Retail and consumer products: Entering a new era of growth

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Entering a new era of growth

Slower-than-historic post-recessionary growth and the persistent high levels of unemployment are key issues facing businesses today. More importantly, employment growth and rising income represent opportunities to drive market share and higher sales.

Winners among retailers and vendors will be those that understand their consumers – what they want, when they want it and at what price they are willing to pay.

The consumer is responding differently than in past cycles, placing more emphasis on value – from the purchase of more private brands when it comes to basic/commodity merchandise, to cross-shopping among distribution channels. Typical of most cycles, discretionary spending is beginning to gain momentum, outpacing overall retail sales. Consumers, aided by the Internet, are smarter and more demanding shoppers. Winners among retailers and vendors will be those that understand their consumers – what they want, when they want it and at what price they are willing to pay. Those that build and act on that understanding will be the companies that prosper in the new era of growth that is now developing.

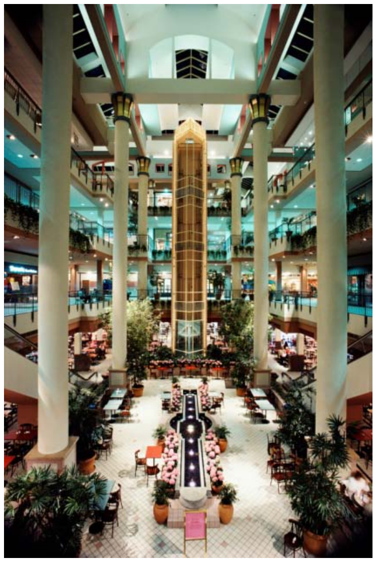
This is an opportune time for companies that have:

- A unique niche or value proposition
- Realistic growth plans (for the next two to three years)
- A strong balance sheet and projected cash flow

Those companies have the capability to capture market share. They can't wait for the environment to improve further; they need to make it happen.

To take advantage of the current environment, companies need to create excitement and the want to buy, rather than the need to buy. Don't offer the same thing as last season; be different.

Loyal and satisfied customers should translate to higher gross profits per square foot and improved profitability for both retailers and vendors.



Adjusting to the new environment

It should not be business as usual. Retailers and manufacturers must think about their business differently; looking at what you did yesterday and trying to do it better is just not enough. Your customer of yesterday is different today and will be different still tomorrow.

New, differentiated and unique merchandise, targeted to the right consumer, is a must. While value will likely remain a key ingredient to purchase (since the closet is still full), retailers need to create the want and desire with excitement – driving incremental sales with targeted, sharper merchandise presentation.

Staying ahead of the curve is the recipe for success. New and fresh merchandise creates excitement, while driving traffic and conversion.

Fittingly, your business plan should evolve, rather than be etched in stone. New issues arise daily and should be addressed on a timely basis. A shorter cycle, from concept to consumer, coupled with maintained lean inventory, will enable quick reaction to both competitive and fashion changes.

Staying ahead of the curve is the recipe for success. New and fresh merchandise creates excitement, while driving traffic and conversion. The goal should be quality of sales and cash flow generation – both of which can then be reinvested in areas consistent with longer-term corporate strategy. Profitability will reflect excellence in execution.

It's all about the consumer

What drives a customer to your products? Why do they buy? And can you make your targeted profit?

In today's environment, it is increasingly important to identify your 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 anyplace 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; be ready to react to any deviation from the plan. There is no crystal ball; reassessment and redirection should be done on a regular basis to maintain share growth and widen the spread from your closest competitors.

Developing a plan for the new era

Management focus has primarily centered on cost containment over the past two years – reducing discretionary spending, slowing expansion, curtailing payrolls and tightening inventory controls. Now management should address a plan for profitable market share growth through the appropriate and strategic allocation of cash flow. Credit markets have eased somewhat, relieving the pressure to fund ongoing operations and presenting management with the opportunity to again pursue innovation, the historic driver of sales. This is the time to go on the offensive rather than the defensive, as there will be less investment in store openings, entry into new markets and implementation of new growth concepts.

Consumer spending patterns have changed steadily for decades and will likely continue to evolve. Following years of an expanding affluent market and increased aspiration among consumers, the pendulum is now moving in the other direction – in fact, it never stops. The consumer is still buying, but more cautiously and with more focus on value, shifting to less expensive products, buying less clothing and eating

out less often. These are likely to be longer-lasting trends, as lower- and middle-income groups fall further behind in bills and debt repayment in the near term.

More affluent shoppers have historically been the first to rebound; however, higher taxes are likely to put a damper on even their spending. They are buying fewer goods as opposed to significantly “trading down” when it comes to the quality or brand status of purchases. All this is coupled with increased focus on lower price points within existing brands.

During recessionary periods, consumers will typically shop more at value retailers, returning to preferred stores as the environment improves. However, recent studies have shown that some customers will be lost for good – buying less expensive versions of national or high-end brand products, replacing them with store brands, shopping routinely at discount and value-format stores and/or trading down to less expensive brands. In most cases, though, quality remains a high priority, which retailers can largely maintain in a variety of ways for this “new” consumer. Some retailers are also broadening price points with an increased offering at the lower end to maintain consumer appeal.

Retailers and vendors must develop a new game plan to grow and prosper in this different environment; those that don’t will be left further behind.

Balance of power shifts more to the retailer

For most vendors, the operating environment has become more difficult as consolidation leads to retailers gaining more leverage. Enhanced buying power and demands for increased margin support are cutting further into wholesaler margins as wholesalers find it more difficult to further lower their costs. Increasing penetration of private and/or exclusive brands is also enabling retailers to buy direct – and in many cases, bypass their historic vendor structure.

Vendors with strong brand recognition have the opportunity to better control distribution and pricing. Brand credibility provides opportunities to extend product categories internally or through a licensing format. In essence, they are better able to control their fortunes if they stay ahead of the curve. Most of the other vendors are essentially middlemen, supplying private label brands, a business that is in a steady spiral of margin erosion as more customers source direct or find lower supply costs. Many are doomed to failure as it is very costly to develop a brand from scratch, although the licensing model may represent some opportunity. Volume growth and economies of scale should be able to offset related costs.

Adapting to a higher-cost environment

Increased imports of lower-priced goods exerted downward pressure on apparel prices beginning in the early-1990s, reducing sourcing costs for most vendors and retailers as well as creating an increased value proposition for the consumer. The resultant margin improvement was enhanced by lower inventories and a faster turnover rate. It would appear that most of those benefits are gradually diminishing, setting the stage for a different scenario in 2011.

Despite a still weak economy, inflationary pressures are building. Aside from currency, cotton prices are higher, there is labor unrest in China, wages have increased, comparisons are being made to lower year-ago shipping costs and soft goods production capacity in some geographic regions has been reduced. Forward orders and contracts have been able to contain some of these higher costs for many, but it will become more difficult in the future. Increased overhead is now a reality through the manufacturing and logistics pipelines; these need to be reflected in selling prices.

The ability to source in lower-cost regions is dependent on availability of qualified labor, raw materials, manufacturing capacity and logistics support. Too often, the lengthened cycle time offsets the potential benefits of lower costs. This, however, is gradually changing.

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It remains a buyer's market. Most vendors reduced costs substantially over the past two years and pushed harder on their suppliers, but that is becoming more difficult, and it will be impossible to maintain profitability as the trend continues. Some would argue it is difficult to raise prices in the current environment, although many companies will soon reach the point of having to lose money on incremental sales if they cannot raise prices.

Out-the-door apparel and accessory prices have been steadily moving higher as retailers eased back on promotional intensity – offering fewer promotions and reduced discounts. Interestingly, consumers have taken those changes in stride as long as there is perceived value. The price/value relationship differs among income groups and types of retailers and generally involves a function of uniqueness, limited distribution and differentiation (color or styling).

There could still be some offsets

Expense reduction and cost savings programs have already been implemented at most companies, but many of those programs need to be escalated. Initiatives should include sourcing, productivity and inventory management. In some instances, streamlining and altering the buying decision-making process should also be considered. This focus has to be ongoing and similar to the painting of the Golden Gate Bridge – once you arrive at the end of the process, it is time to begin the process anew.

Retailers should engage in an ongoing, extensive sourcing analysis, examining the costs of direct sourcing versus agent sourcing, as well as consolidating suppliers. Further economies can be achieved through collaboration and more efficient planning to maintain or improve quality. Logistics and distribution also have to be factored into the equation. The lowest manufactured cost in a remote region might not be the lowest landed cost due to factors such as longer lead times and/or greater shipping distance. Further savings could probably be achieved through exploring direct shipping to a store or a regional distribution center to minimize handling and time in transit.

Thinking about it in another way, the manufacturing cost might equal 20 to 25 percent of the selling price point at retail. If, up to this point, the greatest focus has been on production efficiencies and sourcing, management must ask whether the same effort has been placed on logistics, distribution and other economies.

Accountability could also produce incremental savings with respect to brand management and customer responsibility. A detailed cost analysis of each product can determine whether the product needs to be redesigned or eliminated. Intense scrutiny by retail customer and store distribution should provide insight into improved sell-through and profitability. Markdowns and promotions generally degrade the brand, instead of building a solid foundation upon which to grow business profitability. It would be idealistic to say, “Ship to only A and B stores,” as the retailer generally needs to assort its less profitable C and D stores.

Unfortunately, distribution to less productive stores is a large source of markdowns. Retailers and vendors need to routinely monitor poorly performing locations. Rent reductions might be an option today, but in reality, such actions are only a Band-Aid if traffic and customer base deteriorate. Store renovation might be an option to enhance attractiveness, but such a decision must be justified by a targeted return on investment.

SKU rationalization as a means to profitability

Avoid the trap of broadened assortments accumulated over the years, which has led to the need for a larger store. This common but major miscalculation led to lower sales productivity and profitability. That downward spiral has taken time to reverse, but we are beginning to see its effects today. In some cases, SKU rationalization went too far, resulting in loss of sales, as Wal-Mart recently experienced. It has since reversed that strategy.

Wherever possible, minimize clutter in presentation. Inventory reduction and allocation have been a prime focus over the past 12 months. The consumer will remain value-focused and promotional activity will continue. However, merchandise presentation and differentiation should be a catalyst to drive higher conversion, transactions and sales.

Reducing inventory assortments could provide a more customer-friendly shopping environment, making it easier to tell a merchandising story and create excitement. A too varied and wide selection can blur the message; by simplifying the selection process with fewer distractions, more full-price selling can result. Eliminating the marginal units and redundancy in the assortment should lead to a higher gross margin.

Multiple benefits can be realized for both retailers and vendors. Narrower assortments could lead to lower labor costs and fewer out-of-stocks for retailers and perhaps provide a little more buying power. Out-of-stocks can create a disappointed and perhaps lost customer. Vendors can benefit from sourcing efficiencies from fewer suppliers and lower markdowns/allowances, consistent with an improvement to retailer profitability.

A better-managed pipeline can also improve profitability. By concentrating on fewer SKUs, the global supply chain should benefit from economies of scale. These would include the already-mentioned question of logistics, from manufacturing point to customer. Ensuring products hit the stores on a more timely basis can provide fashion excitement ahead of competitors.

Differentiation is an important key to success

For many years, high cash flow provided for rapid retail expansion and diversification into new formats, driving further store growth. Today, store rationalization is fully underway. There is still excess space and, more importantly, there is too much "sameness." Consumers can walk into any mall in the country and find it difficult to ascertain where they are shopping. The only clues are the exception – some regional differences in design, or perhaps a regional department store chain. Furthermore, each end of the mall is nearly identical; the sole point of differentiation is which storefront is the first to markdown its wares.

The answer to why mall and store traffic has been on the decline for most is simple – aside from economic slowdown, there is little incentive for consumers to visit if they will not see anything new.

This homogenous look could intensify with the prospect of further consolidation. If anything, management must focus on redirecting cash flow towards greater differentiation. A top priority would be intense research into its target consumer, something very few brands or retailers do on a consistent basis. The answer to why mall and store traffic has been on the decline for most is simple – aside from economic slowdown, there is little incentive for consumers to visit if they will not see anything new.

Newness, differentiation and merchandise excitement will drive consumers into stores on a regular basis. This had provided brands such as Abercrombie, Coach, Nike and Ralph Lauren with the pricing power necessary to offset higher operating costs.

Many apparel and footwear brands have operated retail stores for many years. At first, factory outlet stores helped liquidate excess merchandise (and in many cases,

evolved into a format carrying merchandise dedicated to that channel). More recently, a trend took hold in which full-price stores were opened as part of an effort to reduce dependency on the department store channel. This provides better understanding for retailers/vendors of their customers and their customers' motivation to purchase, which should translate to more, full-price selling over the long term.

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 multi-channel 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/or at the first markdown. The strategy of a steadily increasing initial markup to offset the increasing markdown rate/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 was compounded as the tempo of promotional activity increased steadily in recent years, while at the same time, inventory turnover rose. 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 have 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" – 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.

Markdowns (and the corresponding inventory levels from which they come) will continue to have the most significant impact on margins, regardless of the merchandise issues that have also been a factor. Quantity and quality are critical issues, but the industry must strive to have a better merchandise balance. The allocation process needs to be fine-tuned by market and region. While available technology provides data, that data is not always translated into informed business decisions. Such data must be better analyzed by both retailers and vendors.

Higher selling prices are inevitable

The ability to raise prices must be thought of in two distinct segments, with the high-end and "must-own" brands most likely to maintain pricing power.

While low inventories throughout the supply chain have led to reduced promotions and reduced discounts, few are willing to talk about initiatives to raise prices. Consumers have less perceived spendable income and are more discriminating in their choices, particularly for apparel and related items. The ability to raise prices must be thought of in two distinct segments, with the high-end and "must-own" brands most likely to maintain pricing power. As for the larger part of the market, it will depend on retailers such as J.C. Penney and Wal-Mart. While these retail giants have substantial buying power, there is likely not much room to negotiate further discounts. Therefore, the decision comes between maintaining the price point or margin – the direction will need to move toward the latter.

Unit consumption of apparel outpaced total spending in real terms in prior years (because of deflation), and could now perhaps slow to in-line, or slightly below. In some ways, modest inflation could actually be a boost to overall top-line growth and ultimately be more profitable for the industry (such as if sales grew faster than overall costs). The thought of a return to apparel inflation is worrisome. Looking back prior to the early 1990s, inflation prevailed and retailers prospered. Granted, that was a period of tremendous store expansion, with new units contributing to overall comparable store gains. Today, we see the reverse, with the elimination of less productive stores and redundant capacity.

Easy comparisons, low inventory levels and reduced markdowns will only be temporary contributing factors to profitability during an economic recovery, as will the store rationalization process. Increased focus on driving gross profit per square foot may allow retailers to offset lower or slower growth in comparable store sales and the resultant cost pressures. The industry is past the days of moving the markup higher. Rather, the strategy should evolve towards a higher rate of sell-through and inventory turnover.

Focus on maximizing gross profit per square foot

Quality of sales is more important than quantity. Management needs to begin considering how to move back to a model that includes more full-price selling through lower inventory, a better mix and balance. It is sometimes better to lose a sale than have excess at the end of the season. Vendors must be part of that thought process.

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.

As noted previously, store expansion has slowed and is even contracting. Sales growth will likely result from existing stores, rather than new stores. The merchandise mix must be tailored to a specific customer segment and/or local market. For those looking to move towards a more profitable business model, the days of offering something for everyone are over.

Better utilization of online marketing, wherever applicable, offers great opportunities to leverage a brand. In many cases, multi-channel 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. You can raise store and brand loyalty by increasing the satisfaction of your consumers and offering more value-added services. Knowledgeable and helpful sales associates can generally initiate sales opportunities, drive a higher average ticket and shorten the transaction time. Engage your customer 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.

Driving profitable market share

The specialty store grew and thrived for many years by addressing the needs and desires of its customers, but the strategy to maintain a high rate of store openings eventually led to a dilution of the ability to cater to a target consumer. In many cases, the problem was only compounded by management shifting its focus on brand and format diversification.

Retailers and vendors need to develop a closer working relationship as each looks to develop a more profitable business model. They must be willing to reach out and establish best practices in establishing a new partnership. Over time, entrepreneurial and visionary management have been replaced by executives with a primary focus on growth. Unfortunately, the needs of the consumer were forgotten in this transition.

Strategy has to shift back to the consumer by truly understanding their wants and needs. There has to be more collaboration between retailers and vendors in managing the merchandise assortment. More importantly, the key to higher returns is higher gross profit per square foot. That mission can be driven by three factors:

- Turnover, rather than markdown allowances
- "Fashion-right" merchandise with less, rather than more, inventory
- A better in-stock position, with reduced breadth and a heightened focus

This is an opportune time for companies that have a:

- Unique niche or value proposition
- Detailed plan for the future (the next two to three years)
- Strong balance sheet and projected cash flow

With courage and foresight, these are the same companies that will be able to capture market share, move up the ladder quickly and enjoy the spoils that can result from this current operating environment. Management can't wait for it to happen, they must make it happen.

The bottom line?

Focus on the consumer. Drive market share – create excitement and the want to buy, rather than the need to buy. Don't offer the same things you did last season; be innovative. A loyal and satisfied customer should translate into higher gross profits per square foot and improved profitability for both the retailer and vendor.

And remember, if you are doing the same thing today that you did yesterday, chances are someone has already caught up with you.

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