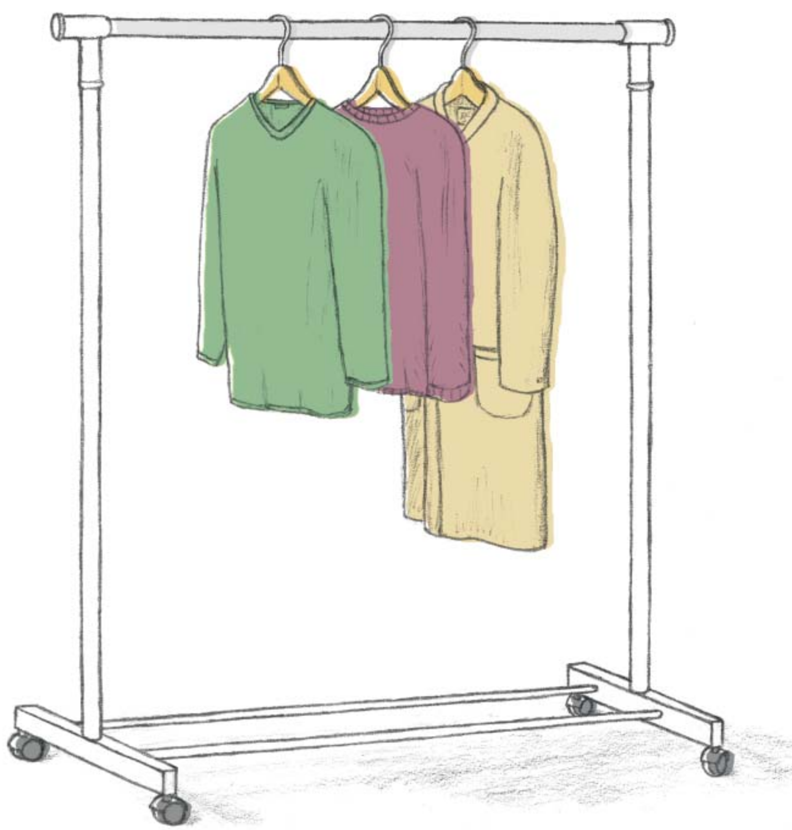
Grant Thornton

Reviving retail
Strategies for growth in 2009



Associate Member Advisory Council
This council of Associate member companies serves as the voice of NRF's sizeable retail trading partner membership. AMAC ensures the needs of NRF's associate member base are met. It also serves as the committee overseer to the NRF Retail Reference Center, managing the Peer Review Group and developing the standards by which submissions are reviewed.

Executive summary

Retailers throughout the country and across nearly all sectors experienced their biggest declines in decades at the end of 2008, and continue to suffer declining sales in 2009. The economic downturn has hit the retail sector hard. But with the challenges, there also are distinct opportunities. Grant Thornton LLP's newest white paper, *Reviving retail: Strategies for growth in 2009*, highlights five key trends transforming the retail sector and offers tips for capitalizing on these areas of growth.

Buyers are choosing clicks over bricks. Buyers may not be buying much, but online sales have suffered less and, in certain categories, grown more than in-store sales. Online retailers consistently outperformed brick-and-mortar stores in their 2008 holiday sales. Traditional retailers need to think about extending their brands into the digital arena, while taking into account the effect of expanding their online presence on issues such as physical store locations, real estate, logistics and costs.

Private-labels are gaining ground over name brands. Private-label brands are growing in popularity in today's economy, particularly among price-conscious consumers. The private-label strategy has been successful in the grocery sector, where nine percent of consumer packaged goods products today are private-label brands. Other retailers must consider whether their products, which typically are more complex, less commoditized and have more brand equity than grocery items, may be suitable for private-label treatment.

Going green is bringing in the green. Consumers are increasingly focused on the environmental impacts of their consumption. Reduce, reuse, recycle – the three Rs of the green/sustainability movement – continue to influence customer behavior, and environmentally sensitive goods and practices are winning a growing share of customer dollars. Not surprisingly, sustainability is a growing area of investment among Fortune 500 companies. Retailers need to both act green and sell green products if they plan to cash in on this trend.

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Executive summary (continued)

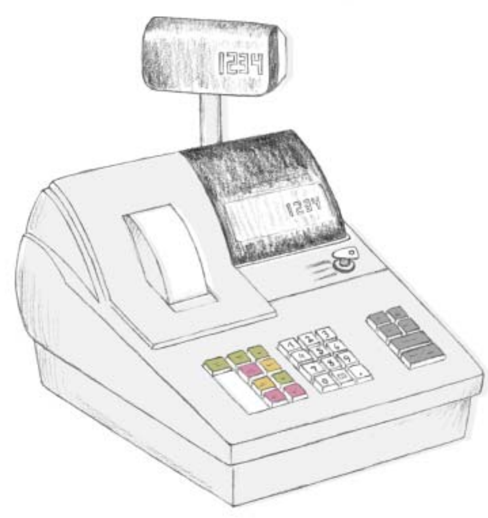
A loyal customer is your best customer. Even when sales are stagnant or declining, there is growing recognition that enhancing affinity among retailers' best customers can produce long-term benefits. Many brick-and-mortar and online retailers sent cards and emails inviting loyal customers in for special shopping experiences such as wine tastings or fashion shows, while others provided perks such as reward cards, special discounts and free or expedited shipping. Retailers should not overlook a thorough analysis of their loyalty programs to track returns on investment.

Improving processes lowers costs and boosts customer satisfaction. There is vast potential for retailers to improve business processes, cut costs and increase efficiency in both customer-facing and back-end processes. Lean thinking is one approach that is becoming increasingly common. Other opportunities to improve bottom-line performance include standardizing work flows, improving inventory management and maximizing store-by-store profitability.

Also included in this white paper is a primer on retail fraud and how to prevent it (see "Understanding and avoiding retail fraud" on page 5) as well as specific recommendations for enhancing your strategy and boosting your bottom line (see "Tips for examining and addressing your strategy" on page 11).

Ultimately, those companies that take the time to re-examine their strategies and are willing to optimize their operations will be positioned not only to ride out this difficult economy but also to position themselves effectively for future growth and profitability. We hope this white paper is useful as you do so.

As always, we at Grant Thornton are committed to helping you make the strategic and operational decisions that will strengthen your organization for years to come.



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Introduction

The holidays are long since over, but for many retailers they were over before they ever began. Few retailers fared well at the end of 2008, with economic news from the sector as bleak as or bleaker than anticipated. Holiday sales fell 2.2 percent, the biggest decline in decades. Overall December sales dropped 1.7 percent and November sales dropped 2.7 percent, according to the International Council of Shopping Centers.[i] Many retailers reported double-digit percentage sales declines.

Falling sales hit all regions of the country and nearly all sectors of retail, from low to high-end, challenging most retailers and pushing many to the brink of failure. A number are contemplating or have declared bankruptcies and announced significant reductions. Those shutting operations entirely include Linens n' Things, Steve & Barry's, Mervyns[ii] and Circuit City, while many other chains are closing large percentages of their stores. Retailers including Ann Taylor, Office Depot, Starbucks and Home Depot are closing substantial numbers of stores.[iii] In fact, retailers are expected to close 73,000 stores in the first half of 2009.[iv]

Unfortunately, the harsh light of a downturn often illuminates and exacerbates existing internal problems, such as less than optimal strategy or execution. In contrast, during times of easy credit, free-spending consumers can help even some marginal operations profit. Challenging economic times test the mettle of retailers, but they also present real opportunities for companies with foresight and discipline. Retailers that position themselves effectively will not only survive now, but also will thrive when the economy rebounds.

Where's retail going?

Although the past year highlights the high-risk nature of the industry, it also offers a chance for companies to fine-tune their businesses in order to take advantage of new opportunities. Grant Thornton has identified five such trends transforming the retail industry and offers tips for capitalizing on these areas of increased profitability.

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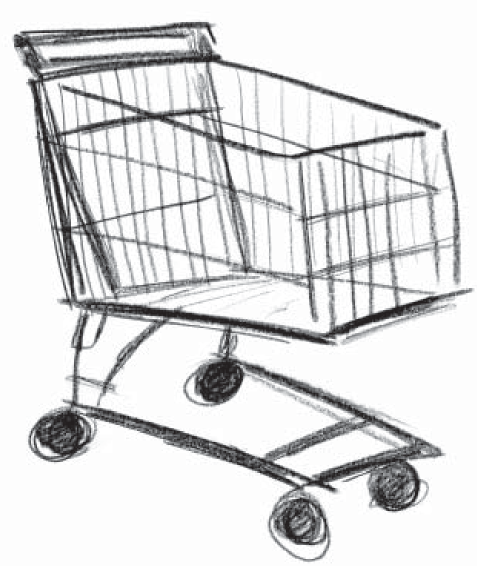

E-centricity: Buyers choose clicks over bricks

Buyers may not be buying much, but online sales have suffered less and, in certain categories, grown more than in-store sales. Online retailers consistently outperformed brick-and-mortar stores in 2008 holiday sales.

Among the few winners in the 2008 holiday season were Zappos.com and Amazon.com, showing the growing power of online retailing. Zappos.com's November and December 2008 sales rose 127 percent over the previous year.[v] Online sellers generally outperformed brick-and-mortar stores, according to a study by comScore, which compared e-commerce data to overall (online and offline) consumer spending data published by MasterCard Advisors' SpendingPulse for 2008 and 2007 holiday seasons. Online sales outperformed overall spending in several product categories in 2008:

- Sales of apparel and accessories each increased four percent online. Apparel declined 19 percent overall, while accessories declined 21 percent.
- Consumer electronics declined just five percent online.
- Jewelry and watches declined 24 percent online, while luxury goods (including jewelry and watches) declined 34 percent overall.[vi]

Online shopping via the Web will continue to grow over the next decade. One need only observe how airline ticketing has evolved online — and its corresponding effect on travel agents — to envision how dramatic the transformation is likely to be. Brick and mortar isn't going away, but these results suggest that traditional retailers need to extend their brands into the digital arena. At the same time, retailers must be cognizant of the ramifications of a greater online presence, such as its impact on physical store sales and locations, real estate, logistics and costs.

Retailers must consider what will work for *their* stores and products. Successful retailers will demand a rigorous analysis of sales trends, customer demographics, product line, profitability and store profitability. Do the retailers' target customers shop online in general? Do they purchase online? Is the operation losing sales to online competitors? Does the retailer offer something tangible or intangible in stores that cannot be replicated online? Will increased online sales improve overall sales or merely cannibalize its brick-and-mortar stores? Lastly, will the right online infrastructure investments capture customer attention and sales and provide an adequate return on investment?

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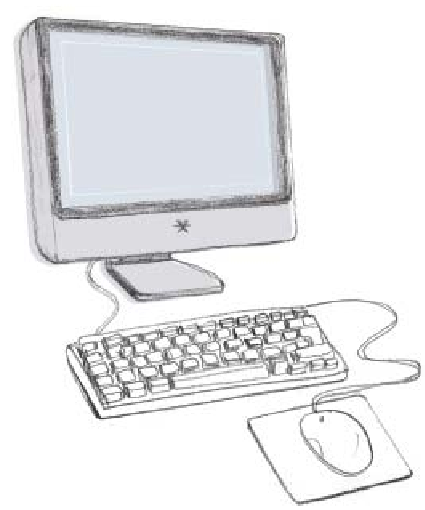

Understanding and avoiding retail fraud

By William Olsen, Principal, Economic Advisory Services

Theft is a perennial risk for nearly all retailers. Depending upon the strength of their internal controls, retailers can be particularly vulnerable to internal losses at the point of sale. Most retailers do a good job controlling their inventories and handling their bulk cash. However, it is the small transactions at the counter where the biggest losses can occur. With numerous ways for an employee to commit a theft at the point of sale, many of these thefts will go undetected without the proper audit procedures in place. Below are nine of the most common examples of retail fraud:

1. **Under-ringing and upcharging.** This is when the cashier does not ring up the entire sale or charges the customer more than the actual cost of the item. This is the simplest way for employees to steal, and is hard for managers to detect. A cashier's digital display, showing the customer what the cost of the transaction should be, is the best deterrent to this kind of theft.

2. **Cash drawer interlock.** The cashier's drawer should not be able to open unless a sale is rung up. Otherwise, transactions can be made and the sales not recorded. If this feature is not available on a register system, the cashier can simply make change for the transaction from the open drawer and the money from the sale is theirs. High inventory costs and lower transactions counts could indicate unrecorded sales.

> It is the small transactions at the counter where the biggest losses can occur.

3. **Sales cancellations.** Most register systems are equipped with a feature to allow a part of a sales transaction to be removed from the system prior to the sales amount being recorded. This feature allows the customer to change or to cancel part of their purchase without voiding other items already entered into the system. This feature can also be used to steal. A cashier can reduce a sale on the register system and still satisfy the customer by providing the correct change and the items purchased. The problem is the cashier can retain the amount reduced for his or her own profit. A large number of sales cancellations and a low number of average-sales-per-cashier may be indications of theft of sales.

4. **Refunds.** Cash theft can be covered up by fictitious refund slips. All cash refunds should be supported by the managers and cashiers signatures and refund activity should be monitored closely.

5. **Coupon reductions/discounts.** Many point-of-sale systems have a discount key for coupon redemptions, special sales and promotions. This can be a license to steal if not monitored properly. A high amount of unsupported discount activity coupled with lower average sales could indicate a misuse of this function.

6. **Tax readings.** A manager with programming capabilities can adjust the tax readings on the register system a fraction of a percent. In a high-volume setting, customers may be overcharged hundreds of dollars a day.

7. **Price adjustments.** The listed price of an item does not have to be the same price programmed into the register system. A manager with programming capabilities can adjust the price of items in most systems. An adjustment of a few cents per item in a large volume-environment could mean the theft of thousands of dollars a month.

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Understanding and avoiding retail fraud (continued)

8. **Training mode.** Many register systems offer a training feature, which allows managers to train cashiers on a register without the activity being recorded as actual sales. A register with this feature allows the manager the opportunity to put a register in training mode while being used for actual sales transactions. The misuse of this feature for theft could be financially devastating to a company as hundreds of transactions could occur daily and not be recorded into the system.

9. **Register removals.** Many register systems can be moved offline and continue to operate. This allows managers to ring up sales that are not recorded as part of storewide sales. Register removals and sales readings should be monitored very closely.

Theft tracks

The following situations may be indicators of fraudulent activity in the retail environment. Any one of these indicators should initiate further investigation by management.

- Decreasing sales with increasing inventory costs
- Lower average sale per cashier
- Lower transaction counts per cashier
- Rising cost of operations without an increase in sales volume
- Decreasing sales while payroll is increasing
- Lack of proper signature authorization on refunds and returned goods

How to prevent retail fraud

Obviously, there are several ways to steal money at the point of sale. The major concern is that many of these methods of theft are not detectable by normal audit procedures. Employers in the retail business must be sure that the register activity at their retail locations is audited on a regular basis. More importantly, the auditors must be trained to look for the theft tracks that could indicate fraudulent activity.

Many retailers have started utilizing exception audit techniques, where excepted ranges of activity on the register system are preprogrammed and a report is generated that will red flag any activity that exceeds the predetermined ranges (i.e., excessive promotions, sales cancellations, refunds, etc.)

It is equally important that retailers establish register and cash handling procedures for all of their cashiers. This includes ensuring all cashier and managers are properly trained and understand the retailer's policies and procedures. •

Private-label strategy: Private labels gain ground against name brands

Private-label brands are growing in popularity in today's economy, particularly among price-conscious consumers. The shift to private-label brands, like any product-driven strategy, requires an understanding of the potential for the retailer, as well as the risks. Two of the factors influencing private-label acceptance among buyers are product price and complexity:

- **Price consciousness:** Price-conscious consumers traditionally prefer private-label brands. Current economic conditions are likely driving private-label sales up, but when the recession ends, will customers stay with a private label or move back to name brands?
- **Product complexity:** Much of the interest in private label has come from the grocery sector, which tends to offer more commoditized products than the retail industry. Retailers need to consider whether less-commoditized products, typically combining complexity and brand equity as key value attributes, are suitable for private label treatment.

Data from the Nielsen Company shows rapid growth for private label — nine percent of consumer packaged goods products, but suggests that this growth is driven by rising commodity and food prices, not by consumers abandoning national brands. Nielsen's director of industry insights, Tom Pirovano comments, "Higher prices in commodity categories like eggs, milk and cheese are driving private-label dollars, not consumers deserting traditional brands."[vii] In addition, retailers must recognize the carrying and other costs associated with private label business when committing to this strategy.

Sustainability: Going green brings in the green

Consumers are increasingly focused on the environmental impacts of their consumption. Reduce, reuse, recycle – the three Rs of the green/sustainability movement – continue to influence customer behavior. Environmentally sensitive goods and practices win a growing share of customer dollars.

Although it is difficult to separate the effects of environmental consciousness from the general economic slowdown, consumers' focus on reusing and recycling cannot be ignored. Purchasing environmentally sensitive goods is, for many consumers, no longer an afterthought but a way of life. Retailers need to both be green and sell green products if they plan to cash in on this trend.

Not surprisingly, sustainability is a growing area of investment among Fortune 500 companies. Eight in 10 of the 65 Fortune 500 corporate sustainability executives plan to maintain or increase their budgets in 2009 despite the economic downturn.[viii] Retailers are demonstrating their commitment to the sustainability movement in a number of ways:

- In 2007, Home Depot committed to invest $100 million over the next decade to build more than 100,000 affordable green homes and plant three million trees through its Home Depot Foundation.[ix]
- J.C. Penney is building a Fairview, Texas store that will use 41 percent less energy and 20 percent less water than similar-sized stores.[x]
- Whole Foods Market became the first Fortune 500 company to buy wind-generated power to cover all purchased electricity used throughout its U.S. operations.[xi]

Customer loyalty: Growing investment in key customers

Even when sales are stagnant or declining, there is growing recognition that enhancing affinity among retailers' best customers can produce long-term benefits, particularly since 20 percent of customers typically account for 80 percent of sales. Many retailers are investing their marketing, promotion, and discount dollars with their most loyal customers, putting as much emphasis on affinity as on generating traffic. In fact, many retailers may have fared better during the holiday season than they realize if they consider their ability to leave positive impressions with key customers as a performance indicator.

Many brick-and-mortar retailers are sending cards and e-mails inviting loyal customers in for special shopping experiences such as wine tastings or fashion shows. Online retailers continue to foster loyalty for returning customers by offering discounts or upgrades to faster shipping methods. Last year, Starbucks offered reward-program members extras such as free coffee refills and two free hours of in-store wireless internet access, while Old Navy offered each reward-program member $10 off a purchase of $50 when he or she makes a purchase during his or her birthday month.[xii]

Customer loyalty programs need to be thoroughly analyzed, using statistical and other analytical techniques to calculate true returns. These same tools should be applied to gift-card usage, often a component of loyalty programs. This is especially critical after a down holiday season: Were consumers wary of buying gift cards amid major store closings and liquidations? Were redemption rates higher than past years as cash-strapped consumers made sure to use the cards they received? In addition, proper gift card accounting to ensure adherence to US GAAP and tax regulations is critical for retailers.

Cost and productivity management: Improving processes lowers costs and enhances customer satisfaction

There is vast potential for retailers to improve their business processes, cut costs and increase efficiency in both customer-facing and back-end processes. Anyone who has waited in a long checkout line while clerks simultaneously answer phones, perform price checks and ring up orders will agree that process improvement is desperately needed in retail. While customer-facing processes offer obvious examples, a myriad of back-end processes can also improve productivity with more efficient approaches.

Lean thinking is one approach that is becoming increasingly common. This involves an intense focus on perfectly satisfying customer demand, while improving productivity and lowering costs by eliminating various forms of waste, e.g., too much inventory, unused time and resources, damaged products, long waits for shipments, etc. A growing number of retailers, such as U.K. grocery and merchandise chain Tesco and Spanish fashion chain Zara, are adopting lean concepts.

There are many other opportunities to improve bottom-line performance:

Improve staff efficiency via standardized work: Standardized work reduces unnecessary steps and errors among the workforce and ensures common best practices by establishing a benchmark for performance. Standardized work and job instruction sheets establish order and repeatability for mundane tasks, so that staff are free to be more creative in customer care and store improvements.

Strengthen inventory management: Improving inventory management can provide three benefits simultaneously: minimizing stock-outs, increasing profitability and improving cash flow. Making inventories leaner can improve cash flow from in-store stocks through distribution centers, and all the way back through the supply chain to suppliers.

Excessive amounts of inventory don't ensure that retailers carry what customers want. Instead, oversupply often hinders retailers' abilities to see and analyze what's available and how it's moving.

To get started, retailers must gain a deeper understanding of which products are truly profitable, how their inventories move, how they vary in popularity by SKU, and how supplier capabilities and customer demands affect their inventory volumes. This analysis enables retailers to establish minimum and maximum inventory levels, replenishment points, appropriate safety-stock buffers, and delivery schedules. Although right-sizing inventory can be challenging, especially in stores with high numbers of SKUs, it can put retailers in sync with customer demand, while reducing costs associated with deep discounts on unsalable merchandise.

Manage bricks-and-mortar: In order to maximize the value of their brands, retailers must understand store-by-store profitability and decide which stores should be supported or closed. Also, retailers will want to use the current market conditions to negotiate better lease terms with landlords.

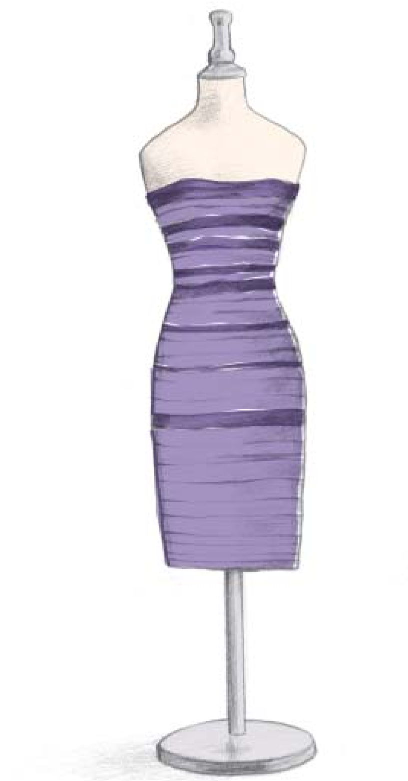
Create a culture and strategy focused on improvement: This is an area where many retailers fall short. An effective culture begins by committed leadership identifying and communicating key corporate objectives, and then translating those objectives into division, store, department and employee goals. For example, if a retailer's primary objective is improved profitability, how is that translated into concrete goals for a warehouse worker, store clerk or janitor? This cascading of strategy and objectives occurs alongside management processes to check performance against these goals, adjusting and improving as they go.

One other important inventory issue may arise for tax purposes in future years. Specifically, it is possible that over the next few years retailers may be unable to use LIFO for federal income tax purposes as a result of either a Congressional repeal of LIFO or as a result of "LIFO conformity" violation caused by the adoption of IFRS by certain taxpayers.

Act now to maximize opportunities

The time is now for retailers to re-examine their strategies and position their companies effectively both to ride out the economic downturn and maximize profitability when the economy rebounds. A number of highly successful retailers, such as Zappos.com and Amazon, have identified and exploited these timely opportunities. So too can other retailers that are savvy and forward-looking.

Certainly, managing the challenges and opportunities facing retailers can seem overwhelming in a downturn, especially considering the many other issues retailers face each day. But after every recession, the winners that emerge during the recovery are those companies that invest the time, effort and resources to position themselves effectively for the future. With many competitors already moving forward, smart retailers cannot afford to wait. •



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Tips for examining and addressing your strategy

Hone product strategy.

Review your product lineup strategies and consider the following questions:

- Will you place entire product lines online for review and/or purchase? How will you differentiate the online market and its demands from your brick-and-mortar stores?
- Are green products in your lineup? Are you emphasizing them appropriately?
- Do you make decisions about what products to offer based on thorough analysis?
- Are your decisions based on overall trends, or targeted at your most loyal, high-volume customers?
- How do you integrate these product lineup decisions into an improved inventory management strategy?

Don't overlook translating what you learn about your online customers' product choices into physical store sales. For example, if your online customers in a certain region are buying certain styles, books or other merchandise, this should influence the promotion strategies of stores in those areas. This strategy is especially effective when certain items such as books can be sold in advance on the Web. Adopting such an approach will also lead to better management of inventories.

Enhance customer loyalty.

- Are you analyzing sales by customer segment and building correlated affinity packages?
- Which incentives are likely to attract your best customers?
- Which rewards are perceived to have the highest value?
- Which in-store and online perks increase affinity and sales?

Remember that affinity isn't limited to products, discounts, reward points and free shipping; customers also value information, such as how to use merchandise more productively or fashionably, as well as how to get the most wear or fun from their purchases. Customers also value intangibles such as trust – supported, for example, with guarantees or generous return policies, which can create an emotional attachment to your brand.

Optimize your store network.

The advent of online retailing has put tremendous pressure on optimizing the placement of brick-and-mortar locations.

- Where does a physical presence boost sales and/or enhance the retail brand?
- Where will online access suffice?

Use sophisticated sales analysis to plot brick-and-mortar customer demographics, including buying habits, age, location and typical driving distances. Then, align your store network, i.e. the number and locations of stores or franchising efforts, accordingly. Factor online efforts into this analysis to help determine where a traditional store may be unnecessary. For example, areas where consumers frequently buy online or can drive to another location may not need a traditional store. This analysis also can indicate new geographic markets that could support both online sales and a traditional store.

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With proper tax planning, opportunities may exist for retailers to deduct some of the costs incurred while updating physical store locations.

Tips for examining and addressing your strategy (continued)

Manage your finances.

During a downturn and recovery, effective financial management is more critical than ever. Your focus should include:

- **Product pricing strategies** — Have you calculated ROI for all current product pricing and inventory levels and assessed potential scenarios for changing channels of distribution (online vs. physical), incorporating loss leaders, bundling, discounting, etc.?
- **Capital investment evaluation and funding** — What are the systems and physical investments (point-of-sale systems, redesign, signage) most likely to impact your store, and how can capital for those investments be best funded?
- **Reevaluation of real estate** — Do you benchmark your square footage vs. similar locations, and leverage that information for lease reductions, value-added improvements, etc.?
- **Tax strategies** — Have you considered the tax ramifications of your buy vs. lease decisions, inventory levels, goods country of origin and gift-card revenues?
- **Managing costs** — Many retailers are surprised at the savings opportunities that exist in indirect cost categories. But when you consider the amount of money spent on bags, labels, signage, fixtures, store supplies, and other indirect goods and services, substantial savings can add up quickly. The key to achieving such savings is a structured, disciplined sourcing approach, ongoing measurement of suppliers, and compliance with contracts once they are established.

Improve your processes.

Process improvement strategies touch all facets of an organization, including financial management and decision-making.

- Can new stores be designed with improved process flows and standardized work in mind (as well as a green focus)?
- Are procurement decisions based on best price at high volumes without consideration of inventory levels and carrying costs?
- Are suppliers willing and able to accommodate the process improvements?
- Are your operations lean and focused on waste reduction (e.g., time, labor, movement, materials, energy/fuels) through all processes (in the store, distribution centers, procurement, accounting, shipping, etc.)? •