN

Annual retail sales are almost SEK 400 billion in Sweden, representing one third of private consumption, of which 52 percent is grocery sales and 48 percent is general merchandise retail (Exhibits 2-3). Internationally, retail trade typically decreases its share of household consumption as income rises. This trend is also true for Sweden. In 1970 the average Swede spent almost 50 percent of his/her purchasing power on retail. Today the share is little more than one third. Instead, people spend their money on other services such as travel and restaurants. Another reason for the decreasing share is that real prices are declining in many retail categories as a result of productivity increases throughout the full value chain.

By its nature, retail is typically a local market with customers coming by foot, public transportation or car. In many retail categories a few large players dominate with many stores and a large share of sales. One example is grocery retail, in which the “Big Three” (ICA, Coop and Axfood) together have more than 70 percent of all food retail.

Exhibit 2

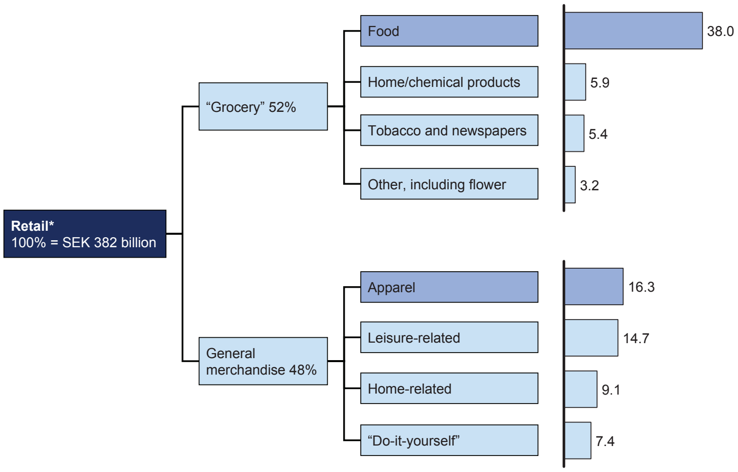
Retail* represents one third of Swedish private consumption
Percent of total private consumption, 2004, 100% = SEK 1,224 billion



* Excluding cars, drugs, and alcohol
Source: Groningen Productivity database; supermarket/SCB; McKinsey analysis

Exhibit 3

The Swedish retail market is almost SEK 400 billion, with food and apparel being the largest segments
% of Swedish household consumption on retail*; 2004



* Excluding alcohol, cars, gas, and drugs
Source: Supermarket 2005; Statistics Sweden (SCB); McKinsey analysis

INDUSTRY PERFORMANCE

The Starting Point for the Sector

In 1990, McKinsey Global Institute (MGI) found Swedish general merchandise retail productivity to be 16 percent lower than the US benchmark. Swedish retail was also experiencing net job losses while the US had created new jobs representing 0.5 percent of the working age population. The productivity comparison was based on the share of highly productive store formats in each country respectively. Sweden's low performance was largely explained by product market barriers inhibiting competition and growth of productive formats:

- *Restrictive zoning laws.* During the 1980s, municipalities actively used Plan och Bygglagen (PBL) to protect existing retail businesses by restricting access to land for large-format stores. The effect was high barriers to entry as the established players already had most good locations and few new outlets were built. It may be noted that this also became an artificial inhibitor to the growth of highly productive formats.
- *Price recommendations.* Industry associations were allowed to issue price lists and openly discuss how industry profitability should be maintained, which drastically decreased the competitive intensity in selected categories.
- *Supplier boycotts.* Large chains used their bargaining strength to make suppliers boycott low-price competitors to avoid price pressure.
- *Voluntary chains.* Many independent retailers cooperated in large voluntary chains, reducing the competitive intensity and thereby decreasing the opportunity for the development of large integrated chains.
- *Market conditions.* The low population density in large areas of Sweden also partially explained the relatively low growth of large format stores.

Also, capital access was a slight problem during the 1980s as banks discriminated against service companies in favor of manufacturing companies. However, this barrier was found to be of minor importance for overall development.

There were two main reasons for the low job creation between 1980 and 1990:

- *Low output.* Sweden had lower output growth compared to the benchmark United States in the period studied. Both countries experienced evolution from small independent stores to large-format stores and specialized integrated chains. However, the US stores more often focused on increased service levels while the Swedish ones focused on high efficiency and lowered employment.

- *High labor costs.* Sweden's high labor costs in combination with low disposable incomes were found to be a major reason for the low job creation compared to the US. Swedish retailers sought to minimize labor costs, while the US retailers experienced innovation and growth in service-intensive concepts.

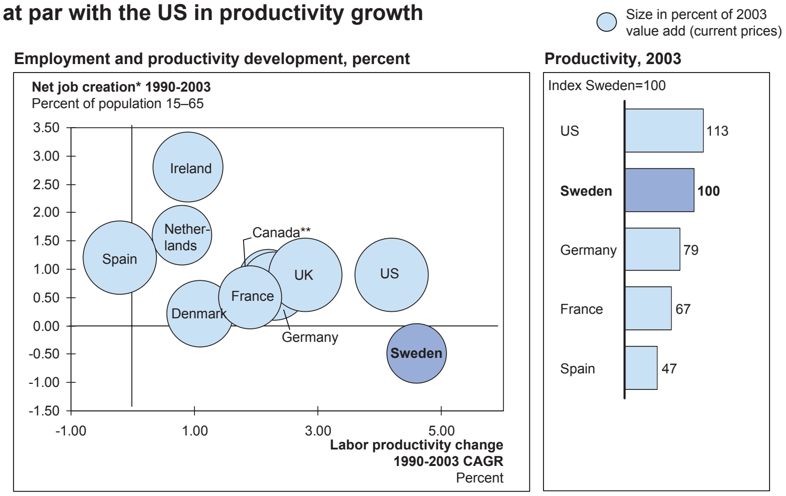
Productivity and Employment Development Since the Early 1990s

Since 1990, Swedish retail labor productivity growth has been strong. Labor productivity increased 4.6 percent annually, on par with the US and ahead of European peers. Combining the labor productivity growth with the absolute productivity levels of 1990 that were measured based on store format mix, Sweden is today more productive in absolute terms than Germany and France but still lagging the US (Exhibit 4).

However, the very strong Swedish labor productivity growth since 1992 has been driven by decreased employment in retail. While the US has been able to increase its output and value added in the sector, the Swedish retail has had much lower growth in value added and instead decreased the number of employees (Exhibit 5). In terms of employment development, Sweden is worst in class with net job destruction while most countries display strong job creation. The economic downturn started the drop in employment in the early 1990s. In 1997, there were approximately 18 percent fewer jobs in retail than at the beginning of the decade. Between 1990 and 2003, the number of people engaged in the Swedish retail sector decreased by 10 percent. However, due to increased use of part-time employees, the total amount of work in the sector decreased by almost 16 percent. The UK and the US, on the other hand, managed to combine strong productivity development with net job creation.

Exhibit 4

Swedish retail sector is worst-in-class in job creation while at par with the US in productivity growth



* Total people engaged in retail sector

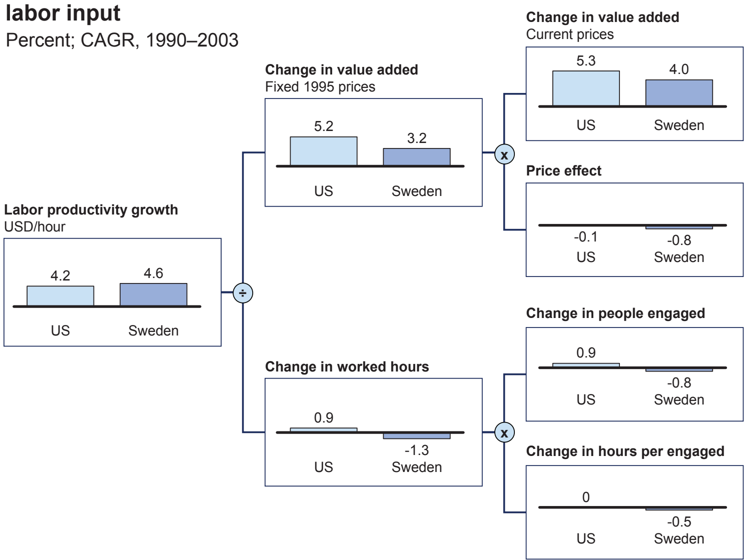
** Canada 1990-2002

Source: Groningen 60-industry Productivity database, Oct 2005; McKinsey analysis

Exhibit 5

Unlike the US, Swedish retail productivity growth is driven by reduced labor input

Percent; CAGR, 1990–2003



Source: Groningen Productivity Database, October 2005; McKinsey analysis

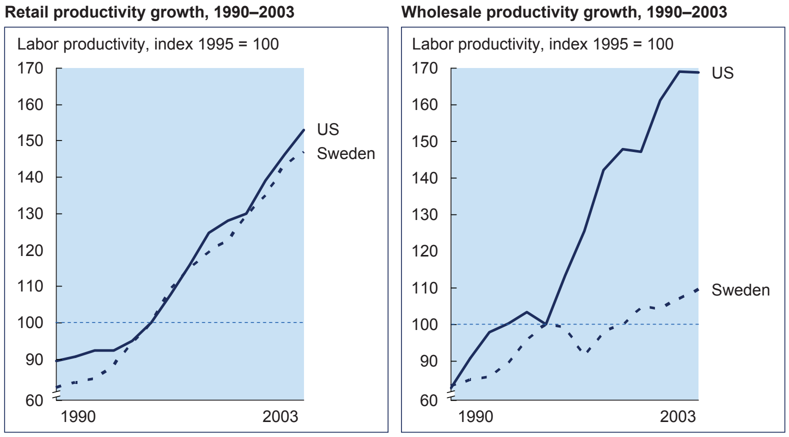
Productivity of the trade value chain

Retail is the last step in the distributive trade value chain. However, there is a trend towards increased vertical integration as supply chain efficiency has become one of the main differentiators of competitiveness. Today, large retailers often control their distribution network and purchase goods directly from the producers. The links between producers and retailers have been strengthened to the disadvantage of the wholesaler. In the US this trend has been very strong, driven by the aggressive growth of retailers such as Wal-Mart and the increased leverage of scale advantages that technology advancements like IT and barcodes/scanners make possible. US wholesalers are increasingly acting as either commodity and goods brokers, or providers of distribution and logistics services. The result has been very strong productivity growth in US wholesale which to a large extent can be explained by the retailers' increased scale and the use of new technology. While Sweden has been able to increase productivity in retail, the pressure to transform wholesale has been lower there and scale advantages have not been as significant as in the US (Exhibit 6).

As retailers are vertically integrating, it becomes more and more difficult to accurately measure and make cross-country comparisons of retail productivity in isolation from wholesale. By comparing the Swedish development with US for both wholesale and retail, i.e. the distributive trade sector, it is clear that Sweden is lagging in both productivity and employment growth (Exhibit 7). Looking at retail alone, Sweden is slightly ahead of the US in productivity growth. One contributing factor may be that some efficiency gains in distribution have been attributed to retailers in Sweden but attributed to wholesalers in the US. Though Sweden has had a strong development in retail, there is still a significant disparity between Sweden's retail development and that of the US where the distributive trade sector has been a main contributor to the economic growth of the entire nation since 1995 (The Conference Board 2005).

Exhibit 6

Driven by retailers' pressure and increased IT usage, US wholesale productivity has grown dramatically


Retail productivity growth, 1990–2003

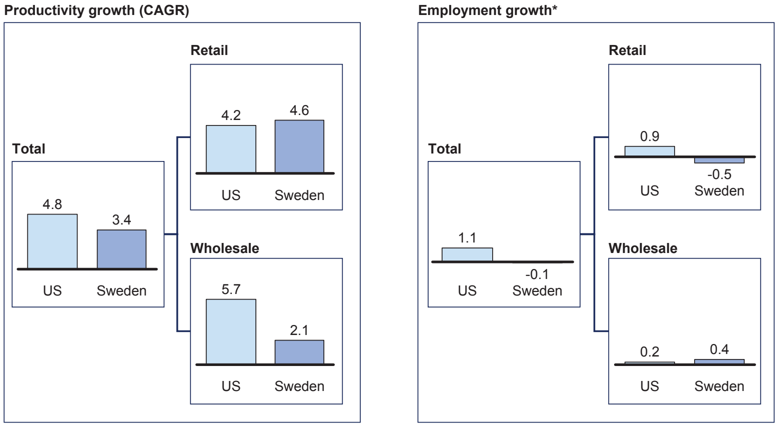
Wholesale productivity growth, 1990–2003

Source: Groningen Productivity Database, October 2005

Exhibit 7

Although Swedish retail productivity growth was higher than in the US, Sweden had lower overall productivity growth for wholesale and retail combined

Percent, 1990–2003


Productivity growth (CAGR)

Employment growth*

* Net job creation as percent of working age population

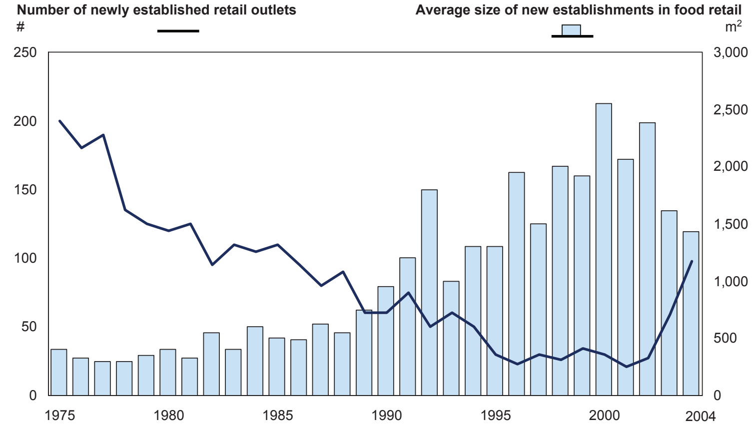
Source: Groningen Productivity Database, October 2005; OECD LFS; McKinsey analysis

Factors Explaining the Productivity Development since 1990

Some of the barriers identified in 1990 have since been addressed, contributing to the high productivity growth in Swedish retail. Between 1990 and 2003, Swedish retail productivity increased by 4.6 percent, compared to 2.7 percent in the preceding decade. However, there is no single action explaining this development. Instead, it is the combination of several contributing factors:

Exhibit 8

Size of new established food retail outlets has increased steadily, partly thanks to eased zoning laws



Note: In 2003–2004 the average size dropped due to Lidl and Netto small hard discount stores (30 and 48 respectively)
Source: Supermarket 2005

- *Eased zoning laws*. Since 1990, Sweden has experienced significant growth in the number of new shopping centers and large-scale store formats (Exhibit 8). This growth was made possible to some extent by changed legislation, but primarily by the municipalities' changed behavior and application of the zoning laws:

  — *Legislative changes*. In 1992, PBL was changed to reduce the influence of the municipality and remove the possibility of discriminating among different types of trade. This change reflected a public discussion during the 1990s regarding the development of large-format retail stores and shopping centers. Many feared a development that would make traditional small-scale shops unprofitable and ultimately close because of the new and increased competition. Due to the fear of local unemployment, and in some cases close bonds between local store owners and municipal government representatives, there was significant resistance in many municipalities to the industry shift. The 1992 change of the PBL led to a significant change in behavior in the municipalities, and allowed for the creation of more productive retail formats. In 1997, PBL was changed back to again allow municipalities to more closely control where and what types of retail stores to be constructed.

— *Behavior changes*. The legislative reversal had less impact than might have been expected, as municipalities had started to see that the development was not necessarily bad. One positive effect of large-format stores was decreasing food prices, and some positive effects of large shopping malls were employment and improved service. Also, municipalities often risked that a neighboring community would promote the construction of a large shopping center, which could negatively impact the traditional stores of both communities while leaving most of the benefits to the municipality allowing the new establishment.

- *Shifting industry structure.* The retail industry has continued its structural evolution through the 1990s until today. The development has primarily been driven by market conditions, but was also facilitated by the decreased resistance in many municipal governments. For Sweden, the most significant shift has been from small independent stores to larger and more productive store formats, shopping centers, and integrated specialized chains:

— *Growth of large-scale formats*. The development of highly efficient large format stores has been driven by the significant scale advantages in store operations. As an illustration, the average size of new established grocery stores was 400 m^2 in 1980, 950 m^2 in 1990, and peaked at 2550 m^2 in 2000. The trend is the same for both general merchandise retail and grocery, while the latter have also experienced growth of hard discounters whose business model is to operate highly efficient stores of typically 800 m^2

— *Growth of shopping centers*. Sweden has experienced a significant growth in shopping centers during the 1990s. In 1990 approximately 20 percent of all retail activity took place in a shopping center; today the figure is closer to 33 percent. This development is driven by the convenience for the consumers of doing their shopping in one place, scale advantages in marketing, and the need for increased retail space as volumes have increased.

— *Increased integration*. In all categories, there has been a strong movement towards greater integration, on behalf of the voluntary chain and independent small stores. The overall driver is the search for scale advantages in purchasing, supply chain, store management and marketing. Fundamentally, the increased integration has come through growth of integrated chains or increased integration of voluntary chains. Often the competitive forces have ensured that both exist in most categories:

  - *Growth of integrated specialized chains.* In many categories integrated specialized chains have taken significant market shares from the less efficient voluntary chains. An example of this is the Do-It-Yourself category where the eight largest integrated chains in 1990 had only 6 percent of sales. By 2004, these integrated chains accounted for 55 percent of sales. Another example is IKEA, the global integrated home furnishing company, which grew its sales in Sweden by 170 percent in the years 1990-2004, compared to the 18 percent growth of voluntary furniture chains in the same period. IKEA, together with H&M, is an exceptionally good example of how Swedish integrated retailers have also succeeded in the international arena.

  - *Increased integration of voluntary chains.* Often as a response to the integrated competitors, voluntary chains have increased their integration to reap scale advantages not only in purchasing but also in branding/marketing, assortment management and financing, etc. Examples are Hemtex (home textiles), ICA (grocery), and many clothing chains.

- *Increased competition.* In 1990, there were several barriers to competition. Since 1990, the competitive pressure has increased in several, if not all, retail categories. Sweden has entered the European Union, and a new Competition Authority has been established. However, the increased competition in retail should not be attributed primarily to these changes except in one important aspect. Beginning in the late 1990s and accelerating in the early 2000s, the

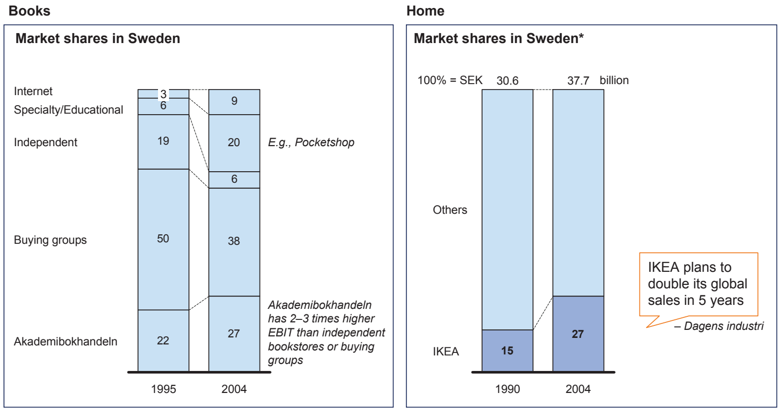
Swedish Competition Authority has actively promoted the positive effects of increased competition in retail and been an important factor in changing the mindset of many (but far from all) policy makers and politicians. The mindset change has allowed the construction of new shopping areas and large format stores, which, in turn, have increased the competition significantly by reducing the barriers to entry. The increased competitive pressure in Swedish retail can be explained by four drivers:

— *Continued growth of category killers*. The growth of category killers increases the pressure on existing stores through their scale advantages in purchasing, supply chain, assortment management and marketing. The growth of these specialized chains is facilitated by the growth of shopping centers making retail space available, as one of the main barriers to growth typically is the lack of prime locations (Exhibit 9).

Exhibit 9

The growth of category killers has increased the pressure on existing shops
Percent of sales

ILLUSTRATIVE

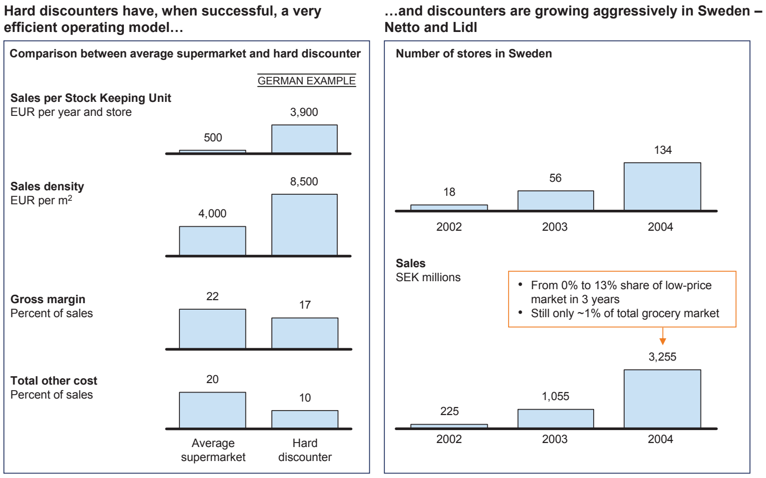


* Market defined as Swedish consumption of furniture, carpets, lamps, home textile and household utensils
Source: MedieSverige 2004; Svensk Bokhandel; Supermarket 1991 & 2005; Dagens Industri November 5, 2005; McKinsey analysis

— *Increased share of highly productive store formats and business models*. The growth of highly productive store formats increases the competitive pressure on traditional stores. Examples of this can be seen in grocery, where large format stores like ICA Maxi take market shares from more traditional supermarket formats. Also in grocery, the hard discounters with their very efficient operating model increase the price pressure (Exhibit 10).

Exhibit 10

Growth of highly productive formats has increased the pressure on existing shops



- From 0% to 13% share of low-price market in 3 years
- Still only ~1% of total grocery market

Source: EHI; Supermarket 2004 and 2005; McKinsey analysis

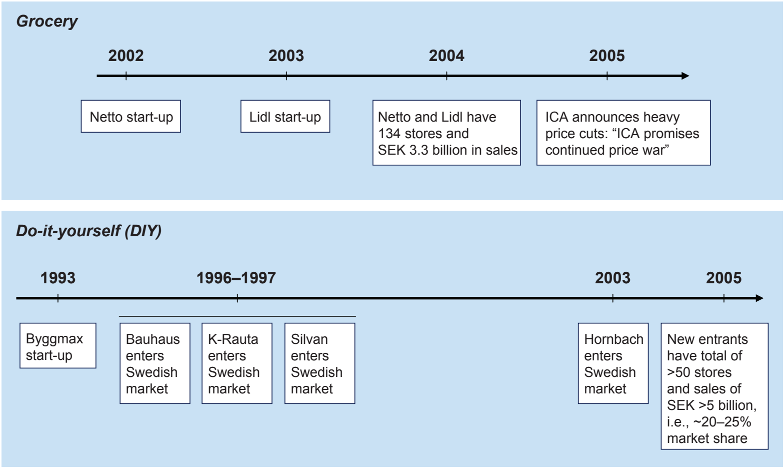
— *New market entrants*. Competition is generally higher if there are few barriers to entry. In retail the key barrier to entry is typically access to prime store locations. Partly due to eased zoning laws, and/or their application, and many new entrants in Swedish retail. In grocery, this is seen in the establishments of the hard discounters Netto and Lidl. In DIY, the market structure has totally changed with the new entrants in the 1990s (Exhibit 11). The immediate effect of new entrants is increased competitive pressure, but they also often operate either with an innovative or a well-proven and efficient business model, further increasing overall retail productivity.

— *New channels*. New channels typically increase competition as they grow their share of the consumers’ purchasing power. In Swedish retail, internet shopping has gone from a concept in 2000 to an established retail channel with annual overall growth of 35-40 percent and a potential to fundamentally influence consumers’ shopping behavior (Exhibit 12).

Exhibit 11

New entrants increase pressure on existing companies

ILLUSTRATIVE



Grocery

2002 – Netto start-up

2003 – Lidl start-up

2004 – Netto and Lidl have 134 stores and SEK 3.3 billion in sales

2005 – ICA announces heavy price cuts: "ICA promises continued price war"

Do-it-yourself (DIY)

1993 – Byggmax start-up

1996–1997 – Bauhaus enters Swedish market; K-Rauta enters Swedish market; Silvan enters Swedish market

2003 – Hornbach enters Swedish market

2005 – New entrants have total of >50 stores and sales of SEK >5 billion, i.e., ~20–25% market share

Source: Branschfakta 2004, HUI; Supermarket 2005; websites; press clippings; McKinsey analysis

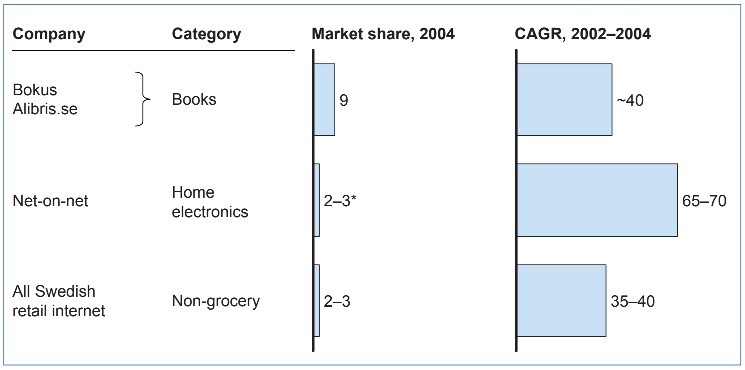
Exhibit 12

Growth of new channels increases competitive intensity

Percent

ILLUSTRATIVE

Position of Internet shopping in Swedish retail, excluding foreign websites



* Estimate based on NetOnNet's Swedish sales of SEK 700 million and market size of "Home electronics" in Sweden is SEK 32 billion based on VAT filings and SEK 27 billion based on NetOnNet information

Source: Supermarket 2004; Branschfakta 2004, HUI; Svensk Bokhandel; annual reports; McKinsey analysis

- *Growth of private label.* Private label products have been driven by lower food prices, but have also increased margins to some extent as retailers capture a larger part of the value chain. The retailer gains bargaining power on the expense of the manufacturers as the retailer ”owns” both the sales channel and the brand. Additional savings come from the elimination of unproductive steps in the value chain, such as the manufacturers’ field sales force. If the competitive intensity is high enough, the increased margin is typically passed on to the customer. Since the 1990s, the share of private label has increased in both food and general merchandise retailing. According to AC Nielsen data private label products accounted for 14 percent of total grocery sales in Sweden, with an average of 36 percent lower price levels compared to branded products.

- *Advanced IT usage.* Supply chain optimization and assortment control has advanced significantly in the past 15 years due to developments in the ways in which retailers use information and communication technology (ICT). The use of barcodes and scanners coupled with the implementation of ICT systems have enabled vast improvements in supply chain efficiencies of retail firms and have also driven the vertical integration of retailers as in the US. The advantages of technology are seen in areas such as:

  — Assortment management. Retailers get better sell-out data and can use it to precisely tailor their product offerings to meet consumer demand patterns. Also, by integrating systems and exchanging data vertically, manufacturers have access to the same data, improving their responsiveness to consumer demands.

  — Inventory management. Retailers can get real-time control over their inventory, eliminating the labor-intensive manual inventor checks. Using this data, orders become more accurate thus reducing inventories as the supplier gets better data on both inventory levels and sales.

The use of technology is costly and therefore dependent on sufficient scale of operations. Following the larger scale of operations, the US retail sector has come far in leveraging the technological advances. Growth of integrated retail chains and big box formats in Sweden is increasing the scale of operations and thus enabling the firms to better leverage ICT systems and more efficient management techniques. In itself, technology development favors larger scale of operations and is consequently a driver in the ongoing industry structure shift towards larger stores and players as well as more tightly integrated chains.

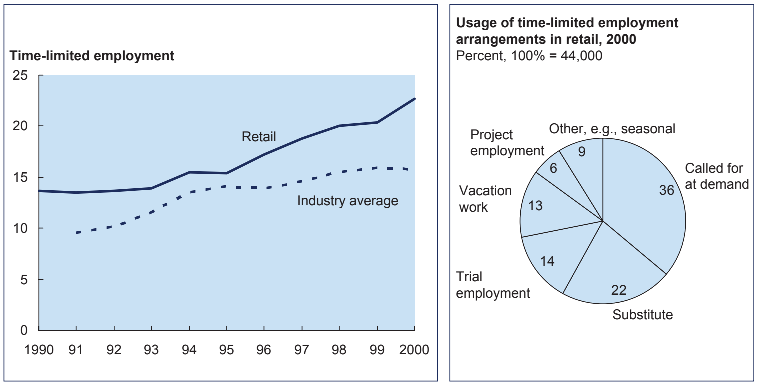
Factors Explaining the Employment Development

The strong productivity growth has not been accompanied by job creation. Between 1990-2003, Sweden experienced a net job loss of 30,000 jobs, representing 0.5 percent of the working age population. This means that the productivity gains have resulted from the downsizing of personnel, not from increased output. The main reason for this is mainly the labor market barriers. Since 1990, the only labor market barrier that has been at least partly addressed is labor flexibility:

- The risk of hiring was reduced when the probationary employment period was set to 6 months in 1994/1995
- The use of time-constrained employment arrangements has increased during the 1990s, partly due to increased flexibility (Exhibit 13).

Exhibit 13

Retail industry is increasingly using time-limited employment arrangements
Percent



Source: HUI, Handelns arbetsmarknad, page 16–18

The Current Barriers in the Retail Sector

Since 1995, many product market barriers have been removed or are less restrictive. Today, the most significant remaining product barrier to positive productivity development in Swedish retail is the application of zoning laws. There has been a change in many municipalities during the last years as a result of a changed mindset; however, the zoning laws are still a major barrier to entry for new retailers and for the growth of highly productive store formats:

- *Speed of process.* Today, it can take several years to change the local building plan (detailed plan) including process of appeal. The time to get a definitive decision is in itself a barrier for retailers that want to grow organically rather than to purchase locations (which can be close to impossible as the existing chains own the first right to all of their store locations). The time-consuming process increases the risk, and discriminates against less capital-intensive players, attempting to establish new stores.

- *Variations in policy*. Today, the decision to build a new shopping center or a new large retail store depends on the political majority of each municipality. Although there is a mindset change regarding the positive effects of increased competition, the opinion of many stakeholders is that Swedish municipalities still vary greatly in their judgments regarding new retail establishments. These variations make it riskier to establish new stores and thus limit competition.

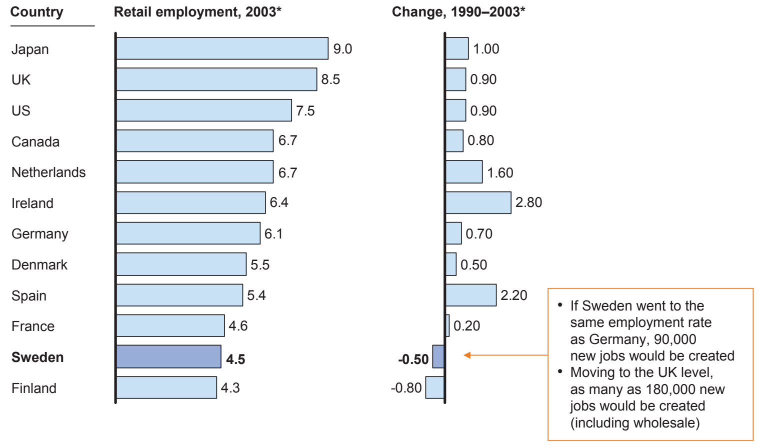
Looking at employment, the Swedish retail industry employs significantly fewer people per capita than other countries. If Sweden went from today's 4.5 percent of working-age population to the German level of 6.1 percent, it would mean 90,000 new jobs, one third of the open unemployment in Sweden as of November 2005 (Exhibit 14).

The explanation behind Sweden's weak job creation is partly the existing labor market barriers, and partly a weaker demand situation, particularly for service-intensive retail concepts. As many product market barriers have been removed or are less damaging today than in 1995, the following labor market barriers have become more important:

- *Labor cost.* The effect of having a high retail labor cost is two-fold: first, productivity gains are more likely to be used to reduce employment instead

Exhibit 14

Swedish retail has a dramatically lower employment level than other countries and has experienced negative job creation
% of population 15–64



- If Sweden went to the same employment rate as Germany, 90,000 new jobs would be created
- Moving to the UK level, as many as 180,000 new jobs would be created (including wholesale)

* Canada and Japan 2002 and 1990–2002 respectively
Source: Groningen Productivity Database, February 2005; OECD Labor Market Statistics Database; McKinsey analysis

of increasing output, and second, only a few consumers with high purchasing power can afford service-intensive retail concepts, thus drastically reducing the demand for service jobs. Sweden has very high retail labor costs:

— High cost compared to other countries. Comparing the PPP-adjusted cost to employ a female shop assistant in capitals over the world, Sweden has the fourth highest cost (Exhibit 15). Sweden also has very few “low-cost” jobs compared to the UK and US. It is difficult to create jobs with lower qualifications since there is no demand at the price at which the services are offered (Exhibit 16).

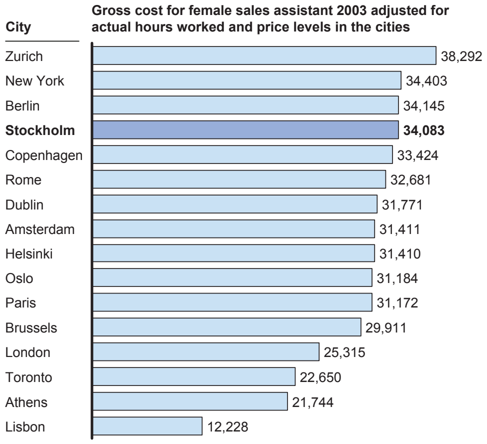
— High relative cost compared to goods. The way taxes are designed in Sweden, services are discriminated on behalf of goods. In the US or the UK, the consumer gets 70-100 percent more services for the price of the same product compared to Sweden (Exhibit 17). The result is that the Swedish consumer more often chooses to buy a product rather than to pay for service.

- *Labor flexibility.* Sweden’s labor laws and the retail collective agreements have not changed significantly since 1990. The flexibility is today limited when

Exhibit 15

High total cost for shop assistants in Sweden compared to other countries

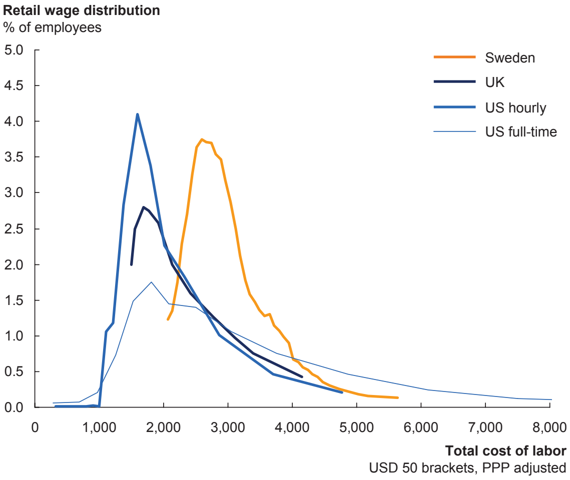
USD per year



Source: Prices and earnings 2003, UBS; Watson Wyatt Global Remuneration Report; McKinsey analysis

Exhibit 16

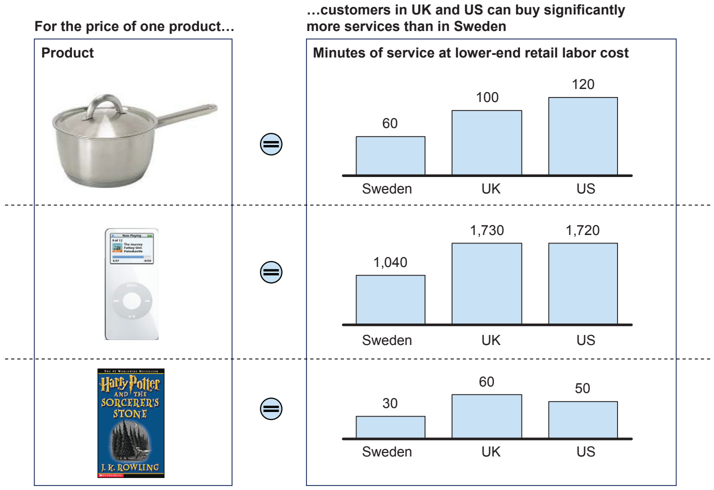
Comparing wage distributions across several countries clearly shows the high labor cost in Swedish retail



Source: Bureau of Labor statistics, US Department of Labor; UK Department of Labor; SCB Lönestrukturdata; McKinsey analysis

Exhibit 17

Compared to the US and UK, services in Sweden are much more expensive than goods, keeping overall retail employment down



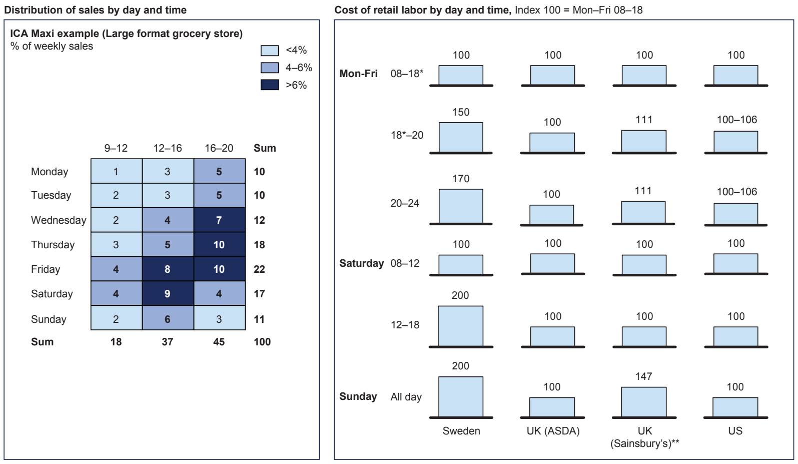
Source: US department of labor statistics; Statistics Sweden (SCB); UK department of labor; UK income data services; Apple; IKEA; Barnes & Nobles; Akademibokhandeln; McKinsey analysis

compared with countries like the US and UK. The main barriers to job creation that are functions of low labor flexibility are:

— High supplements for evening and week-end hours. In Sweden, there is no opening hours legislation, apart from the law that the safety and working conditions of the employees is the responsibility of the employer. In Sweden the opening hours are instead restricted due to the high cost of labor during week-ends and evenings. The Swedish retail employees' union has been successful in maintaining retail wages and especially the unsocial working hours' supplements at high levels. The effect of the supplements is that stores pay up to 100% more for labor at the times when many consumers prefer to shop, e.g. Sundays (Exhibit 18). Shop owners find this to be problematic as expanded hours of operations would attract more consumers but the higher wages often make it counter-productive. From an employment perspective, it is likely that should the supplement be reduced, retail owners would find it more profitable to increase hours of operation and employ more people than today.

Exhibit 18

High cost of labor on evenings and week-ends is a barrier for retail



Distribution of sales by day and time

ICA Maxi example (Large format grocery store)
% of weekly sales

<4%
4–6%
>6%

	9–12	12–16	16–20	**Sum**
Monday	1	3	**5**	**10**
Tuesday	2	3	**5**	**10**
Wednesday	2	**4**	**7**	**12**
Thursday	3	**5**	**10**	**18**
Friday	**4**	**8**	**10**	**22**
Saturday	**4**	**9**	**4**	**17**
Sunday	2	**6**	3	**11**
Sum	**18**	**37**	**45**	**100**

Cost of retail labor by day and time, Index 100 = Mon–Fri 08–18

* 18.15 for Sweden, 18.30 for Sainsbury's (UK)
** Provincial UK, shop assistant with base salary GBP 5.39/hour
Source: När handlar vi?, HUI; Kalenderkorrigeringsgruppen; *2003 Annual Specialty Store Compensation & Benefit Survey*, US National Retail Federation; UK Income Data Services; Hanselsanställdas förbund; McKinsey analysis

— Employer's perceived risk of hiring. The Confederation of Swedish Enterprises notes that Swedish employers are reluctant to employ people due to inflexible labor legislation and collective agreements. Employers also find it troublesome that they cannot lay off unproductive employees. It should be noted that this risk is perceived to be much more significant for small-to-medium sized companies. Large companies have the scale to absorb the consequences of employment problems. The actual impact of the employee protection laws has not been further analyzed, but it seems that the risks to the employer may be overstated in the public debate. However, a negative effect of strict employee protection laws is the increased barrier to enter employment by those not currently in the labor market.

- *Demand conditions.* Compared to the US and the UK, Sweden has a significantly lower share of service concepts and thus lower demand for retail labor. This is driven not only by the high cost of labor as described above, but also by a lower demand for services. There are three primary reasons for the weak demand:

  - — Historical ideals and behavior. There is no tradition in Sweden to pay for especially lower value-added services, and it is sometimes considered as something only the upper class would do.

  - — Low disposable income. Sweden has a narrow income distribution and experienced only modest increase in wealth during the period, leaving only a relatively small share of the population with enough disposable income to pay for high-service concepts.

  - — Low innovation. Partly as a result of low demand for services and high cost, innovation in service-intensive retail concepts has been very low. A second reason is that entrepreneurship in Sweden has not been very attractive due to the perceived administrative burden and high risk. Capital for entrepreneurs has not been abundant, but neither has it been scarce. Today, the perception in the industry is that capital exists and should thus not be seen as a significant barrier.

- *Labor supply.* The labor supply needs to match the demand for labor in order to allow job creation. There is no reason to believe this has not been true for Sweden's retail sector from 1990 until today (Exhibit 19):

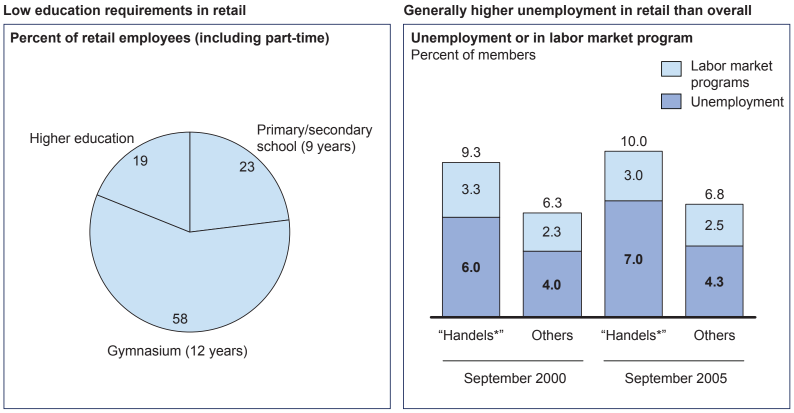
  - — Low educational requirement. To work in retail there are few requirements for formal education. Only 19 percent of retail employees have more than 12 years of education (Gymnasium), and a large share of those are probably university students working part time or temporarily until they find jobs fitting their qualifications.

  - — High overall unemployment. Due to the economic downturn in the beginning of the 1990s there has been high unemployment in the country during the time period in question. In interviews, most store managers report that the problem is too many applicants rather than too few.

  - — Many unemployed retail workers. The unemployment rates are even higher in retail than in the overall economy, further strengthening the conclusion that labor supply has not been an inhibitor to job creation.

Exhibit 19

Lack of qualified labor does not explain Sweden's low retail employment



* "Handelsanställdas förbund", the Swedish retail workers' union
Source: Svensk Handel; AMS; McKinsey analysis

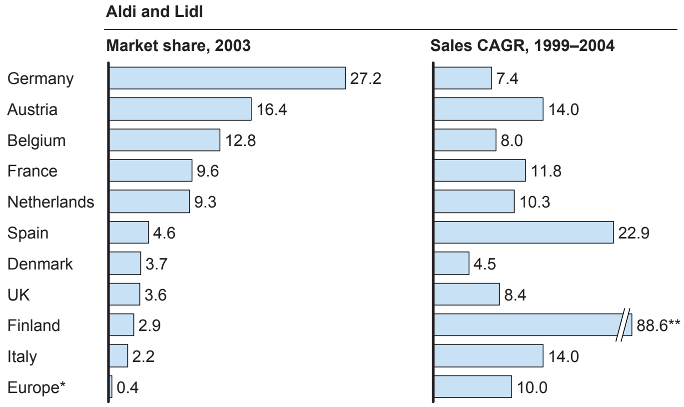
KEY CHALLENGES FOR THE FUTURE

Going forward, the challenge will be to adopt to trends such as a continued shift in the industry structure, increasing use of private labels, and probably a continued internationalization:

- *Continued shift in industry structure.* The industry structure shift will continue to evolve in the Swedish retail sector. This shift will probably include a more pronounced polarization of the market, where both premium and low-price concepts grow to the detriment of the "middle-market" stores:
  - — Growth of both hard and soft discount. Hard discount stores have been largely successful in Germany, while there is a more mixed picture in other countries. It is uncertain whether the German hard discount model will work in Sweden, but the entry of Lidl was an important occurrence as it introduced a new business model to the Swedish grocery market. (Exhibit 20). Discounters, whether they are "hard" or "soft", are likely to continue to grow as they currently account for only approximately 1 percent of Swedish grocery sales and the Swedish population is rather price conscious.

Exhibit 20

Hard discounters have become immensely successful in Germany, less so in other countries
Percent



* 2002 figures
** 2002–2004
Source: AC Nielsen

— Continued expansion of shopping centers. Today, Swedish shopping centers account for approximately one third of Swedish retail. As retail volumes grow further, it is likely that the shopping centers will capture most of this growth and also increase shares in the existing retail markets. Centrumutveckling estimates that 750,000 m^2 of new retail area is needed until 2010. However, it is important not to overestimate the growth of shopping centers. Given living patterns, it is not likely that Sweden ever will come close to the US levels where approximately 75 percent of all retail activities takes place in shopping centers.

— Growth of large productive store formats. It is most probable that there is still room for continued growth of large, productive store formats. This is also a result of the low-price trend that favors large efficient store formats. However, the population density in Sweden is not as high as in continental Europe, UK and the US, which will probably keep the development to levels lower than in those countries.

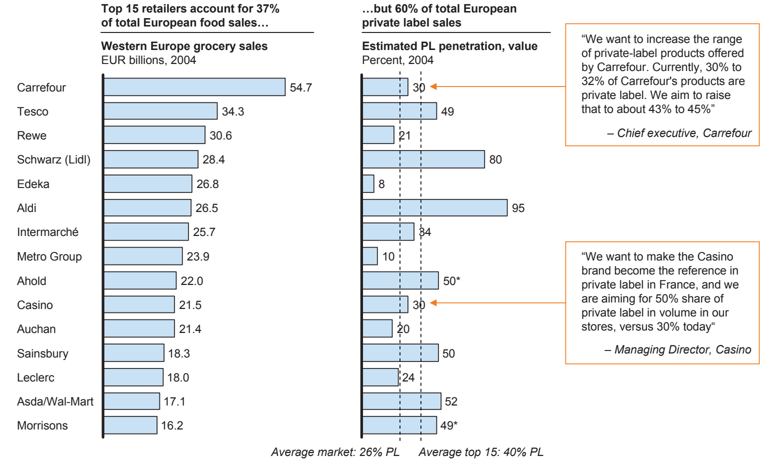
— Growth of service-intensive and premium concepts. In parallel with the development of low-price and value concepts, there will be an increasing market for premium concepts with high value-added. The innovation and growth of those will depend largely on the labor market conditions and reduced barriers to entry for new players.

- Increased importance of private label. Private label offers attractive margins for retailers, and since it currently claims a relatively low market share in Sweden, continued expansion is likely. In relative terms, it will likely be the premium/niche private label products that will increase the most, due to their high gross margin contribution and today's low penetration relative to international benchmarks (Exhibit 21-22).

- *Increased international competition.* In Sweden, the importance of the foreign-owned retailers has increased significantly since 1990 when Swedish retail was essentially a local market. Today, almost 5 times more people are employed in foreign-owned retail companies than in 1990 (Exhibit 23). In a market characterized by such large scale advantages as retail, it is most likely that the ongoing trend of cross-border consolidation will continue.

Exhibit 21

Largest European retailers will continue to drive private label share further up



"We want to increase the range of private-label products offered by Carrefour. Currently, 30% to 32% of Carrefour's products are private label. We aim to raise that to about 43% to 45%"

– Chief executive, Carrefour

"We want to make the Casino brand become the reference in private label in France, and we are aiming for 50% share of private label in volume in our stores, versus 30% today"

– Managing Director, Casino

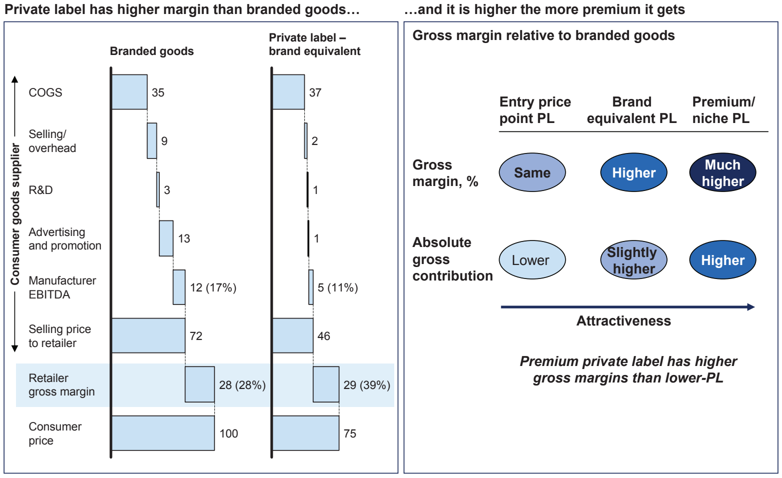
Note: Europe is here defined as UK, Germany, France, Italy, Spain, Holland, Belgium
* In Holland 2002
** Number for Morrison as a whole. Safeway bought by Morrison in 2004
Source: Planet Retail; annual reports; press clippings; Taylor Nelson for UK player

Exhibit 22

Attractive margins on private label vs. branded goods drive increase in private label

DISGUISED EXAMPLE

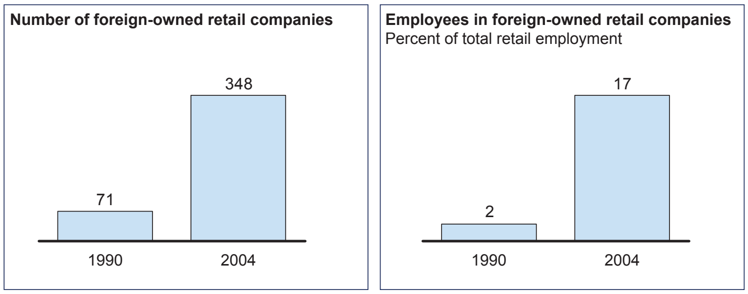
Indexed



Source: McKinsey analysis

Exhibit 23

Swedish retail industry has seen an increase in foreign-owned companies, a trend that is likely to continue



Source: ITPS, Foreign-owned companies

SUMMARY AND IMPLICATIONS

With retail being such an important sector and having such a high potential for job creation, it is important that policy makers, unions and companies work together. The objective should be to further increase productivity by addressing the remaining product market barriers, while actively improving labor market conditions to ensure a net job creation in the years to come.

- *Further increase competitive pressure by addressing zoning laws.* The most important barrier to productivity growth and increased competition in Swedish retail is the access to retail premises:
  - Uniform application of zoning laws. Policy makers should actively promote the ongoing industry evolution. The positive effects of increased competition should be clearly addressed in response to local concerns about marginalization of existing retail.
  - Shortened process time. Policy makers should revise the PBL process to shorten the time to a final decision. It is important to do so in order to facilitate for the industry evolution with increased productivity and lowered barriers to entry for new players.
- *Improve labor market conditions to facilitate job creation.* Policy makers and unions must together support the retail sector's growth and facilitate job creation. The main objective for the union, in addition to the essential function of protecting the interests of people currently employed in the retail sector, could be to assume a proactive role by actively working to allow unemployed colleagues and all potential new retail workers to find jobs. In order to turn the productivity gains into job creation, policy makers and unions must together find ways to make the following changes:
  - Increase flexibility. To increase job creation, it must be possible to employ people in a way that matches the needs of the companies. The recent proposal from the Commission of Inquiry on part-time employment ("Rätt till heltid") is regressive in terms of job growth as it will be riskier to employ part-time personnel, especially for small-to-mid-sized companies. The union and policy makers should actively work in the opposite direction and consider alternatives to increase flexibility rather than erect additional barriers.

  - — Decrease labor cost differential of unsocial working hours. The unsocial working hours supplement is today keeping down retail employment. By reducing the supplement, more people could be employed during evenings and weekends, and the retail industry might lose less ground in the competition for the consumer's purchasing power. The supplement reduction could be compensated through increased salary based on average supplement bore by full-time employees, or by an increased performance/profit based pay.

  - — Reduce labor cost. To make service-intensive retail attract a larger share of the population, the cost of labor need to decrease. This should probably be done in a way that minimizes the price impact for the individual worker, e.g. by revising today's tax wedges.

- *Embrace internationalization of retail.* In the future, Swedish retailers need to fundamentally enhance their own strategic position to meet increased competitive pressure in the home market. This change is positive as the increased competition, the introduction of successful formats and the increased scale of operations will drive productivity growth. To facilitate this change, both policy makers and individual companies have an important role to play:

  - — Increased competition. Competitive pressure will continue to increase as foreign established concepts enter the Swedish market. To meet this competition, many of today's companies need to significantly improve both back- and front-end operations. They should strive for global best-practice rather than being content with excellence by Swedish standards. Both entries and exits are natural for a well functioning market and will ultimately drive productivity. Policy makers should not be tempted or persuaded to inhibit this structural change, as ultimately it will be the Swedish consumers will benefit from the increased competition.

  - — Cross-border consolidation. The scale advantages will further drive cross-border consolidation. While less significant to the overall economy, many individual companies need to grow internationally, either organically or in partnerships, or face the risk of being acquired. Their larger scale will make them more competitive in the Swedish market and thus contribute to increased productivity in Sweden.

In addition to the above, it will be increasingly important for the retail companies to deliberately select a strategic position. The future retail market will probably be significantly more polarized than today. Following an ongoing evolution, the low-price/value segment will further increase in importance with large productive stores and chains and efficient discounters. In like manner, the high-end/premium segment of the market will also show strong growth with increasing shares of the consumer's purchasing power. Several of today's retailers seem to miss the opportunities this development brings, and instead they risk being caught in the middle.

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