Retail and consumer products:

A less stable environment ahead

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It will not be business as usual. A rising tide will not lift all ships.

By all indications, 2012 will be another year of lethargic growth, store closings and increased focus on everyday low prices by several major retailers, all which will have a significant impact on the entire retail landscape. Multichannel is key to survival for many. Online retailing also threatens existing store economics, measurement systems and incentives. As a result, financial metrics are changing, too. Online retail has altered the business model, either because of lost volume from the store or through increased costs of multichannel development. Enhancing the shopping experience is integral to a retailer's success; however, this becomes more difficult for those that are poorly positioned.

In addition, retailer consolidation will likely continue, if not intensify. Marginal formats, brands and secondary store labels are becoming less relevant. Market share will be an integral part of vendor and retailer sales growth. Differentiation, whether it is a point of view, service, selection or a variety of other factors, may become a key traffic driver. *Want* rather than *need* is most critical in driving consumer purchase decisions.

Brands can create and identify *want* solutions to targeted consumers, but understanding and marketing to that customer are keys to success. A recent quote about Apple founder Steven Jobs is most appropriate to our current economic environment: "He created something no one knew they wanted, but now cannot do without."

Stay ahead of the curve

Winners continue to reinvent themselves within a steadily evolving environment. Plans have to be flexible rather than etched in stone, and they need to be reevaluated constantly as competitive issues and the environment changes. If retailers are doing the same thing they did yesterday, then someone else has already caught up to them. Leaders can remain ahead of the pack while the distance between followers widens.

Another year of lethargic growth

Consumer spending, largely tied to employment growth, will likely maintain its slow uptrend. Interestingly, corporate profitability has increased sharply over the past two years reflecting rising worker productivity and the ability to pass through higher costs. However, few managers are willing to expand or invest because of uncertainty due to inaction in Washington, D.C. and fear about a further tightening in the regulatory environment. There is an inclination to only add to the workforce if and when there is a more defined upturn

in business, rather than bear the burden of higher costs in anticipation of recovery. Thus, it seems likely that 2 percent real GDP growth is a reasonable expectation, followed by a similar increase in employment and consumer spending. Importantly, this does translate into higher retail sales, but a rising tide will not lift all ships. Market share will be an integral part of vendor and retailer sales growth this year.

Maybe a more stable economy, but it could be an unstable environment

Store closings and increased focus on everyday low prices by several major retailers are likely to have a significant impact on the retail landscape. No one likes rapid change or business disruption, but this year could witness a significant transformation. Store closings would add to the glut of real estate on the market, especially impactful as the market for big-box stores appears to be waning. Another series of management changes at Sears and Kmart suggests there will likely be further changes in their vendor structure which has been a never-ending process in recent years. Recent reports of difficulty for vendor financing will likely complicate the issue for their suppliers.

J. C. Penney's strategy seems to be better thought out than at Sears Holdings, but the game plan is complex and could have far-reaching implications on the retail sector. Most obvious would be the implementation of a new mark-up structure. While geared to achieve more full-price selling and less promotion, how will this affect department store and mass merchant starting price points? Stores have moved to everyday low pricing in the past, only to see a fall off in traffic, after which the tempo of promotional activity had to resume. The significant reduction in brands at Penney from 400 to 100 will be a windfall to the favored, but will likely have a major negative impact on the discontinued brands. More telling will be the customer response, which could make or break the new strategy.

Kohl's Department Stores joined the list of mid-market retailers reexamining their business model to reverse disappointing sales trends. In its recent conference call with investors, management noted it believed it had lost its edge in the price component of its value equation. Putting it another way, maybe its merchandise was just not sufficiently differentiated or did not generate enough excitement to justify its margin structure. Nevertheless, the overriding issue appears to be one of increased competition for its share of the consumer dollar.

Has Kohl's drifted away from its heritage of a strong connection with its customer, or is its market segment just coming under increased pressures to suggest its business model is in need of an overhaul? The issues may go deeper than the recently completed highly promotional fourth quarter. It appears Kohl's suffers from many of the issues Penney has been struggling with as well.

Some of Kohl's proposed changes include a reduced pace of new store openings and remodels this year. The company will introduce a new prototype store layout to bring its customer back with increased frequency. This will include changes in space allocation to accommodate the introduction of new merchandise categories and brands. Over the near term, a more intensive marketing of sharper pricing is proposed, but there appears to be more pronounced longer-term issues.

Is the mid-tier market shrinking?

While the mid-tier market may not be shrinking, there is increased competition for the consumer dollar, a key topic of conversation in board rooms today. Sears, Penney, Walmart, and Target, to some degree, have been struggling with poor results for a number of quarters and while each has addressed what it believes to be its key issues, there does not appear to be a magic bullet that will work for all. Discount store sales have been

somewhat insulated because of an increasing dependence on food and other consumable items. Obviously rapid growth of the dollar-store segment has been a factor, but so has the significant progress Macy's has had in its market-share penetration. Additionally, many consumers have been frequenting off-price retailers and factory outlets more often where they believe they can buy the same or similar merchandise at much lower prices.

The Internet is undoubtedly a significant factor behind loss of market share at store level. Lack of a strong multichannel focus for some could have resulted in lost opportunity to capture incremental impulse purchases both online as well as in the stores. Kohl's management noted its online business was very strong in the quarter, up 40 percent, albeit from a small base, whereas its overall sales were relatively flat, and down 2 percent on a comparable store basis. Free shipping is rapidly becoming the norm and cutting into margins, unless one looks at this purely on an incremental basis, which does not appear to be the case.

Prices are likely to trend lower as more stores move towards everyday low prices throughout the mid-tier at the expense of margins. What would be the impact of scaled back promotions? One would obviously need to sell more units to match last year's dollar volume; however, overhead and selling costs per unit would not likely go down, resulting in lower profitability. Reduced store expansion and opening costs could be a potential offset in the near term. Increased focus on store renovation is expected to enhance store sales productivity as well as the opening of smaller format stores. Bottom line: lower gross margins and expense pressures are likely ahead. The mid-market as we know it is probably not shrinking, but the market served by traditional mid-market retailers is. As previously mentioned, market share gainers will likely continue to be traditional department stores that are broadening price points, dollar stores, off-price retailers and the Internet.

So what happens to the traditional mid-tier retailer?

The landscape is evolving; thus additional share of market could be up for grabs. Penney and Kohl's are looking to reverse momentum as they strengthen their value message with sharper prices. Focus should probably be on more of the right merchandise in the right place at the right time, in addition to the right price. This will probably lead to increased exposure to own label or exclusive merchandise in the quest of maintaining a targeted margin, but they would also have to absorb the risk of excess inventory with no vendor to push back on. Key will be their ability to develop the proper business model to achieve targeted profitability that can generate cash for reinvestment. Otherwise they will continue to retrench.

Mall sales productivity, according to the International Council of Shopping Centers, rose from an annualized monthly rate of $30 per square foot in first quarter 2003 to $38 in fourth quarter 2006, dropping back to $30 in first quarter 2009 and then approximating $36 in third quarter 2011. Coincidently, mall vacancy rates dropped slightly to 9.2 percent in fourth quarter 2011 from an 11-year peak of 9.4 percent in third quarter 2011. However, given the number of store closings recently announced, that rate could move up again in upcoming quarters. Importantly, store traffic, number of stores shopped and conversion rates continue to decline largely due to growth of the Internet and increased frequency of more value-priced destinations.

Enhancing the shopping experience is integral to a retailer's success. However, that becomes more difficult for those that are poorly positioned. Coming back to the point of declining shopping mall productivity, as sales per square foot declines, management will cut expenses to maintain margin, but as service declines, sales drops further. The wheel just keeps spinning. Defensive action cannot move a strategy to one of strength. To change a store from a liability to an asset requires a different management mindset. There is no shortage of any place to buy anything. Becoming a destination point can make the difference. A loyal customer can be

several times more profitable than a new one and maintaining a strong loyalty program can generate multiple repeat visits.

It's all about the consumer

What drives a customer? Why do they buy? In today's environment, it is increasingly important to identify customers and anticipate their needs and expectations. There is a difference between what consumers say they want and what actually drives their purchases. A customer walks through the door expecting a shopping experience that offers the right product at the right price in the right place. Market share winners have become more sophisticated in speaking with their customers about quality before and after purchase.

More emphasis needs to be made on post-purchase focus groups as to what drives customer satisfaction. Most important is what they were looking for and did not find, or why they did not buy. These insights need to be shared with the supplier, who should be involved in product development so as to better tailor the assortments, mix and promotions for the target customers, and localize those offerings by market. Value and uniqueness are both key to the process. In theory, a retailer should sell items that cannot be sold any place else. The consumer either shops for value or according to emotion, and sometimes both. The Internet has made competition fiercer as consumers easily research prices and know a product's true value. A recent study by brand and customer loyalty research firm Brand Keys noted that emotional factors accounted for as much as 70 percent of the decision to purchase, whereas 30 percent was based on rational factors, such as category attributes. Building brand credibility is crucial in impacting perceived value.

Loyal customers must also be leveraged. Successful brands and retailers are sufficiently differentiated, which drives traffic, excitement, conversion and profits. Customer loyalty is rapidly becoming an important part of the value equation and potentially a more profitable one. A satisfied and loyal consumer will tend to purchase more often and in larger quantities than a new customer.

Management needs to have insight, but often will fail because of poor execution. It takes a different and forward-thinking mindset. The game plan needs to be monitored continually and leadership must react to any deviation from the plan. There is no crystal ball. Reassessment and redirection should be done regularly to maintain share growth and widen the spread from the closest competitors.

Multichannel is key to survival

Ten years ago, many thought brick and mortar retailing was bound for extinction because of the growing threat of the Internet. That turned out not to be the case, however, online retailing threatens existing store economics, measurement systems and incentives. Bricks and mortar have an advantage over online only with the ability to create excitement and the *want* to purchase. Apple is a prime example of this, as well as some luxury retailers. Retailers have always believed customers will always be there, which was a wrong assumption. Moreover, they have become less tolerant of a poor shopping experience. Integrating the process and reaching out to the target consumer with a specific product or idea can drive incremental traffic to site or store. The shopping experience is further enhanced with store pick-up for instant gratification or ease of return to the store.

While there are retailers growing and thriving, online sales are growing about four times faster than overall retail sales. As retail consolidation continued over the past decade, strong companies not only survived, but appear to have secured a solid position in multichannel retailing. Furthermore, it is estimated that customers who shop both in store and online spend at nearly twice the rate of in-store shoppers alone. It appears as

though many multichannel retailers are growing their online distribution faster than many of those who sell only over the Internet. Albeit from a smaller base, the trend is worth noting.

Retailers are becoming more reactive, adapting to social media and mobile use by their customers. The objective is to make stores and wares friendlier to the online environment. Product descriptions and reviews allow for ease of comparison, which, along with competitive pricing, are a winning combination. While there are many online-only sites that offer these, retailers provide the opportunity for instantaneous pickup through their store network. In the case of Best Buy, this represented about 40 percent of the retailer's online sales. The keys to success are integration, implementation and execution, making the process seamless to the consumer. Ability to ship from a store eliminates the need for a separate distribution center and potentially solves many out-of-stock issues.

Cost differentials are beginning to narrow. Free shipping, once a perk or an incentive, is now becoming the standard. Retailers, from Nordstrom to Walmart, with a wide variety of goods, are now offering free shipping for both purchases and returns. This is quickly becoming a standard. These sales tend to be more profitable than average for most retailers, however, bearing the burden of shipping is raising the cost structure for Internet sellers. There also appears to be more pressure building by states and local entities to capture sales tax. This will probably succeed in time, eliminating another advantage of the online-only sites.

Ease of return is becoming more important to the consumer. Despite free return shipping, physical stores are rapidly becoming more desirable because of their ability to exchange for another size or item. Perhaps more important, the resulting transactions are often larger than the original placed online. A satisfied customer can become a loyal customer, and a more profitable one.

Building a customer relationship is a key ingredient to profitable growth. Dialogue and interaction before, during and after the transaction are essential to building a relationship. Retailers and vendors should analyze and explore opportunities to enhance the shopping experience. Retailers should develop a strategy to become more proactive with the consumer and reach out with new ideas, products, fashion, technical specifics and specially focused promotions. Listen to customers and implement changes based on what they say. Flash sales are now becoming a new and useful tool for a number of stores and can generate incremental and profitable sales growth.

Target, according to recent press reports, sent a letter to its suppliers in an attempt to stop "showrooming" demanding a different product for distribution through its stores. It could be successful because of its size. Although, Target's online business is small, around 1 to 2 percent of its total, it is interesting that the company envisions this as a big threat and is looking at ways to address.

Over the recent holiday period, a number of news commentators noted that Best Buy was mentioned as a showroom for Amazon and other Internet sellers. The ability to do a competitive price check and buy elsewhere has been made easy through a smart phone. Best Buy makes every effort to be competitive and offers the advantage of store pickup, which provides for instant gratification.

Best Buy came up with one solution. Findings from a recent survey bolster the retailer's strategy by indicating, "the combination of convenience, confidence and value as a key factor drives an exceptional shopping experience." Accordingly, Best Buy just announced its Perfect Match Promise which includes, "free phone support and enhanced return and price matching policies to better fit consumer lifestyle." The promise is simple:

- 30-day free phone support to get product up and running
- 30 days of easy returns with no restocking fees
- 30 days of competitor price matching

Perhaps this began as a defensive move to combat Amazon, which will probably cut into profitability at the outset. However, to the extent Best Buy can develop more loyal customers; the long-term effects will likely mean enhanced profits.

Think about doing it differently

Retailers and manufacturers need to engage in intense self-analysis. This includes consumer research in order to determine the wants and needs of target customers. They need to increase their value proposition with new and differentiated merchandise, find a path to a more efficient sourcing and logistics structure, strengthen the brand (whether national or owned) and finally, implement a multichannel distribution network.

Inventory management is important in managing the distribution process. Simply put, inventory management is the means of ensuring that the appropriate selection and quantity of merchandise is in place for a higher rate of sale at regular price and at the first markdown. The strategy of a steadily increasing initial markup to offset the increasing markdown rate or allowance must be reversed so that the consumer perceives greater value at the start, without searching lower-priced channels first. This will help preserve brand integrity and limit the amount of branded product distributed through off-price outlets and discount formats.

This issue has compounded as the tempo of promotional activity has increased steadily in recent years, while at the same time, inventory turnover continues to rise. The consumer has been well educated to wait for the sale, with much of the price drops funded by manufacturers taking on an ever-higher rate of markdown allowances. A number of retailers have tried to wean customers off this promotional cadence, only to see store traffic and volume decline.

The sourcing strength of large organizations is a significant advantage, especially for owned brands that can push back on the manufacturer for better pricing. Such pushback is becoming more difficult due to deterioration of vendors' financial conditions. Better collaboration between the two could provide the incentive of fresh, new and differentiated product. The largest of the national retailers has become too commoditized through their brands' reliance on *safe* merchandise, with buying decisions today reflecting a trend towards the overly price sensitive.

Management's mindset needs to gravitate towards the specialty store model, focused on turnover and profits per square foot. This again comes back to *Retailing 101* and knowing your customer, providing the appropriate level of service and offering the right product (at the right time and at the right price). Creating that back-to-basics mindset should drive traffic, sales productivity and profitability.

Customizing the assortment and tailoring it to the customer is key. While consumers are most focused on value, they are also interested in differentiated and unique merchandise, an important component of the price-value equation. Breaking the 80/20 rule, with greater variety and more frequent flow, creates excitement, drives traffic and results in conversion. Shorter cycle time and replenishment will be central to maintaining a fresh look.

Better utilization of online marketing, wherever applicable, offers great opportunities to leverage a brand. In many cases, multichannel distribution can be more profitable than a single line. Up-to-date product and

pricing information is critical as the consumer who is looking for customized and unique products is likely to be the most responsive.

Improving the shopping experience as a way to differentiate cannot be overlooked. Store and brand loyalty can be raised by increasing the satisfaction of consumers and offering more value-added services. In addition, knowledgeable and helpful sales associates can generally initiate sales opportunities, drive a higher average ticket and shorten the transaction time. Retailers must engage customers and be responsive to questions, problems or issues. Such actions can drive repeat visits and result in full-price selling.

Many of these initiatives should be included in the planning process. Assessing results on a regular and timely basis is critical. Management must be ready to react to any deviation from the plan and not wait in hope that a situation will improve. In reality, the odds are that a situation will only worsen. Both the brand and the product must remain relevant, and the needs of the consumer should be constantly reevaluated.

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