OLIVER WYMAN

THE OLIVER WYMAN RETAIL JOURNAL

ВЫПУСК 3

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ПРЕДИСЛОВИЕ

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Уважаемые читатели!

Я рад представить вашему вниманию третий выпуск издания Oliver Wyman, посвященного розничной торговле.

Следующие несколько лет обещают быть непростым временем для розничной отрасли. Перспективы роста остаются туманными на многих рынках, в особенности для ключевых игроков, испытывающих все большее давление со стороны новых розничных бизнес-моделей (как в традиционной, так и онлайн-торговле). В этих условиях многие сети из числа крупнейших и наиболее успешных уже столкнулись с трудностями – иногда очень явными и признаваемыми публично. Как следствие, тема поиска успешной стратегии в меняющихся реалиях нашла свое отражение как в нашем регулярном общении с клиентами, так и в отобранных для этого издания статьях.

Правила успешной игры начинаются с признания очень простой, но крайне важной закономерности: все бизнес-модели в рознице проходят ряд различных жизненных этапов – от разработки и запуска до зрелости и стагнации, за которой следует спад в условиях борьбы с новыми конкурентами. Факторы успеха на каждом этапе различны, а переход от стадии роста посредством экспансии к фазе зрелого роста является, на наш взгляд, наиболее сложным испытанием. Статьи, которые представлены в данном издании, раскрывают сущность основных этапов развития розничного бизнеса, а также связанные с ними ключевые факторы успеха и типы угроз для зрелых розничных форматов. Мы также описываем виды стратегии по борьбе с конкурентами-дискаунтерами и по созданию устойчивого онлайн-бизнеса.

Разумеется, при составлении настоящего издания мы не прошли мимо и классических тактических приемов по управлению финансовыми результатами розничного бизнеса. Дополнительные резервные источники денежного потока существуют даже в самых оптимально выстроенных сетях – знание их местоположения дает дополнительное пространство для стратегического маневра, особенно важное в условиях ухудшения общей экономической ситуации.

В нашем издании содержатся статьи, где рассматриваются многие из указанных проблем и пути их успешного решения на примере розничных сетей из различных стран. Мы также рады представить результаты нашего стратегического исследования рынка продовольственной розницы России в сопровождении с нашей интерпретацией текущих рыночных тенденций. Надеемся, что подобранные нами материалы вызовут у вас профессиональный интерес и пригодятся в ежедневной деятельности.

С уважением,

Philip Gudgeon

Филип Гаджен
Глава российского офиса Oliver Wyman

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РОССИЙСКАЯ ПРОДУКТОВАЯ РОЗНИЦА

НА ПОРОГЕ КОРЕННЫХ ИЗМЕНЕНИЙ

На протяжении последнего десятилетия стратегия успешного роста на российском розничном рынке следовала относительно простой логике: выбор подходящего формата и его масштабирование в городах и регионах, где современная торговля недостаточно представлена. Уже сегодня потенциал подобной экспансии видится ограниченным по мере того, как основные игроки вступают в прямую конкуренцию в крупных городах и за их пределами.

Новое исследование Oliver Wyman рассматривает российский рынок продовольственной розницы, претерпевающий структурные изменения, с точки зрения потребительского восприятия. Понимание того, как покупатели видят предложение розничной сети (и выстраивание сетью соответствующей стратегии поведения) становится залогом успеха в условиях растущей зрелости рынка.

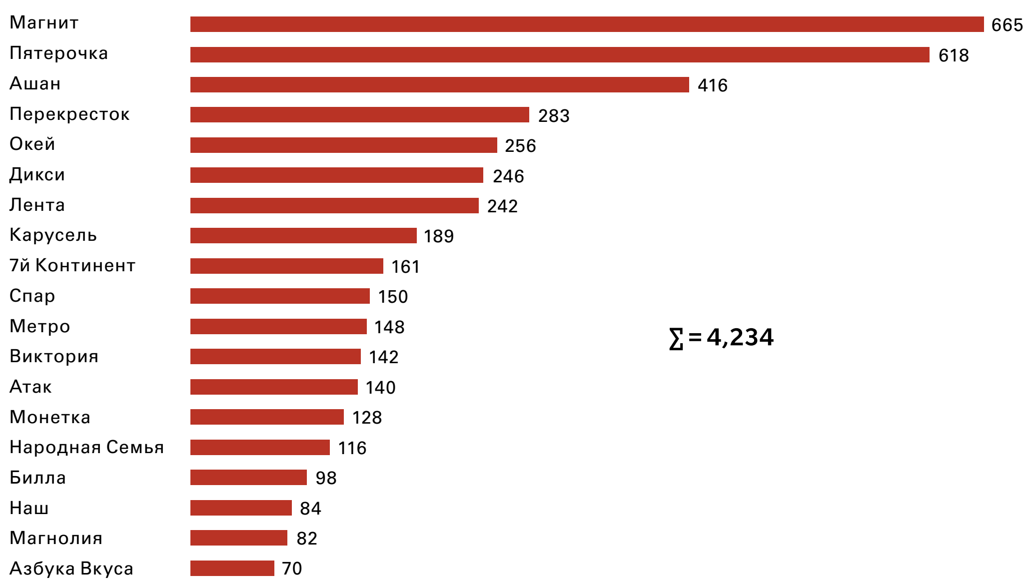
ВВЕДЕНИЕ В КОНЦЕПЦИЮ ВОСПРИЯТИЯ ПОТРЕБИТЕЛЕЙ (CPM)

Восприятие потребителей является надежным индикатором направления развития компаний во многих отраслях. Успешный игрок лучше остальных конкурентов понимает и реагирует на потребности клиентов. Многолетний опыт Oliver Wyman свидетельствует о том, что потребительское восприятие в сфере розничной торговли может быть выражено в разрезе двух основных категорий: «предложения» (Offer – включает в себя восприятие ассортимента, качества и уровня обслуживания) и «ценности» (Value – восприятие цен, промо-акций и программ лояльности). Нанесение общего балла клиентского восприятия для каждой сети в данной системе координат приводит к созданию графика восприятия потребителей (Customer Perception Map – CPM) – простого и в то же время эффективного инструмента для понимания розничного рынка, как в целом, так и на уровне отдельных компаний.

ОПРЕДЕЛЕНИЕ ВОЗМОЖНОСТЕЙ РАЗВИТИЯ ДЛЯ РОССИЙСКОГО РЫНКА

В конце 2014 г. компания Oliver Wyman провела первое исследование потребительского восприятия на российском рынке продовольственной розницы, опросив более 2 000 покупателей 19 крупнейших сетей в пяти различных регионах России (Центральный, Северо-Западный, Южный, Приволжский и Уральский федеральные округа) и двух городах федерального значения (Москва, Санкт-Петербург). Каждый респондент оценивал привлекательность своей основной и второй по важности розничной сети (таким образом, общее количество оценочных мнений превысило 4 000 – см. приложение 1) в разрезе более 40 вопросов, охватывающих ключевые аспекты восприятия – от ассортимента, качества и удобства осуществления покупок до удовлетворенности ценовыми уровнями.

Приложение 1. Разбивка респондентов по розничным сетям (основная и вторая по важности сеть) – все регионы проведения исследования



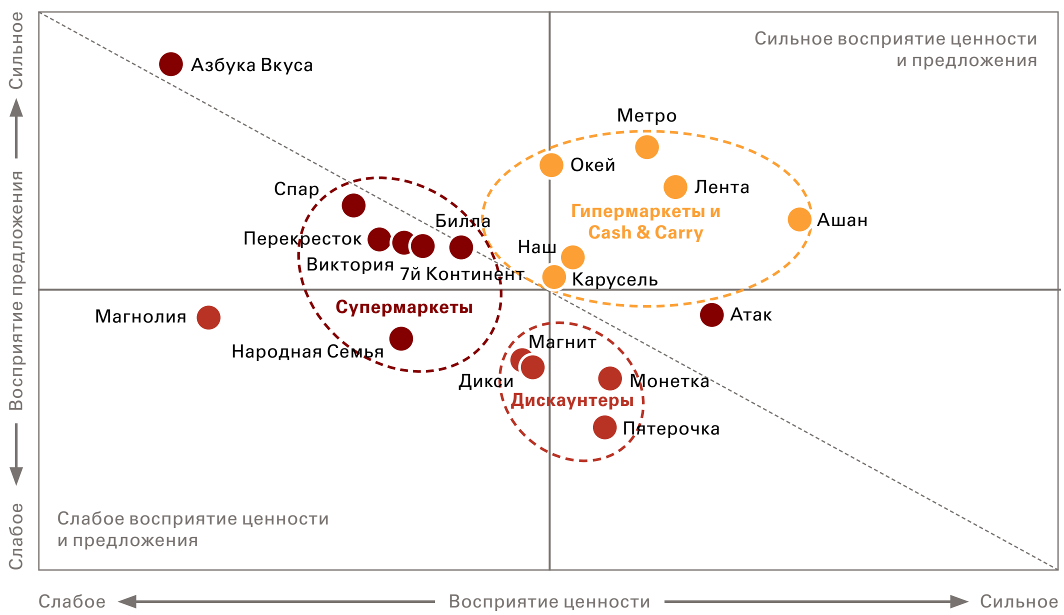
Наиболее статистически важные критерии восприятия, по мнению российских потребителей, перечислены в приложении 2.

Приложение 2. Наиболее статистически значимые критерии восприятия в продовольственной рознице для российских потребителей – все регионы проведения исследования

ВОСПРИЯТИЕ АССОРТИМЕНТА	ВОСПРИЯТИЕ УРОВНЯ ОБСЛУЖИВАНИЯ	ВОСПРИЯТИЕ ЦЕНЫ
1. Категория Fresh	1. Общая атмосфера	1. Товары эконом-класса
2. Товары премиального класса	2. Чистота магазина	2. Бренды
3. Кулинария и охлажд. продукты	3. Наличие товаров	3. Безалкогольные напитки
4. Бренды	4. Вежливость персонала	4. Бакалея
5. Бакалея	5. Скорость обслуживания в зале	5. Товары первой необходимости

Приложение 3. График восприятия потребителей CPM для России

Российский рынок продовольственной розницы, 2014 г.



Приложение 3 представляет итоговую версию графика CPM для всего российского рынка продовольственной розницы. В отличие от более зрелых западных рынков, где, как правило, на графике CPM четко видны различия в восприятии между крупными форматами (гипермаркетами), супермаркетами и «жесткими» дискаунтерами, межформатные различия воспринимаются российскими потребителями значительно менее явно. Это отражает меньшую зрелость местного рынка, который до недавнего времени развивался (и отчасти по-прежнему развивается) в режиме экспансии, при котором большее внимание уделяется открытию новых, а не дифференциации существующих магазинов.

Анализ графика CPM позволяет сделать следующие выводы в отношении российского рынка продовольственной розницы.

1. Российский рынок недостаточно дифференцирован в глазах потребителей. Наличие движущей силы дифференциации по-прежнему неочевидно, причем восприятие различий в категории ценности сильнее, чем в предложении. За исключением крупноформатных игроков, российский потребитель не ощущает существенных отличий между большинством игроков на рынке.
2. Фактор цены однозначно важен для восприятия потребителей, в особенности в условиях ухудшения экономической ситуации. Однако это не единственный фактор, который будет играть важную роль в ближайшие годы – поддержание ценового преимущества, не подкрепленного иными факторами, затруднительно и требует значительных инвестиций при отсутствии подходящей операционной модели.
3. Мы ожидаем, что будущие лидеры рынка заложат основы своего преимущества уже в ближайшее время, предприняв ряд инициатив, которые позволят им успешно пройти через возможные ценовые войны, не только не ухудшив, а даже улучшив восприятие своего предложения (в том числе и в онлайн-сфере).

ДИФФЕРЕНЦИАЦИЯ

С недавнего времени российские розничные сети уделяют немалое внимание дифференциации, в основном с переменным успехом. Это особенно наглядно проявляется в формате супермаркетов и «мягких» дискаунтеров, где большинство потребителей по-прежнему не ощущает существенной разницы между игроками – обескураживающая новость для тех сетей, которые в последнее время придавали дифференциации особое значение.

Анализируя положение сетей на графике CPM, можно сделать вывод, что в настоящее время только «Ашан» находится в наиболее выгодной ситуации благодаря сочетанию высокого восприятия ценности и предложения. На другом конце спектра находится «Азбука Вкуса», которой удалось успешно дифференцировать свое предложение.

Остальные сети, представленные в исследовании, имеют в целом средние баллы восприятия потребителей. По мере продолжения текущих процессов консолидации рынка и его перехода на более зрелый уровень (в особенности в крупных городах), обеспечение большей дифференциации будет выходить на передний план для тех сетей, которые хотят продолжить свое успешное развитие.

ЦЕНЫ ВАЖНЫ, НО НЕ ТОЛЬКО ОНИ

Обеспечение конкурентоспособных цен является неотъемлемым атрибутом розничной сети, который зачастую воспринимается покупателями как должное. Текущий экономический спад и общая рыночная неопределенность в России еще более подчеркивают важность работы с ценообразованием. Согласно исследованию Oliver Wyman, до 60% российских потребителей озабочены ценовой нестабильностью – для сравнения, только 20% выражают обеспокоенность отсутствием товаров на полках. В этой связи розничным сетям необходимо адекватно реагировать на восприятие ценовой неопределенности с помощью процессов управления категориями и работы с поставщиками. Это зачастую подразумевает поиск точечных решений по ценовому позиционированию отдельных товарных наименований и калибровке ценовых уровней с целью предотвращения снижения общей маржинальности и ухудшения потребительского восприятия.

Принятие комплекса верных ценовых решений выходит на передний план еще и потому, что потребители не готовы переплачивать за аналоги товаров, попавших под импортные ограничения в России. Выработка устойчивой стратегии поведения в сложившейся обстановке станет одной из ключевых забот всех российских сетей в ближней и среднесрочной перспективе: в качестве основного направления мы ожидаем активизации работы с локальными и региональными поставщиками и инвестирования в развитие собственной торговой марки.

БОРЬБА ЗА ПОТРЕБИТЕЛЯ

К настоящему времени только нескольким игрокам удалось найти верную нишу и определить своего потребителя. В то же время недавние программы по переформатированию некоторых сетей свидетельствуют о том, что на рынке имеется потенциал и амбиции для дальнейшей дифференциации (в особенности в крупных городах), которые пока что не нашли должного отражения в общем восприятии потребителей.

Вне зависимости от запланированных или внедряемых инициатив по борьбе за потребителя следует признать, что постепенный переход отрасли из режима «экспансии» в режим «оптимизации» требует от большинства игроков развития иных компетенций, чем те, что обеспечивали успех на предыдущих этапах. По нашему опыту, данные компетенции трудно развить оперативно, однако большинству розничных сетей в России необходимо действовать без промедления для того, чтобы соответствовать растущим и изменяющимся ожиданиям покупателей и не отставать от траектории наиболее передовых конкурентов на рынке.

ВЫВОДЫ

Конкурентное давление на российские продовольственные сети возрастает, в особенности в крупных городах. Для того чтобы преуспеть в обостряющейся борьбе, игрокам необходимо укреплять ценовое восприятие, при этом одновременно значительно улучшая предложение в части ассортимента и сервиса. Привлечение потребителей все больше будет определяться обеспечением привлекательных цен, дифференцированного ассортимента и превосходного уровня обслуживания.

Для улучшения данных параметров сетям в первую очередь необходимо точно определить свои слабые и сильные стороны в маркетинговых и операционных компетенциях. Первым шагом может стать проведение профессиональной диагностики бизнеса. Следующим необходимым шагом должна стать разработка мероприятий для развития отстающих ключевых компетенций. Примером подобных инициатив может быть переход на клиентоориентированную аналитику в части принятия решений по ценообразованию, промо-акциям, ассортименту и выкладке, а также внедрение передовых процессов в управлении магазинами. Также все более значимую роль будет играть обеспечение стратегического контроля над цепочкой поставок. Каждая из вышеперечисленных инициатив представляет собой отдельную объемную программу повышения уровня компетенции, которая требует обособленного планирования, исполнения и контроля.

Перед российскими продовольственными сетями открываются большие возможности на новом этапе развития отрасли, поскольку уровень дифференциации на рынке по-прежнему невысок. Для успешной реализации имеющегося потенциала, игрокам необходимо не только определить амбициозные цели, но и обеспечить оперативность в их реализации. Следующие несколько лет определят будущих лидеров отрасли.

EVOLUTION, GROWTH, AND REVOLUTION

Lifestage changes in retail

Why are most of the world's largest retailers struggling with thinning margins and lacklustre growth? The weak global economy and competition from online upstarts are partly to blame, but there's something more fundamental going on: many retailers have reached a stage of their development where rekindling growth now means transforming the business, not just getting better at doing what worked before.

Retailers progress through recognisably different "lifestages," each characterised by a different model of growth. At some point, every growth model runs its course and, when that happens, finding new opportunities requires different capabilities and often different channels and formats. To move from one lifestage to the next, a retailer must reinvent itself – in effect becoming a different type of business. The transformation can be wrenching, but those retailers who understand when and how they need to change have a real head start on their rivals.

RETAIL LIFESTAGES: AN OVERVIEW

Every retailer has its own story to tell. But strip away the details, and the basic narrative often looks the same: a similar story of a progression through different lifestages, perhaps halting along the way. Retailers succeed and fail in fundamentally similar ways, and often at predictable moments.

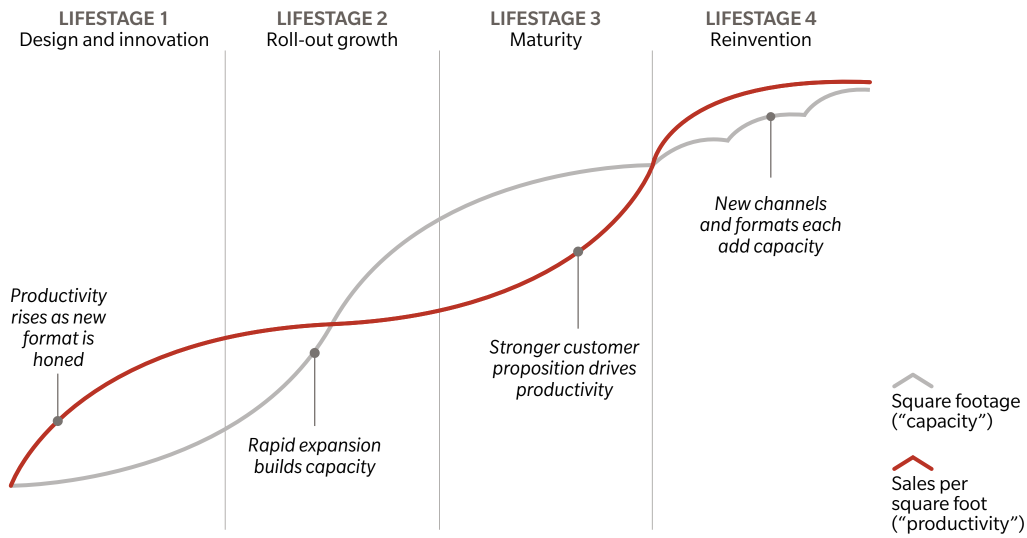
There are four characteristic retail lifestages, as illustrated in Exhibit 1.

The first is **design and innovation**. In the beginning, young firms nurture and cultivate a winning, high-productivity format with strong customer appeal and favourable economics. These formats might be physical stores, online properties, or a combination of the two. The aim is to come up with a retail business that is new, different, and profitable.

Next comes the stage of **roll-out growth**, where the goal is to increase in scale as quickly as possible. For bricks-and-mortar and online players alike, economic value is created through ever greater volume, not from tinkering with the proposition. Efficient, rapid expansion is paramount.

Third in this progression is **maturity**, where the primary challenge – usually a difficult one – is to grow sales based upon the same "footprint." The best retailers make massive improvements in both delivering their core proposition and deriving value from it, reaping large rewards in the process.

Exhibit 1: The evolution of a retailer



Finally, retailers reach the stage where complete **reinvention** is needed. This lifestage shares many of the characteristics of the retailer's early years: new formats are spawned, new channels opened, new services offered, new value capture mechanisms engineered, new acquisitions made, and new alliances forged.

The idea that retailers evolve through different lifestages is straightforward. What's less obvious is that the capabilities and skill sets required for success differ completely from one lifestage to the next. This is why transitions can be such a struggle: a natural response to faltering growth is to do more of or to get better at things you already do well. That's an easy reflex but it's wrong. Instead you need to be investing to build new capabilities. This is a far harder and more uncertain task but, at these turning points, it's the only way to progress to the next lifestage. Understanding what it requires is therefore vital, as we describe in the following pages.

FROM DESIGN TO GROWTH

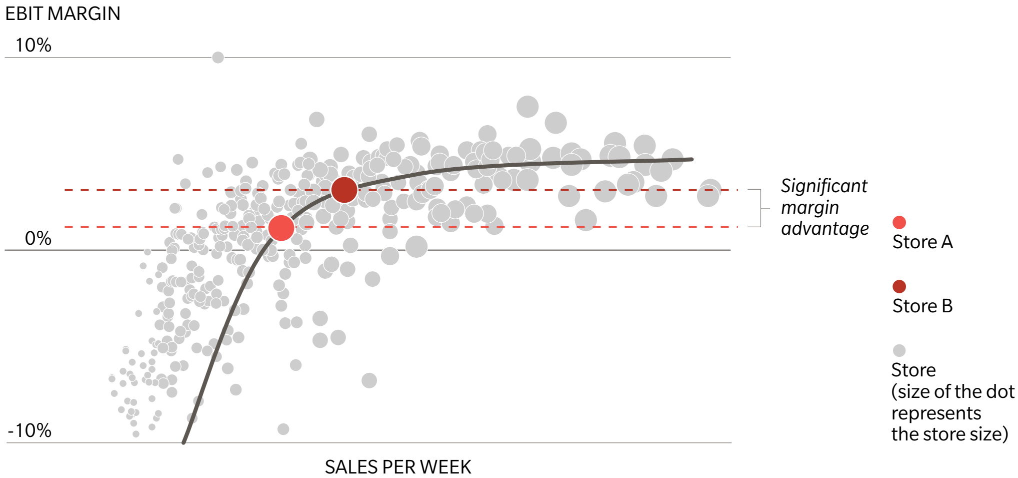
The retail ecosystem constantly tests new formats. In the first lifestage, rapid innovation and ceaseless tinkering are crucial for tilting the odds in your favour. Growth tends to be relatively modest, since the core challenge is to improve the productivity of a small number of stores – coming up with a format formula that has both great customer appeal and attractive economics.

Retailers in the design and innovation lifestage tend to be led by visionary individuals. Risk taking and luck play a role, but the ones who ultimately come up with a strong, replicable format are those who identify unmet customer needs and have the creative talent to profitably serve them.

Contrast this with the profile of a retailer pursuing rapid roll-out growth. The retailers that thrive in this second lifestage do so largely based on superior operational execution and real estate prospecting.

Exhibit 2: A small-scale advantage makes all the difference

Getting leverage over fixed costs gives disproportionate spoils to the winners



Once a retailer has a successful format, it usually starts expanding rapidly, moving from one market to the next. To pull this off, costs must be ruthlessly minimised, and a large estate needs to be run just as efficiently as the first few stores were. Only retailers with an outstanding operations department can accomplish this, so it's little surprise to find lean, command-and-control organisation structures at the centre of growing, second-stage retailers. Management is by rule, not by exception: there's no time to attend to the idiosyncrasies of each and every location.

Superior capabilities in real estate can also be decisive in this lifestage. For every store, the best possible location can confer a sales advantage of at least 10% over a less desirable site, creating substantial intrinsic profit advantage for a business with high fixed costs – as shown in Exhibit 2. Some of this advantage is priced into the real estate cost but some isn't. Knowing how to find undervalued locations or achieving lower build costs can confer a profitability edge of at least half a percent, and add up to an overwhelming advantage over time.

What does this mean? Retailers moving from the first lifestage into the second often have the uncomfortable realisation that the very skills that used to be so vital – creativity and risk taking – are turning into liabilities or obstacles to growth. This is inevitably a culture shock, leaving many feeling that the very entrepreneurialism that led to success is being smothered and replaced by a "cookie cutter" approach.

Clearly, many retailers have managed this transformation successfully, and some have moved onto extremely steep growth trajectories in the process. The best-known historic example is probably Walmart, but there are others. For example, in Germany both the discounters and MediaMarkt grew smoothly and rapidly, becoming massive businesses in the space of a decade. In contrast, countless promising retailers have lacked the discipline to execute instead of tinker, and have never reached the roll-out growth lifestage – nor become household names.

FROM GROWTH TO MATURITY

The transition into maturity is perhaps even more challenging. Once high-potential sites for new stores dry up, the heightened competitive intensity among mature retailers means that even remaining viable can be a challenge. This pressure is only intensified by the perennial – though often overlooked – margin squeeze that results from wage inflation that outpaces price inflation.

Growth for mature retailers comes from a different source: like-for-like or identical stores sales growth. Constrained by space, the winners in this lifestage are those that learn to fight for market share in head-to-head battles. Such contests are won by the store with the superior customer proposition.

Once again there is a stark difference between the skills retailers now need to succeed and those they have honed during the prior lifestage. Like-for-like sales growth is a trading and marketing game, not a store operations one. Local differentiation and tailoring the proposition of individual stores or clusters – previously an unnecessary distraction – are suddenly where the big opportunities lie.

To engineer a consistently superior customer proposition, a mature retailer must develop an edge across the key customer-facing levers – product, value, service, and brand. It needs the tools and processes to make day-to-day decisions simpler, quicker, and better than competitors. The best mature retailers spend years recruiting expert support teams and ratcheting up their level of analytical sophistication to make this possible.

Winning share from competitors means giving customers reasons to make the switch. These strategic differentiators need to be things that customers clearly want and value: in grocery, a better fresh offer; in electronics, the superior knowledge of staff in store; and so on. Retailers that don’t re-tool themselves to find and exploit these types of advantage will see their growth engines stall once they reach maturity. Classic examples of retailers making this transition successfully are Target in the US and dm in Germany: in different markets and at different points in time, each was a pioneer in applying advanced marketing and trading techniques to differentiate their stores and pull away from their rivals.

FROM MATURITY TO REINVENTION

For retailers to grow beyond this point, there is yet another transition to make. No matter how well engineered, any given store format can only be stretched so far. The solution? Retailers in the fourth lifestage need to reinvent themselves, and that means developing yet another skill set. Mature retailers must learn to push themselves to be on the bleeding edge of new format development. Experimenting often and being prepared to handle failure is part of this; so too is scanning the landscape for clever upstarts that might be acquired and scaled up rapidly.
If all this sounds familiar, it should: moving beyond the third retail lifestage sets a premium again on creativity and entrepreneurialism, the same traits that propelled the retailer’s journey through the first lifestage. But pulling it off in an organisation with hundreds of stores and tens of thousands of employees is a challenge on an altogether different scale.

Retailers will also need to look for growth beyond the core business, for example from new categories and channels, or alternative business models. The online channel offers opportunities to add new categories without the old space and inventory concerns. It also means space allocations should be reviewed much more frequently: when particular categories move online, retailers need to be quick to allocate their space to new products. New services offered might capitalise on the power of the brand, for example grocers offering banking services or introducing restaurants or gyms. As for alternative business models, current trends towards subscription or rental models are likely to permeate nearly all retail sectors to some degree.

There are many possibilities, and it's impossible to predict whether a new idea will work in practice. As with format innovation, agility and a lot of fine-tuning are essential to finding something game changing. The best examples of retailers establishing successful new businesses and formats are probably to be found in UK grocery, where Tesco and, to a lesser extent, Sainsbury's developed new small store formats and at the same time successfully expanded into financial services and other areas during the early 2000s. Of course, many other retailers are in the process of transforming themselves into multi-channel businesses – but in most cases it's too early to tell which will succeed and which will fail.

CONCLUDING REMARKS

Although the differences across sectors and geographies might seem enormous, in fact successful retailers tend to go through similar stages of development, and face similar – and predictable – challenges at similar points. Whether they sustain that growth and remain viable throughout that journey largely depends on whether they are well prepared for their next lifestage. This might sound straightforward, but it's anything but: lifestage transitions are true paradigm shifts that require firms to rethink the foundations of their businesses. The upheaval they generate is enormously difficult, both culturally and financially, but retailers that succeed will have built capabilities that are hard to replicate and they will reap substantial rewards at the expense of those who don't make the shift quickly enough.

QUESTIONS EVERY RETAILER SHOULD ASK THEMSELVES

4. **What lifestage am I in?** Understanding this is vital to formulating a plan for long-term growth and for anticipating the next several sets of obstacles.
5. **Do I have the skills I need?** A mismatch here is a problem that you need to rectify quickly to maximise growth from the sources currently most accessible to you.
6. **How long will this lifestage last?** Every growth source dries up at some point and every lifestage ultimately ends. You'll need to keep this in mind as you think through the development agenda for your organisation. Remember that preparation can take years, so get started early.
7. **And what skills will I need in the next lifestage?** As the transition approaches, you need to be steadily closing this skills gap. The important thing is to recognise that you probably have one: moving between one lifestage and another inevitably takes a fundamental change in mind-set.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STRATEGIES TO SURVIVE

Keeping customers and growing profit through the next decade of upheaval in retail

For years, retailers occupied a privileged position in the value chain. With direct access to customers and clear visibility of the choices they made, they effectively had a monopoly on customer relationships – simply because they had the physical locations customers visited. This put them in a powerful position relative to their suppliers and allowed many of the most successful retailers to widen the scope of their business by serving ever more of their customers' needs.

But this is coming to an end. Technology has reduced the role of bricks-and-mortar sites by making responsive, two-way, information-rich relationships possible at a distance. The old world in which customer relationships were the sole domain of retailers with physical stores is disappearing and a new battle for customers has begun. In this perspective, we describe how these changes are challenging traditional retailers and what they need to be doing now to still be profitable in ten years' time.

A NEW BATTLE FOR CUSTOMERS

Consumers now have more choice about where, how, and from whom they buy; how products get to their homes; and with whom they share information about their shopping behaviour. This is a fundamental change and although in some markets its impact is only beginning to be felt, it will ultimately affect retailers everywhere. Online retail has allowed customers to easily search for products from any source, opening up a route to market for any manufacturer or retailer almost irrespective of geography. This has enabled the rise of retailers – such as Amazon – with unprecedented reach across countries and categories, whose scale enables them to offer a huge catalogue of products. But it has also allowed tiny retailers to access the global market, often via intermediaries or marketplaces.

Simultaneous with this growth in competition, the nature of customer relationships is changing. E-commerce is sometimes characterised as being more transaction-focused than bricks-and-mortar retail, but this isn't always the case and some of the giants, including Amazon, are building customer relationships far deeper than traditional bricks-and-mortar retailers, precisely because they can't rely on location to bring in customers.

These changes are disrupting the retail value chain in major ways: for example, manufacturers are reaching consumers directly, asset-light business models are becoming more common in retail, and there is growing competition to own the last mile.

Manufacturers can reach consumers directly

A few years ago, most manufacturers were still pondering whether they wanted to sell direct to consumers: many were wary of trying to circumvent their retail partners. But today there's little debate about whether this is the right strategy and many manufacturers are building successful direct-to-consumer businesses.

For example, sports brand Nike has been growing its direct-to-consumer business and this now accounts for about 20% of its sales. Procter and Gamble's e-store sells bulky items like washing powder and detergents as well as smaller products like razor blades. The fact that their delivery costs can often be lower than retailers' margins gives manufacturers a strong financial incentive to build direct relationships with customers.

Asset-light business models

An interesting trend in recent years has been the evolution of asset-light business models, which disintermediate traditional service providers from their customers by making better use of information, providing better front ends, and offering better customer experience. This has already caused real disruption in some sectors such as travel, where businesses such as TripAdvisor and Priceline have had a transformative impact. While there are no fully formed models of this type in retail today, it doesn't take much imagination to see that this may soon change:

- **Digital wallets** have been launched by some payment providers, who are also making a play to own customers via deeper understanding of their spending habits across sectors. How long will it be before businesses such as PayPal and Google Wallet make recommendations to customers, provide price comparisons, and enable purchasing all from within their own apps?
- **Price comparison websites** already exist in most retail markets, either in the shape of giants like Google Shopping or as sector-specific solutions such as mySupermarket. Today, most of these send customers to the retailer to complete the transaction but how long will it be before this changes?
- **Visual discovery tools** like Pinterest allow users to curate picture boards of products under a theme and share with other users. Such tools also send users to the retailer to complete the transaction but, again, could this change soon?
- **Apps** exist that help customers to plan their meals to a budget or plan a weight loss programme, or just to save time. These typically generate shopping lists or feed into grocers' online stores, but will the businesses that operate them soon be looking to cut the retailer out completely?

Growing competition to own the last time

Last-mile distribution is a problem – one that traditional retailers solved for manufacturers by building stores and consolidating demand into them. Until recently, the only option for online retailers was to rely upon existing distribution networks, sending products by mail or using firms such as UPS and DHL, and many still operate in this way. But for some products and markets this isn't possible: for example, with fresh food where temperature control is critical.

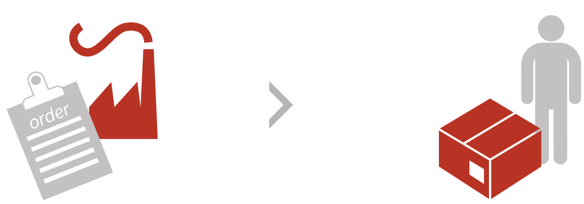
Some online retailers have built their own distribution networks, and these (along with their expertise and technology) are becoming real business assets in themselves. In the UK, online-only grocer Ocado has just licensed its platform to Morrisons, one of the biggest bricks-and-mortar supermarket chains.

Companies are also recognising that owning the last mile and offering rapid, reliable delivery is a great way to build deep customer relationships. For example, part of the logic behind AmazonFresh is that the delivery encourages shoppers to add other non-food items to their basket from across the Amazon range. At the same time, the increased scale it brings moves Amazon significantly closer to being able to provide same-day delivery.

Google Shopping is perhaps even more interesting, as it is a "retailer agnostic" proposition, and could easily also start carrying products direct from manufacturers. Exhibit 1 shows a couple of examples of how future purchasing experiences could entirely circumvent a traditional retailer.

Exhibit 1: How future customer journeys could entirely remove retailers from the value chain

BRANDED GOODS



- Order placed directly with manufacturer
- Order delivered by manufacturer or specialist fulfilment company
- No interaction with retailer

RETAILER'S OWN-LABEL GOODS

- Order placed through online aggregator
- Order delivered by online aggregator or specialist fulfilment company
- No interaction with retailer, although retailer may pick the order in stores or from warehouse

RETAILERS' TRADITIONAL STRENGTHS ARE BEING ERODED

Many retailers may not yet be worried by these emerging trends. After all, they are used to dealing with changes in customer behaviour as well as new retail formats and models. And traditional retailers' business models are underpinned by some real strengths.

The problem this time is that not only are these emerging trends intensifying the battle for customers, but the new competitive environment that is taking shape is also eroding many of these traditional strengths.

Physical store assets are no longer enough

Many retailers' greatest strength was the combination of choice and convenience: choice from efficiently aggregating products from many suppliers and manufacturers under one roof and convenience from having locations easy for customers to access. But this is no longer enough: if customers can get the same products more conveniently or cheaply via another route, some of them will.

Of course, this won't put large retailers out of business overnight. In the short term, its effect will probably be limited to a greater tendency towards basket splitting – where customers obtain some products by another route – perhaps direct from some manufacturers or via niche online retailers. But even this is a worrying trend as the economics of most retailers are very sensitive to small volume losses due to the fixed costs in their stores and supply chains and, as ever, the highest margin products are likely to disappear first.

Offering the lowest prices is getting tougher

Value-focused retailers have succeeded by being the local price leader for commodity items or branded products on the basis of a very low-cost supply chain between manufacturer and store. But in most sectors this is becoming ever harder to do. Now that customers are able to shop anywhere, it's a lot harder to be the "local" price leader and new competitors may be able to build even lower-cost operating models. Online-only models have therefore been able to undercut established retailers in many sectors because of their leaner costs and lower margin expectations.

Being the value leader has always involved high stakes: if customers are choosing you only based on price, those customer relationships will change quickly when a better offer comes around. In the future, bricks-and-mortar retailers in most sectors are likely to find it much harder to win and retain customers this way.

Technology is changing service and advice

Some retailers are built around old-fashioned principles of service and advice. In certain markets, these models may be resilient in their current form, particularly when face-to-face contact remains an important element of the shopping experience. But it is also true that information-based services are either replacing or improving on service and advice in many customer-facing businesses. An obvious example is in books, where store-based advice and service have been almost entirely replaced by internet reviews and recommendation engines.

Because technology can have other advantages besides cost, this trend may well extend much further. The success of self check-in terminals and apps in the airline business suggests that some customers might actively prefer to avoid face-to-face contact in some situations. Overall, retailers need to be alert to the possibility that there may be a better or cheaper way of providing the advice and service that wins them customers today, and this is likely to involve new technology.

HOW CAN RETAILERS FIGHT BACK?

In ten years' time, what will the world of retail look like? Which of today's successful retailers will still be the key players in their markets? Without wishing to be alarmist, we think everything we've just described suggests that – sooner or later – there will be fundamental changes in every retail sector. Some retailers are better placed than others to cope with these changes, but over the coming decade all are likely to face real challenges.

To hang onto the kind of customer relationships they now have, many retailers will need to redefine themselves by asking why customers need them and how their business model needs to change to remain viable.

The uncomfortable truth is that the lines between manufacturers and retailers and between retailers and logistics providers are becoming ever more blurred. As such, there are cases in which the role of the retailer itself may be in question: if customers can get products via a cheaper or more convenient route, eventually some of them will. Some retailers risk being turned into "dumb supply chains" that provide fulfilment for asset-light information-based services that are one step closer to customers.

Faced with diffuse or long-term trends and threats such as these, a common reaction is to assume that they're too uncertain or too far in the future to matter. This is understandable but it's a mistake: retailers need to act before they start losing large numbers of customers, because once they do their strategic position becomes much weaker.

There are three things we believe retailers should do to meet the new challenges they face:

1. Boldly play the movie forward for your sector
2. Identify new ways to win customers and own customer relationships
3. Think more like an agile start-up – and start innovating and experimenting right now

1. Play the movie forward

The first step is to make a candid assessment of your real strengths and weaknesses. This means asking some searching – and uncomfortable – questions about your customers and your business.

Fundamental questions

- How do customers see us today, compared to our competitors (both new and traditional)?
- What is the core thing that we do that customers can't get elsewhere? Will this still be unique in ten years?
- Which other businesses are (or could be) closer to our customers than we are?
- How easy (or difficult) is home delivery for our products?

Example detailed questions

- What role does information and advice play in our sector – and how can customers best access it?
- What about other incursions into the value chain, such as payment providers and digital wallets?
- Which parts of our business – categories, geographies, stores – will be profitable in five years' time?

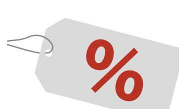
These are tough questions. But it's crucial to be realistic, not optimistic, about the future of your business because, too often, wishful thinking means that management teams don't understand the potential impact of the threat until it is too late.

Exhibit 2: Example survival strategies for a large food retailer

The overall aim is to continue to own the customer and consolidate spend by serving all of their food-and-nutrition-related needs in a differentiated and highly convenient way, while at the same time developing a separate business line as a branded manufacturer.

Information-based services: Start offering customers a wide range of sophisticated information-based services, such as diet and nutrition management, menus and suggestions, as well as self-scan and product finder apps in store. The aim is to drive customer retention within the existing ecosystem.

Last mile: Make a big play for the last mile by investing in a home delivery network, while at the same time leveraging physical store assets by offering click-and-collect shopping.



Subscription: Launch a subscription-based offering with reduced prices in return for a monthly fee.

Product differentiation: Continue to push product differentiation through excellence in own-brand ranges and start selling these products through a range of channels, including third-party channels for ambient products.

2. Identify new ways to win customers

To stand a fighting chance, traditional retailers will need to take full advantage of the new strategic possibilities that technology has opened up.

Value-added services are one example. These have been around for a while but have typically been narrow in scope – perhaps being limited to installation, credit cards, or personal shopping. But technology has revolutionised what can be offered. Retailers can now reach customers across the whole of the shopping experience and start building a relationship with them before they even decide to make a purchase, let alone visit a store. In addition, they can more easily maintain this relationship long after a purchase has been made.

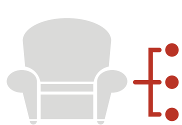
Online and mobile technology is continuously unlocking new ways for retailers to create value for customers. Credit cards are being replaced by mobile wallets and physical shopping is being made easier with "scan and go" applications. Meanwhile, personal shopping is being brought to the masses through recommendation engines, and lifestyle management apps are being created to help manage food spend, budget, and health goals. Individually these might look like modest changes but together they are starting to add up to something significant – and new applications are being invented almost every day.

Owning the last mile also offers new opportunities. Historically, retailers won by having convenient store networks. These days, convenience means something different, with home delivery and localised collection points becoming the key points of differentiation. With competition for owning the last mile becoming fierce, Amazon and Google have begun building their own in-house services and some retailers may themselves be well placed to enter this market – particularly high-frequency, large-basket retailers, such as grocers.

Exactly which combination of strategies makes sense will clearly depend on the characteristics of your business and customer proposition and will be very different for different retailers, as Exhibits 2 and 3 suggest.

Exhibit 3: Example survival strategies for a design-led home furnishings retailer

The overall aim is to move closer to being a pure design and manufacturing business.



Third-party channels: Start selling products through a range of third-party channels such as internet giants and other larger retailers.

Online: Rapidly develop an excellent in-house online offering.

Store estate: Dramatically reduce the size of the store estate, keeping only flagship stores and showrooms.

3. Think more like an agile start-up

Many of the things established retailers will need to do are far from their standard operating procedures and current core competencies. This puts any new business models at risk of being crushed by the existing organisation before they have a chance to grow. To beat competition from dynamic start-ups, established retailers will need to think like them. Defensive behaviour by the core business, the wrong metrics and success criteria, and the difficulty of recruiting and retaining the right people are all obstacles that must be overcome.

One way of doing this is to create a new business unit that isn't constrained by the rules and culture of the core business and where success will be measured on a different basis:

Example 1

If it's important to develop and drive the adoption of information-based apps and services, it may well be best to build a separate business that operates at arm's length to the parent company. This would enable it to recruit people with the right skills and pay them on a different basis from the core enterprise, and to operate with different practices – for example, adopting rapid agile approaches to IT development. Its success could also be judged on different metrics, with the new venture being valued as a startup would be: on customer acquisition and retention, rather than short-term financial performance.

Example 2

When there is a strategy to push own-label products into new thirdparty channels, a separate business unit structure would help protect the new venture. There may be some in the core organisation who would, understandably, focus on the cannibalisation from "their" existing channels and stores and undermine what the strategy is really trying to achieve.

It takes time to develop new skills and capabilities, which makes it essential to start figuring out how to transform your business as soon as possible. Trial and error is a requirement when it comes to developing, testing, and honing new business models so, if selling through thirdparty channels will be part of the answer, start trying it now, even if you think demand will be initially low. If sophisticated data-based apps are going to become important, launch beta versions as soon as possible, even if at the beginning not many customers use it. Remember: there is simply no substitute for accumulated experience.

CONCLUDING REMARKS

Over the past decade, the retail value chain has changed significantly and the next few years will bring even greater disruption. Having lost the privileged access to customers they once had, retailers today face a much broader and more diverse set of competitors from manufacturers to payments providers, logistics companies, and internet search engines. In some cases, they risk becoming little more than fulfilment operations for others or being driven out of business.

To meet this existential threat, bricks-and-mortar retailers need to build capabilities that stretch far beyond their traditional areas of competence, and to be as aggressive as their new set of competitors in seizing the opportunities technology offers. Taking an honest view of the prospects for the business is a vital first step. Retailers then need to find ways to innovate as fast as their competitors can – which may require significant changes to the way the business is organised, to foster a genuinely entrepreneurial culture within a large and established business. They need to start now, and act fast and decisively.

These changes won't be smooth or painless. And because this is unfamiliar territory, there will inevitably be a significant element of trial and error. But the unvarnished truth is that time is not on the retailers' side – and though making quick decisions always carries risks, not making them may spell disaster.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CHANGING THE RULES OF RETAIL

Viable models for e-commerce

With shopping moving online and store sales stagnating, many established retailers see their internet business as their primary source of growth. But although most now have a significant online presence, profit remains elusive: e-commerce has been great for customers but has done little for retailers' earnings. It's clearly difficult to come up with a viable model for an online business, but, as this article explains, it's not impossible.

E-commerce has changed the rules of retail in two fundamental ways: firstly by shifting it to a winner-takes-all environment; and secondly by transforming the economics.

1. RETAIL IS NOW A WINNER-TAKES-ALL INDUSTRY

Markets are no longer local but national or, in many cases, international. When distance mattered, every store had a built-in advantage with customers living or working nearby. Comparing retailers wasn't easy, and switching between them wasn't effortless, so each store effectively competed with a small number of local rivals. If a store was in a convenient location, it could attract trade without offering the lowest prices, the best products, or the most helpful service – it didn't have to be the best at anything, as long as it was "good enough" and near to its customers.

Online, all this has changed. In most retail sectors, location is irrelevant and price comparison straightforward. Customers can easily shop around in search of the best deal. The implication is clear: competing online is about being the most attractive to customers, full stop. Customers must see you as the best choice or else they won't consider shopping with you. You don't have to be the best at everything – but you do have to be the best at something.

2. E-COMMERCE HAS TRANSFORMED THE ECONOMICS OF RETAIL

The new economics of an online world make it much harder for retailers to earn a profit. Greater competition has increased price elasticity and depressed margins, while on the other hand, e-commerce requires less investment and usually involves lower fixed costs than bricks-and-mortar retail. But the decisive difference is that many e-commerce operators have low expectations about their current financial performance: as businesses, they are valued based on profits they might make in the future, not profits they make today. Some online retailers are effectively running their entire operation as a loss leader, in the hope of buying a customer base that will confer a lucrative position years down the road. And in a winner-takes-all market, competitors who expect low (or no) earnings depress profitability for the entire sector.

SUCCEEDING ONLINE

Together, these two changes explain why it's so difficult to come up with a viable online business: you need to identify areas where you can be the best choice for customers yet still earn a profit. Just as only a few types of bricks-and-mortar concepts proved successful – the category killer, the one-stop-shop, the discounter, and so on – only a handful of online models can offer defensible long-term value creation.

Viable online businesses fall into one of four categories:

1. The absolute cheapest prices in the market
2. The best assortment and service
3. The first place customers look
4. A fantastic end-to-end shopping experience

No online business achieves more than one of these and, in contrast to the bricks-and-mortar world, there's no room for a generalist "jack of all trades" retailer that does a pretty good job across all dimensions. To succeed online, you need to be first choice for a particular set of customers on a particular set of purchase occasions. The rest of this article discusses what this means in practice, and explains how each of the four models can provide the template for a successful business.

Model 1 The price leader "The cheapest"

The price leader is the most straightforward online business model, see Exhibit 1 for two examples. If you can offer the lowest prices, the price transparency of the internet is a huge advantage. You don't need expensive facilities, lots of staff, or even a brand (beyond being seen as reasonably trustworthy) provided you have an advantaged source of supply, or extremely low operating costs, or both. For products that are usually bought on their own and that have straightforward purchase dynamics, being the lowest price in the search engine is often enough.

Three types of company compete in this space:

1. The multi-category internet giants who have the logistics networks and scale to be cost advantaged
2. The off-price merchants selling grey market, diverted, and over-supplied branded goods (particularly in clothing, jewellery, and other low-volume-per-SKU, "fashion" categories)
3. The sole traders who feature so heavily on eBay and Amazon's marketplace

This is a tough model to pursue if you aim to build a defensible large-scale business, because it requires either massive scale or an advantaged source of supply. Without one or the other (ideally both), systematically offering the lowest prices is financially ruinous – especially for bricks-and-mortar retailers where online prices tend to drag down in-store prices and make it impossible to cover fixed costs.

✓ **Where it works:**	Searched categories, one-off purchases, and simple purchase dynamics
✓ **How it wins customers:**	By winning the price battle, search by search
✓ **How it earns a profit:**	Advantaged sources of supply and low cost structures

Exhibit 1: Examples of retailers that have established themselves as price leaders

	ESTABLISHED: VENTE-PRIVÉE	UP AND COMING: MADE.COM
What it is	• High-end discount fashion	• Designer furniture made to order
Successes so far	• €1.1BN turnover in 2011; €1.3BN turnover in 2012. 2.5MM unique visitors per day with 18MM members in Europe • Ten years old and still growing • Expanding into other countries • Lots of copycat sites	• Young, growing business established in 2010 • Sales £10MM+ • On the UK government's Future Fifty list • Hired 100 FTE in 2012 • Also expanded into France and Italy
Customer proposition	• Online "flash sales" of a limited period (3–5 days), with 24 hours' notice	• Designer furniture 70% cheaper than the high street • Customers vote for their favourite designs and • only the most popular get made
Profit model	• Privileged supply from designer brands looking to clear excess stock • Secret sales mean they aren't listed on price-comparison sites so branded suppliers are less worried about devaluing their brands or cannibalisation	• Re-engineers the value chain – from made.com to manufacturer to consumer • Pieces only commissioned after orders are placed, allowing low stock levels and negative working capital

Model 2 The category expert
"The best assortment and service"

Just as category killers won for many years by creating a dominant customer proposition within their categories, there is a role for category experts online. Most online purchases satisfy a single easy-to-define consumer need – "I want a new TV" or "I need a car seat" – and the search-led way that most consumers shop works well for that type of purchase.

But the consumer experience most websites deliver is hopeless for more complex purchases. When needs are less well-defined – "I need some new shoes" or "I'm looking for a new sound system" – the search-based approach doesn't work well and the endless aisle that is so powerful in other situations just becomes clutter and confusion. While some search-based sites tackle this problem by using consumer reviews, retailers that really understand the purchase occasion and provide an experience that is optimised for it can create a real advantage. In categories where consumers repeat purchase, that superior experience can be translated into long-term loyalty.

Not all categories are suited to the category expert model: the categories that were the basis for the most successful bricks-and-mortar category killers may not necessarily be the same as those used by successful online category experts. Nonetheless, there remain purchase occasions with particular (and in many cases, particularly demanding) service requirements which can best be served by businesses that have been specifically designed around them (See Exhibit 2).

✓ **Where it works:**	Complex purchase occasions; medium frequency purchase cycles; many-to-many product dependencies; discrete sets of categories not bought together with others
✓ **How it wins customers:**	Customers know it's where they can find the products that best meet their needs
✓ **How it earns a profit:**	Natural margin is raised by differentiation and long-term loyalty, based on hard-to-replicate expertise

Exhibit 2: Examples of retailers that have established themselves as price leaders

	ESTABLISHED: ZAPPOS.COM	UP AND COMING: WIGGLE.COM
What it is	• Mass market shoes and clothing retailer • World's largest online shoe store	• Specialist sporting goods retailer • Owned by private equity firm Bridgepoint Capital since acquired for £180MM in 2011
Successes so far	• Acquired by Amazon in 2009	• Revenues up from £86.3MM in 2011 to £140.8MM in 2013
Customer proposition	• Range authority: – 50,000+ types of shoe – Large speciality range – Out-of-stocks can be pre-ordered • Strong focus on customer service: – Call centres open 24/7, no scripts, staff build brand "legend" by going the extra mile	• Range authority: – Full range of cycling, running, and swimming gear – Shop by brand or category • Expert advice: – Buying guides for each category – Live webchats with an advisor available • Low risk: – 12-month returns policy – 30-day test ride on bikes
Profit model	• Driven by repeat custom	• Driven by a differentiated, expert proposition

Model 3 The default destination “The first place you look”

The default destination is the online equivalent of the one-stop-shop where a consumer knows they can always get what they want at a fair price – essentially, it’s what convenience has come to mean in the online world. Such retailers offer all the assortment a customer is likely to need, a solid website, a no-hassle shopping experience, and prices that are reliably competitive (if not always the absolute cheapest). Their aim is to build a customer base that sees them as the default option for all of their needs.

This has been the approach Amazon has taken (see Exhibit 3). As the categories it sells broaden, it meets more and more of a typical household’s needs and the logic for just going to Amazon without checking anywhere else becomes stronger and stronger. Meanwhile, an AmazonPrime subscription creates long-term lock-in. Today, Amazon’s lead in customer consideration, category breadth and assortment, and favourable price perception, all make it hard to see how anything other than an intricately configured consortium of other retailers could compete on a level playing field.

But there are other customer segments – small businesses, schools, young families, silver surfers, and so on – around which similar models could still be built. The challenge is to define your target and be relentless about serving their needs better and better over time. Half-hearted won’t work. For example, to target small businesses, an office supplies retailer needs to provide everything they need, not just some of it. The aim is to become the default destination for an office manager, and leave them with no reason to shop around. Achieving this means tailoring shipping and invoicing arrangements and offering services as well as physical goods. This is a fundamentally different business approach for retailers who have traditionally defined themselves in terms of the products they sell.

✓ **Where it works:**	Customer segments with wide-ranging but identifiable needs
✓ **How it wins customers:**	By conveniently meeting all their needs at reliably low prices
✓ **How it earns a profit:**	By building default shopping behaviour

Exhibit 3: Examples of retailers that have established themselves as the default destination

	AMAZON	STAPLES
Initial proposition	• Started as a category expert book retailer, selling its first book in 1995 • Able to carry many times the number of titles as the incumbent bricks-and-mortar players	• Established in 1986 as an office supply superstore and for a long time was a category killer
Development	• Established itself as a broad price leader, offering products below RRP on nearly all lines, either through its own fulfilment or its marketplace • Rapidly expanded into other categories and became focused on owning the last mile • Deeply customer-focused, with membership and subscription services increasing customer retention • Developed into default destination for many households	• Branched out into related categories (e.g., break-room supplies and office furniture) and services to become the default destination for B2B office supplies • Focused on improving customer engagement, for example by acquiring Runa, an e-commerce personalisation company • Currently redesigning strategy around fewer stores and more online business

Model 4 The customer experience captain
"A fantastic end-to-end shopping experience"

For many of today's biggest bricks-and-mortar retailers, this may be the most interesting model, since by its nature it's a multi-channel concept that leverages physical store assets. It's also the most difficult to explain, because no retailers have fully delivered it.

In the past, apart from advertising and perhaps some direct mail, customers' only contact with retailers took place in the store at the point of purchase. However, now the shopping experience begins long before a customer sets foot in a store, continues long after they leave it , and can be helped along by today's technology at many touchpoints along the way.

By using technology to seize more chances to interact with customers, and linking this seamlessly into value-adding, relevant in-store experience, a traditional retailer should be able to build a compelling customer experience that differentiates them from online – and bricks-and-mortar – competitors.

To take advantage of this opportunity, a retailer needs to understand the often subtle or implicit choices that customers make at each stage of the shopping experience. As shown in Exhibit 4, these will vary from one product category and purchase occasion to another but, at the most basic level, customers move through four identifiable, sometimes overlapping or iterative, steps. The starting point for a retailer is to identify opportunities to engage with the customer at each step and to ask themselves some existential questions about what customers are looking for, how to deliver it, and using which channel (see Exhibit 5).

Exhibit 4: Questions to be answered and acted upon at each stage of the shopping experience to enable a retailer to fully engage with a customer

Trigger
- When, why, and how do customers start thinking about buying?
- How can we help them, not just "spam" them?

Search
- Who do different types of customers consider?
- How do they choose?
- How can we encourage them to choose us?

Purchase
- How much does the purchase experience matter in itself for different types of customers?
- What are customers looking for?
- How can we deliver the best possible experience?

Post-purchase
- What happens afterwards?
- What can we do to exceed customers' expectations?

Exhibit 5: Examples of how some retailers could innovatively engage with customers at each stage of the shopping experience

Trigger

A toy store alerts family members that a birthday is coming up and makes suggestions based on trends, prior purchases, feedback, and so on

Search

A DIY retailer notices a customer is researching many products. It offers the customer an opportunity to book a consultation with an in-store expert and a "spend more and save more" voucher

Purchase

An electronics retailer offers customers three options on arrival in store:

1. Fast track for those who want to pay while a store associate fetches the product
2. Specialist assistance
3. Regular browsing

Post-purchase

A grocer emails recipes based on what the customer bought at their last shop, and sends reminders when the best-before-dates of those products approaches

Clearly these are strategic, conceptual questions, far removed from the day-to-day reality of running a retailer. But answering them is a key first step in building a true multi-channel retailer.

What might a true multi-channel retailer look like? Aligning pricing across channels; integrating logistics networks; being able to sell products through different channels; delivering well-designed apps and websites; and offering reviews, recommendations, and advice are all necessary but they aren't enough on their own.

To make this model work, a retailer will need to mine customer data to understand choices and shopping behaviour better than ever before. This goes beyond in-store experience to the end-to-end shopping experience. This approach will require identifying purchase occasions that didn't exist in the past and aren't yet well served. It will require mastering the use of social media and other channels to help the retailer become customers' first choice. It also requires recognition that different customers shop in different ways, and a successful retailer must provide the right level of service and assistance to each of them, without seeming pushy.

In this model, the online and offline worlds should enhance the experience in each other.

To date, this is something that has been developed further in the services industry than in retail. For example, airlines now use real-time mobile survey data to pick up customer frustrations in the airport and smooth things over when the customer reaches the lounge or aircraft. In addition, hotel chains can predict where a customer might like to go next and when. In the end, a bricks-and-mortar store may play a reduced role compared to today, but will still be a crucial element of delivering the best possible end-to-end experience.

The end-to-end shopping experience needs to become just that: a genuine proposition with value-adding customer interaction at all stages of the shopping experience. While many retailers are addressing some aspects of this today, none are covering all in a powerful and compelling way.

Perhaps most challenging of all, a retailer will need to do all these things in a way that makes customers' lives better, easier, and nicer, to help them rather than just sell things to them. Of course, no retailer has yet achieved all this, but the examples in Exhibit 6 give some indication of the opportunities that are opening up and of the ways retailers can capitalise on them.

✓ **Where it works:**	Potentially anywhere, with the most obvious being complex purchase occasions where neither store-only nor online-only provides the best experience possible, and categories where choices have strong subjective elements (for example, fashion, furniture, luxuries, and gifts)
✓ **How it wins customers:**	By making their lives easier and better
✓ **How it earns a profit:**	By becoming a fundamentally new breed of retailer, achieving differentiation through a unique customer proposition at the same time as right-sizing bricks-and-mortar assets

Exhibit 6: Examples of retailers that have established themselves as the customer experience captain

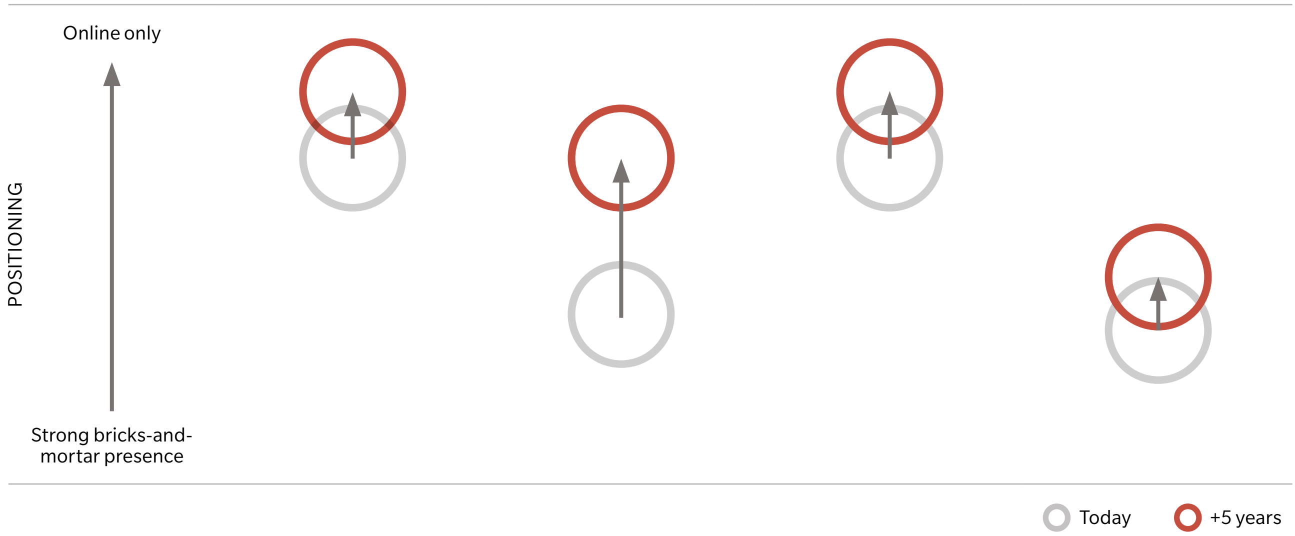
	ESTABLISHED: JOHN LEWIS	UP-AND-COMING: SEPHORA
What it is	• UK department store	• Perfume and cosmetics
Successes so far	• One of the only major high-street retailers to see consistent growth through recent downturn	• Owned by LVMH • $4BN revenue in 2013 • Expanding aggressively into China
Customer proposition	• Stores offer: – Ability to see and touch the full range, notably big-ticket categories like furniture and electronics – Cooperative approach, owned by staff, resulting in high-quality service in store – Wide range of services such as home fittings and installation, personal style advice, etc. • Website is fully integrated to enhance stores: – In-store booths allow customers to browse, check stock, and order online – Free click-and-collect, using sister supermarket Waitrose to gain nationwide reach – Gift lists selected and held in store, but can be accessed and purchased online	• In-store experience is essential for trial, events, and classes • Online experience gives access to reviews and ratings and the full range of products • Effectively integrated the two channels, allowing customers to: – Book store classes and events through an app – Scan in-store products with their phone to see ratings and reviews – Access music, magazine, and book downloads through the Sephora Shares app, boosting adoption of the technology
Profit model	• Online is driving growth: during Christmas 2013, online represented a third of sales, having grown 22% over previous year and compared to a 1.2% growth in store sales • New smaller stores are being developed with an edited range complemented by terminals to order online	• Reinforces underlying category expertise model benefits of differentiation and loyalty

CONCLUDING REMARKS

A high-level review like this inevitably simplifies some of the issues involved, but it can also help identify where the opportunities for long-term value creation lie. E-commerce is a particularly challenging part of the retail world, and one common theme that emerges across all four models, summarised in Exhibit 7, is the need for radical innovation, not just incremental improvement. With technological change accelerating and competition becoming ever more intense, building a successful retailer based on any of the four models takes genuine creativity and bold, decisive action: a cautious approach won't build the deep moats to protect profits in the long run.

Exhibit 7: Summary of viable online business models

	MODEL 1: THE PRICE LEADER	MODEL 2: THE CATEGORY EXPERT	MODEL 3: THE DEFAULT DESTINATION	MODEL 4: THE CUSTOMER EXPERIENCE CAPTAIN
Where it works	Searched categories, oneoff purchases, and simple purchase dynamics	Complex purchase occasions; medium frequency purchase cycles; many-to-many product dependencies; discrete sets of categories not bought together with others	Customer segments with wide-ranging but identifiable needs	Complex purchase occasions where neither store-only nor onlineonly provides the best experience possible, and categories where choices have strong subjective elements
How it wins customers	By winning the price battle, search by search	They know it's where they can find the products that best meet their needs	By conveniently meeting all their needs at reliably low prices	By making their lives easier and better
How it earns a profit	Advantaged sources of supply and low cost structures	Natural margin is raised by differentiation and longterm loyalty, based on hard-to-replicate expertise	By building default shopping behaviour	By becoming a fundamentally new breed of retailer, achieving differentiation through a unique customer proposition at the same time as right-sizing bricks-and-mortar assets



ONLINE GROCERY

Where can it work and what is the threat?

Pure-play online grocers are nothing new: companies have been experimenting with the concept since Peapod and HomeGrocer.com launched in the late 90s. But while in the past many pure-play online grocers failed, recently more and more are experiencing sustained growth, suggesting they're here to stay.

The momentum that AmazonFresh has built up is particularly interesting: in the US, Amazon has announced plans to roll out AmazonFresh to 30+ markets by the end of the year, and they had already made clear their intentions to enter Germany as well. Exhibit 1 shows some of the most prominent examples of pure-play online grocers around the world.

But despite their recent success, questions remain regarding the profitability of online grocers – so their long-term growth potential is unclear. In the US, many still limit their operations to a small number of major metropolitan areas. Is it possible to run a profitable home delivery business that isn't supported by sharing fixed costs with physical stores? It's reported that players such as Ocado and FreshDirect are already profitable – but is this just because they operate in densely populated areas?

Exhibit 1: A few of the pure-play online grocers around the world

	OCADO	FRESHDIRECT	AMAZONFRESH	YIHAODIAN
Current markets	UK – urban areas	US – select metropolitan areas on the East Coast	US – California and Seattle area Germany – coming soon	China – many areas
Delivery	Free with Ocado SmartPass membership (£70+ per year), or pay per delivery (price depends on demand and order value)	Pay per delivery (price depends on location)	In most markets, free with annual Prime Fresh membership ($99 per year)	Pay per delivery (price depends on weight and location)
Good to know	Also provides technology for Morrisons' (UK top 4 grocer) online offer	Fresh products a much higher share of baskets than at typical grocers	Constantly innovating to try and capture larger share of wallet (e.g., Dash)	Currently majority owned by Walmart 1,000 virtual stores

Online grocery involves a set of complex financial relationships, many of which are still evolving. Distribution costs are, of course, highly significant and are strongly affected by scale. Fulfilment costs are similarly important: they are heavily influenced by the picking technology and processes that are used, as well as by basket size and product mix, and they scale in discrete steps as new distribution centres are required. How much different customers will pay for delivery and how precisely timed and reliable the delivery needs to be all affect distribution costs – and are changing month by month as attitudes towards online shopping change.

The economics of online grocery retail are therefore complex and rapidly evolving, and vary significantly from one business to another. But there is a common theme: the importance of scale. To be viable in the long term, every online grocer needs to achieve profitable scale – and this means that the reach of pure-play online grocers will ultimately depend on some basic economics. At the simplest level, there are three key drivers of the viability of online grocery in a given market:

- Population density: a key factor in the economics of the last mile of delivery
- Total population and grocery spend: drives efficiency of both delivery and fulfilment by fully utilising fixed assets
- Market price levels: drives gross margin achievable by an online grocer

To understand where pure online grocers are most likely to be viable, we have developed a profitability model based on the financial reports of a set of current online-only grocers and on our own industry experience, and fed in data for each of the three key drivers for each market. By way of an example, the rest of this article discusses our findings for the US.

WHICH US MARKETS CAN BE PROFITABLE?

By looking at how population density, total population, grocery spend, and market price levels are likely to affect profitability in different markets across the US, we can predict what market share levels would be required in each area for a home delivery grocer to break even, assuming operating efficiencies remain as they are today. Our results imply there are 40 markets, together covering 50% of the US population, where an online grocer could break even with less than 5% market share. These markets are shown in green (like Seattle) and yellow (like Dallas) in Exhibit 2. As a point of comparison, in more developed online grocery markets such as the UK, online grocers are already at about 5% market share and still growing strongly.

There are another 26 markets (shown in red, like St. Louis, in Exhibit 2) that are only marginally more challenging for an online player, and where a 7% market share would be enough for them to break even.

Exhibit 2: Market share required to break even for a pure-play grocer by US market

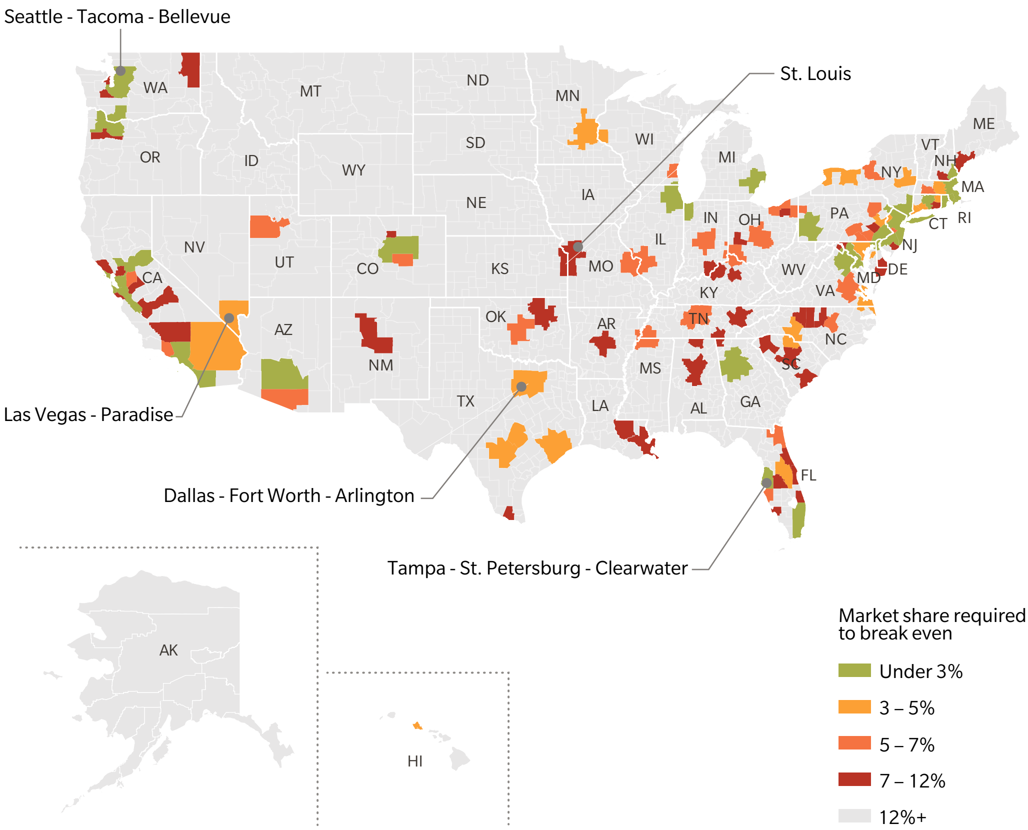


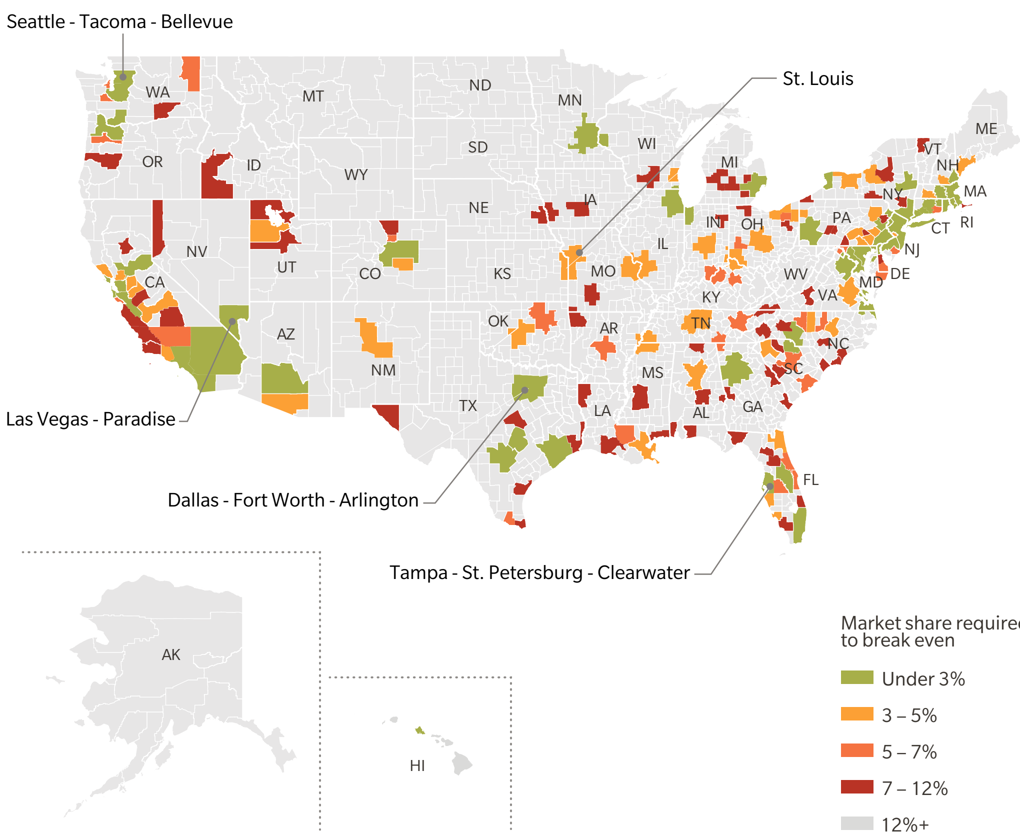
Exhibit 3 shows three example Metropolitan Statistical Areas, to illustrate trade-offs at work. Both Tampa and St. Louis have large populations and relatively low market price levels, but St. Louis has much lower population density and a small market price disadvantage. So while there are superficial similarities, the market share needed to break even varies considerably. Las Vegas has a smaller population and slightly lower population density than St. Louis, but a high market price level means a lower market share is needed to break even.

Exhibit 3: Comparing three market areas with different characteristics

MARKET	POPULATION	POPULATION DENSITY	MARKET PRICE LEVEL	RESULTING MARKET SHARE REQUIRED TO BREAK EVEN
Tampa - St.Petersburg - Clearwater	2.7MM	High	Low	**Under 3%**
Las Vegas - Paradise	1.9MM	Medium	High	**3 – 5%**
St. Louis	2.7MM	Medium	Very low	**5 – 7%**

Over the coming years, we anticipate that the economics of home delivery grocers will evolve as operators come up the learning curve and find new ways to bring down their costs. Additionally, as they start to scale to multiple markets, there will be brand and fixed-cost leverage advantages. This will open up new markets and mean that markets that are already attractive may be able to profitably support more than one pure-play online competitor. For example, if online players get 10% more efficient, the number of markets where the breakeven market share is 5% or less would increase to 80, to include places such as St. Louis. The total number of markets where a 7% share is enough to break even would rise to 108, and at this point pure-play online grocers would be able to cover up to 70% of the US population – and therefore become a real threat for almost all conventional grocery store operators. Exhibit 4 shows the detailed picture for the whole country.

Exhibit 4: Market share required to break even after 10% efficiency improvement



CONCLUDING REMARKS

It is clear that online grocery poses a real threat to traditional grocers in the US; in other rich countries that have higher population density, the threat is greater still. While the market share losses to online grocery might sound small, a relatively small drop in volume can mean a massive fall in profit. When a typical grocer has 2% EBIT and 20% volume variable margin, online grocers capturing 10% of market share would erase all of the profitability of the traditional grocery store sector – and even taking only 5% would cause significant changes.

Of course, this also means there are opportunities for those that take the initiative to go after the online market themselves. In many markets, only a couple of players will be able to achieve the scale needed to break even. Being the first mover fundamentally changes the economics for whoever follows, including Amazon. Perhaps most importantly of all, established grocers have fixed assets (stores, warehouses, trucks, customer data, a brand) that mean they are particularly well placed to move quickly and shape the market.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HOW TO BEAT LOWER-PRICED COMPETITION

Profitable growth strategies

Over the past decade, low-priced competitors have become major players in every retail market. The discounters in Europe, along with Walmart, warehouse clubs, and dollar stores in the US, have all been growing much faster than traditional full-range retailers. The rise of e-commerce operators who compete aggressively on price has been even more dramatic.

These low-priced competitors have a fundamentally different business model, and can survive on much thinner margins than traditional retailers. In most cases, a bare-bones operating model keeps overheads to an absolute minimum, while a high rate of sale means negative working capital makes a meaningful profit contribution. Many low-priced players have other advantages besides, including:

- Discounters' streamlined assortments help to keep store and supply chain costs down
- "Club" retailers generate steady additional income from membership fees
- Online retailers run picking centres with much lower fixed costs than bricks-and-mortar stores, and expect lower margins

Overall, these differences add up to a huge cost advantage. If a traditional retailer's operating costs account for around 20–30% of revenue, a low-priced competitor's will typically be 10–15% (see Exhibit 1).

Exhibit 1: Cost advantage of low-cost competitors

	TRADITIONAL SUPERMARKET	TRADITIONAL HYPERMARKET	LOW-COST HYPERMARKET	DISCOUNTER
Sales	100.0%	100.0%	100.0%	100.0%
Cost of goods sold and shrink	-69.0%	-73.5%	-76.0%	-81.0%
Gross margin	31.0%	26.5%	24.0%	19.0%
Store labour cost	-13.5%	-12.5%	-8.0%	-4.0%
Central costs	-14.0%	-12.5%	-10.0%	-8.0%
EBITA[1]	3.5%	1.5%	6.0%	7.0%

1 EBITA: earnings before interest, taxes, and amortisation.

So **in terms of their fundamental economics, low-priced competitors simply aren't comparable to traditional retailers – but customers still see them as attractive alternatives**. This leaves full-range retailers in a difficult position, because even a modest loss in volume can undermine the efficiency of their operating model.

FIGHTING BACK

Nonetheless, over the past few years there have been numerous examples of full-range retailers successfully growing in markets threatened by low-priced competition: in the UK, the major grocers (until recently) and John Lewis; in North America, Kroger, Whole Foods, and Nordstrom; in France, Leclerc, Auchan, and Casino; in Germany, Rewe, and Edeka; as well as a variety of smaller speciality, apparel, and home improvement retailers across all geographies. They have achieved this in different ways, but there are some fundamental similarities between their strategies.

In summary, there are four things retailers threatened by low-priced competitors need to do to fight back:

1. **Narrow the price gap**. Traditional retailers are giving their customers a good reason to shop elsewhere – they're just too expensive compared to the low-priced players. You usually can't close this gap completely, because your cost structure doesn't support it, but it's vital to ensure it's as narrow as possible.
2. **Play to your strengths**. As well as minimising customers' reasons for shopping elsewhere, you need to give them a positive reason to shop with you. If you're a full-range retailer, you need to make it clear where you're offering more than the low-priced competition. This means innovating continuously and aggressively in the areas customers really care about.
3. **Get much more efficient**. There's no escaping from the fact that competing with low-priced retailers is expensive. Although traditional retailers can't replicate the ultra low-cost business model of the discounters, they need to make big improvements in efficiency if they are to sustain a competitive proposition overall. This means taking a hard look at today's operating practices, and ensuring that everything you do is worth more to customers than it costs you to provide it.
4. **Take the long view**. Mounting an effective defence against low-cost competitors will take time – several years at a minimum. This poses a huge challenge in itself for a large, established retailer with tough quarterly earnings targets to meet. It means making significant investments with long time horizons, and putting customer satisfaction tomorrow ahead of profit today.

It's important to emphasise that all four entail a real shift in culture and mind-set for a mature retailer. But at the same time, they're much more than a defence against new low-priced competitors – they're also a counter-attack against traditional, full-range rivals. Holding your ground against the former invariably means gaining against the latter.

The rest of this article explores these strategies in more detail.

CASE STUDY 1

GENERAL MERCHANDISE RETAILER DRIVING GROWTH IN THE FACE OF LOW-PRICE COMPETITION

Context

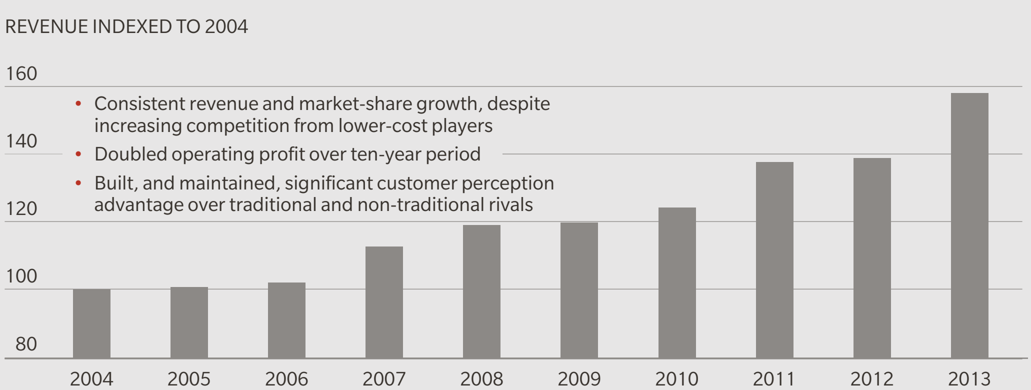
A general merchandise (GM) retailer, whose main categories are home, fashion, and electricals, was under simultaneous threat from a number of online and bricks-and-mortar competitors. These competitors included the likes of Amazon and Ikea, and all had significantly lower-cost operating models than the more traditional GM retailer. The macroeconomic climate was favourable to lower-cost competitors, given the post-financial crisis recession, so the GM retailer knew it had to take action to defend its market position.

What they did

- Took action on value
  - Invested in prices, but selectively and focused on higher elasticity categories such as electricals (high degree of price transparency online)
  - Maximised use and awareness of price guarantee (which was already in place)
- Ensured that the range structure covered all customer needs
  - Launched new value ranges to compete directly with lower-priced competitors
  - Upgraded core ranges to ensure they maintained differentiation and customer perception advantage
- Leveraged operating model to deliver superior customer service
  - Ensured that their higher-cost labour model delivered a noticeably superior customer experience, which customers valued
- Launched and developed multi-channel capabilities
  - Were early to the market in developing multi-channel capabilities, and continually developed to stay ahead of the market
  - Stole a march on other traditional rivals; as a consequence, were much less harmed by rise of online competitors

Results

Exhibit 2: Revenue



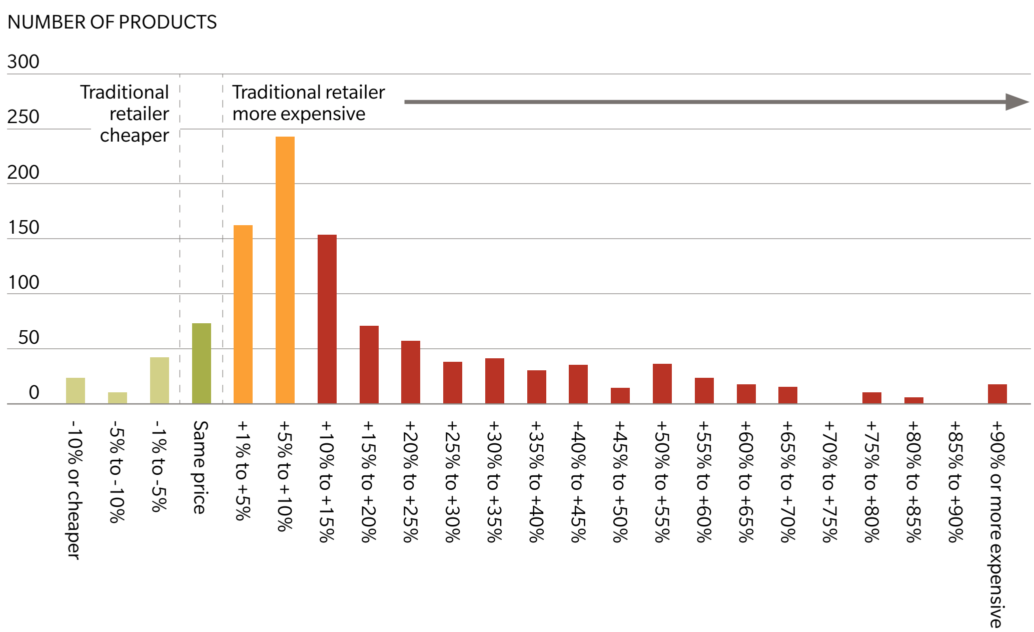
NARROW THE PRICE GAP

The main reason shoppers choose low-priced retailers is obvious: they're much cheaper. To avoid giving your customers a reason to shop elsewhere, then, the first requirement is to narrow the gap on price.

Of course, this isn't easy. Matching the low-price players on price isn't an option, given the difference in operating models. And because it will hurt you much more than it does the low-cost player, they'll probably have room to react by cutting their prices even further. A strategy of matching all shelf prices would be suicidal.

Fortunately, it's not necessary. **Most customers will pay slightly more for something a lot better. The problem is that nowadays many full-range retailers are only slightly better**, but a lot more expensive. To get back into contention, you need to narrow the price gap to a level that customers can accept, with a particular focus on core lines. What does this mean in practice? The "acceptable" level of price difference varies, based upon which customers shop each product category and how they shop it. It also depends upon how differentiated you are on other aspects of the offer. But today the price gap between traditional retailers and lower-priced competition is often at least 10% and, in some cases, can be 20% or more (see Exhibit 3). This is just too big for most customers. To be a realistic option, the difference needs to be no more than a few percentage points and, on directly comparable high-profile products, you may need to go further and match the lower-priced competition, perhaps backing this up with a price guarantee. This implies a ruthless, relentless focus on investing in price.

Exhibit 3: Distribution of products for traditional retailer based on price difference vs lower-price competitor



It might mean introducing a "discount" or "value" brand, if you don't already have one. The categories where this is important need to be carefully identified, as it's likely to be costly, particularly in the short term when it will be difficult to source product of appropriate quality. It's important to emphasise that the new ranges need to be comparable on quality with those offered by the lower-priced competition: offering lower quality at the same price won't work, and is likely to hurt the brand in the long run. Given that lower-priced competitors have a sourcing operation that's specifically designed to find the absolute best-value low-cost products, they are certain to have a cost of goods advantage, especially to begin with.

Managing the financial impact of introducing a new "value" brand is obviously essential, and this requires understanding switching within categories and knowing how much volume will end up in new "value" products, or in core lines where prices have been significantly reduced.

It's also important to consider how customer perceptions will be affected: if all you have is a few low-priced products "swimming in a sea" of much more expensive ones, it's unlikely that customers will think you offer great value. The key in both cases is to ensure that your range structure and price tiering step logically up from entry level to premium products, with a good choice of low- to mid-level ranges in between.

There are broader strategic considerations as well. If your price investments spark a price war with your traditional competitors across all markets, they won't be effective or affordable, so it's vital to make sure competitors are unwilling or unable to react. Pulling this off requires careful selection of the products to be featured, reliable estimates of the financial impact, and meticulous planning for an overnight roll-out of large numbers of price changes.

Finally – and most importantly – investing in price is emphatically not a one-off investment. Competing effectively takes a continuous emphasis on keeping prices down. And it's not limited to those lines that are matched to competitors, even though these are likely to be the priorities.

PLAY TO YOUR STRENGTHS

Closing the price gap is a defensive move. A traditional full-range retailer will never be able to offer better value than a discounter or online competitor; they can prevent price from being a major weakness, but it will never become a strength. When it comes to giving customers a positive reason for shopping with you, then, it's important to focus on the areas where you are significantly better than the low-priced competition. **To put it another way: your business costs more to run than theirs, so it's vital that you make the most of this**.

Exhibit 4: Stores are better environments for building baskets

	TYPICAL IN-STORE BASKET CONTAINING A PARTICULAR TELEVISION	TYPICAL ONLINE BASKET CONTAINING THE SAME TELEVISION
Items in rest of basket	4.8	1.3
Sales of rest of average basket	$103	$45
Margin on rest of basket	$39	$17

The meaning of "differentiation" varies by sector. In general merchandise, it's about superior service, deeper expertise, and an engaging shopping experience that limited-range discounters and online competitors just can't match. A bricks-and-mortar store with a broad assortment has some inherent advantages: it has much more potential for driving impulse purchases and building baskets (see Exhibit 4); seeing the physical product is always worth something to customers; and in many categories after-sales service is still important. Since customers have a reason to visit the store in the first place, then, a full-range player that can keep "showrooming" to a minimum can still compete effectively. Of course, this requires a narrow overall price gap, perhaps backed up with a price guarantee.

In grocery, the strongest differentiator available is a superior fresh food offer, and this is where supermarkets who have responded successfully to discounter and dollar-store competition have focused. By offering better quality, choice, and service along with a more engaging customer experience, some grocers have been able to bolster their position in the face of lower-priced competitors. In so doing, they have also driven significantly more customer traffic than their traditional rivals.

It's clearly essential to keep costs down while you strengthen the proposition. **The key to driving more customer traffic in an affordable way is to understand exactly what customers value, and how much they value it.** In other words, you need a clear idea of how much it's worth to them to be able to find store staff to ask for advice; to spend two minutes less waiting in line; or to be face to face with a full assortment of the products they might want.

Armed with this understanding, the next step is to identify cost-effective ways of differentiating yourself from lower-price competitors in areas that customers care about. It's important to stress the need to avoid wishful thinking: the key question is, "Will this be worth more to customers than it will cost us to provide?" If the answer is "no" – or if you can't be sure one way or the other – you need to look for other ways of differentiating your stores. Developing this level of understanding is difficult, but it can be achieved through the right combination of detailed customer research and analysis of store-by-store financial performance.

GET MUCH MORE EFFICIENT

Everything we've described so far comes with a price tag. Price cuts never really "pay for themselves;" they should be seen as part of a broader ongoing strategy of offering customers consistently good value over the long term. And investing in better service, higher quality, or new formats obviously costs money too. The challenge of funding these investments can appear insurmountable for retailers struggling with wage costs that constantly rise faster than prices.

In this context, the only solution is to build a much lower-cost business model. Without fatally undermining the proposition, full-range retailers can't hope to get their costs down to the levels that low-priced competitors achieve but, as with price competitiveness, they can narrow the gap. **Low-priced retailers ruthlessly drive out costs in areas of the business that customers don't care about. If a large mature retailer is to compete, it needs to do the same**.

Building a lower-cost business model and creating a differentiated customer proposition are two sides of the same coin: in both cases, the key is to understand what customers truly value and what they don't. A retailer that offers (for example) higher-quality products or more staff to help customers in stores does so because it believes customers value it, but it's essential that this be validated with the best evidence that can be gathered. Significant research, both qualitative and quantitative, needs to be carried out to guide the refocusing of the proposition. The guiding philosophy is one of achieving "value for money" as far as operating costs are concerned: ensuring everything you do is ultimately worth more to customers than it costs you to deliver.

Where do full-range retailers tend to overspend, relative to the things that customers care most about? Clearly, the mix of opportunities will vary greatly from one sector to another but, in our experience, two key areas are typically store labour that isn't customer facing (see Exhibit 5) and goods not for resale. Product assortments that are fundamentally inefficient are also common. For example, it's not unusual for grocers to carry too many SKUs in highly perishable fresh food categories. In attempting to offer "more choice" they drive down rates of sale, sacrificing product freshness and quality to such an extent that the customer experience becomes dramatically worse and the category's economics are undermined.

Exhibit 5: The difference in store labour costs between a traditional retailer and a lower-cost competitor

	TRADITIONAL RETAILER	LOWER-COST COMPETITOR		DRIVER	TRAD RETAILER	LOWER-COST COMP
Checkout	-2.5%	-1.5%	+1.0%	Checkout speed	8 sec	4 sec
				Cashier utilisation	85%	90%
Replenishment	-4.5%	-3.5%	+1.0%	% Volume hand-stacked	50%	25%
				% Volume in pallets	5%	30%
Service	-3.5%	-1.5%	+2.0%	Service FTEs per $10MM of sales	4.6	2.4
Management	-3.0%	-1.5%	+1.5%	Management FTEs per $10MM of sales	4.5	1.7
Total	**-13.5%**	**-8.0%**	**+5.5%**			

Promotional activity is another area of opportunity, since most promotions look more profitable (or less unprofitable) than they really are. They cannibalise more volume from competing products than is typically acknowledged, particularly when you take account of purchases "pulled forward" from the future. And their complexity imposes hidden costs throughout the business that aren't accounted for: the time taken to plan and execute promotions is a significant burden on traders, while the massive volume fluctuations they produce generates additional work in the supply chain and for the stores. In most retail sectors, then, selectively cutting back promotions can deliver significant gains to the bottom line.

TAKE THE LONG VIEW

The strategies we've described entail significant investment and major organisational upheaval. It's much better to choose to meet these challenges early on than to be forced to address them later, but this requires taking a long-term perspective that can be difficult to reconcile with the day-to-day pressures faced by a mature, publicly listed retailer. When times get tough, there's always a danger that buyers will sacrifice tomorrow's performance to meet today's earnings target by raising prices or cutting promotions. Meanwhile, investing to defend market share means acknowledging that tomorrow's performance is already under serious threat – never an easy prospect to face up to. Nonetheless, taking the long view is essential for three reasons.

Firstly, new competitors in a market usually start off small (see Exhibits 6 and 7). It's rare for a retailer to have the capital or the logistical infrastructure required to open a large number of new stores at once. In general, these early ventures need to succeed to enable further expansion, so when a low-priced competitor enters a new market, an incumbent has the opportunity to prevent them gaining a foothold. One way of doing this is through localised improvements to the proposition: prioritising store upgrades or refurbishments, increasing service levels, or introducing localised loyalty programmes or promotional activity. Of course, this requires recognising the new entrant as a threat rather than dismissing them as being "too small to worry about," and being prepared to invest now to avoid facing a much greater threat in the future.

Exhibit 6: In Germany, discounters started off small before growing to 40% of the market

MARKET SHARE OF DISCOUNTERS IN GERMANY

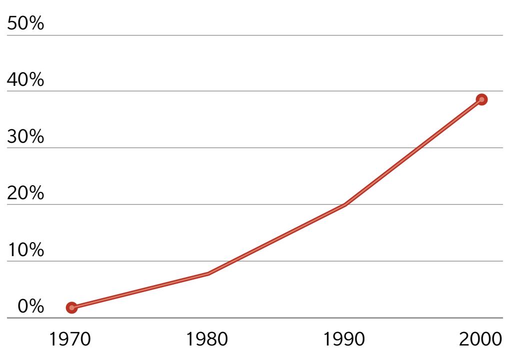
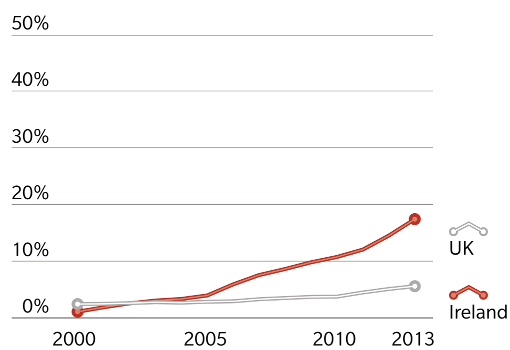


Exhibit 7: Now other markets are starting to see rapid growth of these previously small players

UK AND IRELAND MARKET SHARE EVOLUTION OF GERMAN DISCOUNTERS



Secondly, customer behaviour changes slowly: although many individual customers respond quickly to changes in competitiveness or the attractiveness of the proposition, a significant proportion doesn't. As a result, it usually takes at least two to three years to reach a new steady state of trading performance. These effects can be even slower if the new low-priced competitors start with an "acceptability" disadvantage, such as the social stigma associated with discounters for many years in the UK or distrust of online shopping in the early days of Amazon.

From the point of view of a traditional retailer, this is a mixed blessing. On one hand, it means that being uncompetitive on price today doesn't mean customer traffic instantly collapses. On the other hand, it makes inherent weaknesses hard to spot early, because their full effect only becomes apparent later. And it means that when you do strengthen the proposition, it takes a long time to reap the rewards. Patience and sustained commitment are essential.

Thirdly, you can learn a lot from new low-priced competitors. Some innovations are potentially worth much more to you than they are to a newcomer, because you already have hundreds of stores in which to implement them. And if their new format is clearly winning with customers, you may be able to develop a format of your own that replicates its best elements. The concepts that a new low-priced competitor uses against you can be highly effective against your traditional rivals – given sufficient time and investment.

Ultimately, then, fighting back against low-priced competitors requires single-minded and sustained commitment: it always takes a carefully planned programme of investments in price competitiveness and the proposition, spanning several years and funded by step change improvements in operating efficiency. Case Study 2 gives an example of what this means in practice.

CASE STUDY 2

REACTING SUCCESSFULLY TO DISCOUNTER ENTRY

Context

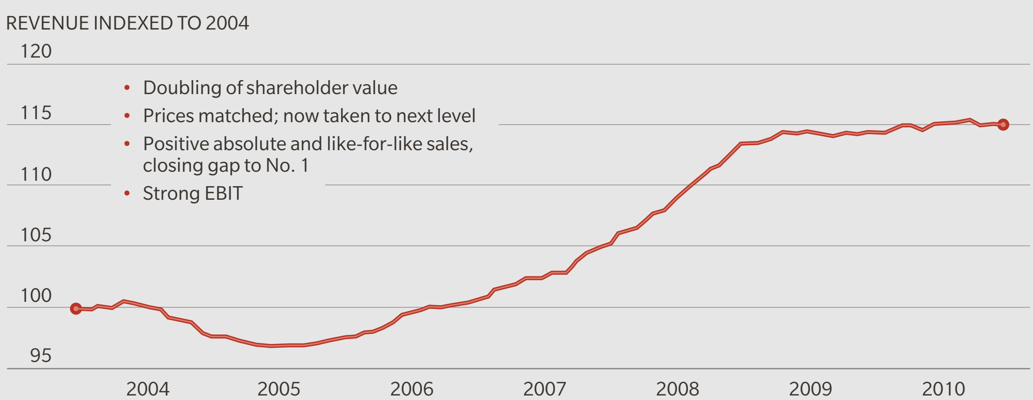
A grocery retailer with over 800 stores occupied second position in a concentrated market. The grocery retailer was suffering from negative absolute and like-for-like sales development and was being threatened by discounters entering the market. It had a proposition centred around offer and in particular brands and choice. Its price position was 5% above the market leader, with a much greater price gap to discounters. The grocery retailer recognised that it needed to become more competitive if it were to turn around its decline in sales.

What they did

- Took a decision to act early, before discounters had made significant inroads into the market
  - Set up a virtuous cycle of sustainable growth and funding – through a steady ordered series of initiatives over multiple years
- Closed the gap on value
  - Invested over 10% of sales in price (over five years)
  - And pre-emptively launched an entry-level own-label range to fight discounters
- Created an advantage on offer
  - Built a proposition based on trust and positioning themselves as the "agent of the customer"
  - In particular, reinvented the product catalogue and launched 20+ new own-label ranges to better meet customer needs
  - And localised range and space to better meet customer needs in each store
- Freed up cash to fund the investment in growth
  - Developed a series of funding initiatives and capability upgrades
  - These included optimisation of promotions, range optimisation, cost of goods sold sourcing reductions, and supply chain optimisation

Results

Exhibit 8: Revenue



CONCLUDING REMARKS

As we see it, the strategies described here are the best way for a traditional full-range retailer to fight back against low-priced competitors. Narrowing the value gap, reinvigorating the proposition, and ruthlessly driving down operating costs can make the difference between slow but certain decline, and a return to sustained profitable growth.

Of course, this isn't easy: the fundamental changes required pose a huge financial, organisational, and cultural challenge for a mature enterprise. But there are examples of retailers who have pulled it off, and in so doing have successfully fought back against discounters, online competitors, and their historic rivals alike. And while winning against the low-priced competitors might be painful, losing to them hurts a lot more.

THE DISCOUNTER THREAT

A conversation on front-line retail strategy

Hard discounters and aggressive e-commerce operators are gaining a foothold in many retail markets globally. With a fundamentally different business model to traditional retailers, their economics support low prices in a way that traditional retailers' don't.

We discuss this threat and what retailers can do to resist it in the previous article, "How To Beat Lower-Priced Competition." Our aim in this paper is to share the perspective from the front line: we interviewed Roland Berner, who was Senior VP of Strategy at REWE Group, a €50BN trading and tourism group based in Germany and operating in 15 countries.

Are you surprised by how fast the discounters are growing internationally?

ROLAND BERNER (RB) No – given the combination of external factors and internal strengths of the discounter business model, I am not surprised by the growth rates we've seen in the UK, the US, and many Eastern European countries. In the UK, for example, the recession helped discounters take off, but Aldi and Lidl actually sowed the seeds many years ago – so they were well prepared to benefit from the economic downturn. Because they are not under constant pressure from shareholders, they can afford to pursue a long-term strategy – they aren't forced to become profitable or grow rapidly in each market in a short time frame.

Why do discount formats seem to be easier to export than other formats?

RB Discounters have a winning combination: a transferable customer value proposition and an easy-to-implement business model.

Their customer value proposition and brand promise is consistent and clear. They bring something new to a country: they're not just another traditional grocer. That's something that many large retailers, who've been successful in their home country, seriously underestimate. And the discounters, especially Aldi, are also good at adapting to local markets. For example, in Switzerland there is a big focus on the local provenance of fruit and vegetables – while in the US stores are a bit bigger, with more SKUs, but still fundamentally stick to the core business principles.

Roland Berner

After acquiring a Master's degree in economics at Zurich University, Mr. Berner worked for seven years at Accenture, supporting clients in the retail and consumer goods industries. In 2003, he joined the Swiss Bon Appétit Group, initially as Marketing Director for one of its distribution lines and later as Head of Strategy. From 2008–2013, he was Senior VP Strategy of REWE Group. Today, he acts as an independent strategic advisor.

The discounters' business model is low on complexity and is now tried and tested in many markets. Its implementation is further supported by their willingness to pay for really good talent. They pay above the industry average, for both store personnel as well as management, and are creative with their incentives: in Germany, Lidl offers an Audi A4 to each of their 3,200 store managers who achieves his or her targets, representing a potential €100 MM investment in employee satisfaction and retention. Discounters also benefit from their attractiveness to local suppliers. While they are certainly tough negotiators, they have a reputation for fairness and bring with them large and steady volumes, without the complexity of highly promotional retailers.

From your experience of how the discounters evolved in Germany, how do you anticipate things will play out in other markets?

RB Having seen Aldi and Lidl in multiple countries, I think there is no standardised play. In some countries they are really bold and act quickly; in others they bide their time. What you can be sure of, though, is that they will be well prepared and persistent, and that they will be fast learners. It's a big risk for any established player to think that discounters will stay small. In fact, the discounters will use their small size to their advantage in the beginning – a price war will hurt them a lot less than the established players while their volumes are small. Then, once discounters become mainstream – once shopping at a discounter is no longer seen as something that's only for poorer customers but is also for the "smart shopper" – discounter growth becomes very hard to stop. In Germany, discounters now have over 40% of the market. I don't expect other markets to reach that level but I could see, for example, the UK reach 15–20% in the long run.

And of course, the situation is different for each market. In France, the market share of the discounters is actually decreasing from an all-time high of 16% in 2009. There are strong players, organised in cooperatives (Leclerc, Système-U) and highly focused on their home market, that have had some success fighting back against the discounters. In particular, Leclerc has an excellent price perception, promoting its own price comparison tool "Qui est le moins cher?" ("Who has the best price?") on the internet.

So is there such a thing as a "discount shopper"?

RB Yes and no. Yes, in that there are people who can't afford to shop elsewhere, and in many countries this group is growing in number. About half of all German households purchase more than two-thirds of their fast-moving consumer goods at the discounters.[1]

No, in that once discounters reach the acceptability "tipping point" almost anyone might be a discount shopper for at least some of their basket. New parents might be attracted by the prices of nappies and other baby essentials; other shoppers may use discounters for their staples and use the savings to go to more premium speciality shops for the rest of their baskets. In Germany, 85% of all households shop at Aldi at least once a year.

1 GfK Purchasing Power Europe 2013/2014, available at www.gfk.com.

What mistakes do established retailers make in competing with the discounters?

RB The most common mistake I have seen is underestimating the discounter threat, and only reacting when it's too late. Established retailers often see discounters as small, perhaps niche, competitors; then the discounters become widespread – and widely accepted – and it becomes very hard to stop them growing further.

Often, they also underestimate the performance of discounters in fresh food categories. They interpret a limited range as a poor fresh offering. However, that limited range allows incredibly high turnover, so it can be of very good quality. And it will consist of the core lines that are very important to overall price perception.

Finally, I've often seen retailers try to match the discounter prices through their entry price brands, but they fail to match the quality. These days, customers easily become aware of this via social media, forums, press, TV, and consumer protection organisations.

How do you think established retailers can best combat the threat from discounters?

RB The reality is that once discounters have reached the acceptability tipping point, established retailers will lose share – but those losses can be stemmed and won't necessarily be equal among all incumbents. It's important for retailers to recognise discounters' strengths and not let them build too big a lead on these dimensions, and also to develop or strengthen real points of differentiation that customers value. In general, I would advise retailers to react in two ways: by upgrading their value proposition to customers and improving their internal processes.

Developing a more competitive value proposition usually requires several different tactics, which together can make a difference. On price, the most critical thing is matching the discounters on entry price points – and quality, especially on fruit and vegetables. Retailers should also excel at delivering value through their own brands, not just copying discounters' ranges but developing a unique, high-quality, great-value range of their own. More broadly, retailers need other points of differentiation. This could be niche capabilities and services, speciality ranges that customers love and that discounters can't easily carry, or really relevant and value-adding loyalty programmes. Wherever possible, grocers should remove barriers and make shopping less difficult. This is something discounters do very well – shopping with them is easy. Established retailers need to focus on making shops easy to navigate, products and prices easy to compare, and check-outs and service counters efficient. Finally, they should play up the human factor where possible, aiming to bring not just efficiency but all-round excellence to customer service.

Internally, traditional retailers should look to reduce complexity. Complexity is a massive threat as it slows decision making and responsiveness while driving up costs. In particular these retailers should take a hard look at processes that involve lots of departments (for example, own brand processes which may involve category managers, buyers, and brand managers) as there is very often misalignment across these processes. Core and supporting processes need to be streamlined, responsibilities and performance measures need to be clarified, and incentives need to be aligned across the different parties involved.

Retailers should think about decentralising some decision-making power to the front line who have direct customer contact. This is a competitive advantage of large cooperatives with independent retailers, such as REWE Group and Edeka in Germany or Leclerc and Système-U in France. Finally, I think many retailers also need to upgrade their key competencies – especially category management, pricing and supply chain management, where intelligent tools can really transform the speed and quality of decision making.

Retailers will naturally turn to their cost base too, but it's usually very difficult to make a big move on costs. The biggest two cost items for retailers are personnel and rent. It would be very risky to try to change these on a large scale in a short time frame: there's a good chance that in doing so, traditional retailers would undermine their strengths and points of differentiation. Some of the improvement tactics discussed earlier, such as reducing internal complexity and bringing more efficiency to store operations, are good examples of ways to bring costs down with less risk.

A lot of that might sound obvious, but my experience of the German market would suggest it works not only in the fightback against discounters but also in the fight against other traditional retailers.

Are there any chinks in the discounter armour?

RB Just as traditional grocers encounter challenges as they try to become more like discounters, discounters also face challenges when they try to apply some of the traditional grocers' elements to capture more of the market. A few examples that come to mind are breadth of range, city centre locations, and opening hours.

If a discounter tries to increase its range or open smaller city centre locations, it will be deviating from the tried-and-tested formula and result in additional complexity.

Lengthening store opening hours breaks the formula in a slightly less obvious way. In the basic discount model, all fruit and vegetables are ideally sold by the evening and replenished overnight. Therefore, extending the opening times make it harder to compete with supermarkets on fresh food in the evening.

Should more traditional grocers be looking to launch their own discounters, especially if Aldi and Lidl aren't yet major players in their markets?

RB I think it's risky for a retailer to launch its own discounter, in particular if it's planning on running it as part of a large group. Traditional grocers are complex businesses with a broad customer proposition, while discounters are specialised. A good analogy is a decathlete versus a specialist sprinter: the decathlete may be a great all-round athlete but in a head-to-head 100-metre race the specialist will win every time.

In a large retail group, there tend to be so many internal processes that discounters don't have, adding complexity to what needs to be a very low-complexity business model. The cultural differences between an effective discounter and a large retail group also make it very difficult to copy discounters. So if a traditional retailer were to launch its own discounter, I would strongly recommend they run it as independently as possible.

Even Schwarz Group, which has Lidl as a traditional hard discounter and Kaufland as a larger format (but still applying some of the discount principles very successfully), runs the two as highly independent companies. However, it does not shy away from applying some of the hard discount principles to the Kaufland operating model.

Another interesting example is Carrefour's spin-off of its discounter Dia in 2011, going public at the Madrid stock exchange. Since the IPO, Dia's enterprise value has more than doubled and it's been trading well everywhere except for the French market, where Carrefour recently bought it back.

As well as the discounters, traditional grocers also face ever tougher competition from online retailers and convenience stores. Are these threats similar to the discounter threat?

RB In one way, the threats are similar: for the traditional grocers, simply trying harder with their current business model is not the right answer. E-commerce and convenience stores both have different business models, and this needs to be recognised.

But I think the big difference between the discounter threat and the upcoming e-commerce business and convenience stores is that the latter actually present big opportunities for traditional grocers. E-commerce can be a good fit for a traditional grocer and in markets such as the UK and France this is showing traction. In food e-commerce, there are two main models: the pure delivery model on one side and click-and-collect on the other. For the first, a trusted retail brand and deep customer knowledge are prerequisite (e.g., Tesco); for the second, the physical store base is an asset, as shown by the French hypermarkets and the growth they have achieved through this approach.

Convenience stores have similar competencies and brand promises to traditional grocers, although of course they face challenges of their own in terms of product range and logistics. So, like e-commerce, it may not be an easy area for traditional grocers to move into, but I think in many cases it's worth trying.

I suppose one other similarity is that, just as traditional retailers shouldn't underestimate discounters, they also should not underestimate the threat of e-commerce giants like Amazon or CPG players on ambient food and "near-food" products. Particularly on bulk items like toilet paper or nappies, you can see a path by which these players could cut out traditional grocers.

Overall, then, what do these changes mean for traditional grocers?

RB When we consider the different directions in which the market is evolving, we can see that clear format definition is disappearing. This can be tough for retailers who have had a successful formula that has been relatively unchanged over the years. Pretty much every retailer needs to be re-examining their business model and finding a new sweet spot between value proposition, key competencies, and economics.

LIPPINCOTT

EXPERIENCE INNOVATION

The next frontier to differentiate and drive growth

For many decades, the major focus of innovation efforts has been on the product. The persistent drive to add features, incorporate new technologies, and create niches has lead to breakthrough innovations. The strongest product innovators in software, electronics, consumer products, and automotive categories have created billions of dollars of economic value. Such innovation has spawned service winners as well: the perfectly designed credit card rewards scheme; the simplest mobile phone plan; and the healthiest, hippest quick-service restaurant menu.

Increasingly, however, companies are finding that certain returns from these product efforts are harder to rely on. Today's product innovations, and the growth they create, are often incremental, narrow and fleeting. Global competition and technology diffusion mean that competitors quickly match most improvements. And the radical transparency of digital and social media prompts consumers to quickly switch allegiance with each new alluring offer. For many of today's most innovative and up-and-coming brands, the product is not the star. This article from our sister company Lippincott looks at how customer experience is driving differentiation and growth.

A NEW TAKE ON INNOVATION

Companies are creating new value and gaining brand loyalty not by focusing on specific product features or design, but by reimagining the broader experience of how customers use their products. San Francisco-based car service Uber didn't change the vehicle or retrain the drivers; it fundamentally changed how you order, meet, and pay for vehicles for hire and car sharing services. Airbnb didn't redesign the travel portal or the hotel; it completely rethought how people can find the room they need. And while Gillette is looking at one more blade on the razor, innovator Dollar Shave Club arrives on the scene with a simple, low-cost mail subscription model, fuelled by social-media frenzy.

Even legendary product innovation leaders see they can increase sales by improving the experience. Nike Plus is innovating the fitness experience and the community, not the shoe. Tesla's electric car is truly like none other, but Tesla also allows you to buy it with one simple eDocs digital signature, request home delivery, and service the car with roaming technicians who can remotely diagnose issues.

Warby Parker saw that purchasing fashion eyewear is cumbersome and made expensive by the specialist optometry channel. So it redesigned the buying process, from beginning to end, to work over the Web. Warby Parker embodies the creative potential of great experience innovation – from the $95 price, to the donation of glasses to those in need for every frame purchased, to the cool flagship stores, the unusual packaging, and even the fact that they sell a monocle. Even traditional players see that innovating the experience creates real rewards: US car insurance company Progressive recognised that insurance can be a boring arm's-length relationship until you have an accident, where its on-site accident assistance provides huge relief in a stressful and unfamiliar situation.

These companies redesigned the customer experience – not just the traditional product features – to address unmet needs, create conversations and drive differentiation and growth.

By taking a broader view, each of these companies discovered adjacencies that wrap around their products or services to create an immersive environment. These companies have mastered a new discipline that we refer to as "experience innovation" – creating new ways to delight customers by taking a broader view of their lives and how they interact with your product, and delivering new, unexpected "signature" moments. These experience innovators solved customer problems in a way unique to their brands – with a rich array of experiences that surround and connect to the core offer. Increasingly, experience innovation trumps product innovation.

THE EXPERIENCE IS THE BRAND

Experience innovation, of course, is not new. Virgin's airport clubs, Nike's flagship stores, Starbucks cafés and Disney's Parks set the standard many years ago. These innovators show us that the experience isn't just about the planes, the shoes, the coffee, or the even the rides – it's about how we feel when we use the product or service.

But while many companies may recognise this, very few deliver or approach it the right way. In a recent Forrester study, more than 80% of senior business leaders say their companies are focused on improving their customer experience. And yet 85% of firms have no systematic approach to determine what a differentiated customer experience even looks like, let alone create one.

The reality is that innovating the experience is increasingly a competitive necessity. In today's digital world, with more brands and touch points than ever before, customers can quickly lose attention and affection. And mobile and social technologies enable your brand to accompany customers any place and any time, opening up vast new avenues to add value. Innovating on the experiences allows you to create conversation (as US mass retailer Target's pop-up store with Italian fashion house Missoni does), differentiate in unexpected ways (as Tesla does with offers to come to your home to service your car rather than making you go to a dealership), and enhance loyalty (as Amazon Prime does with its free shipping, limitless book borrowing, and digital streaming). Innovating the experience generally holds greater opportunity than advancing the core product. But it is also much harder.

A DIFFERENT MIND-SET

Achieving experience innovation is challenging for many reasons. Firstly, within an organisation, products are typically managed by one owner while an experience can have dozens of masters, all with separate goals and metrics. After a strategy is forged, changing an experience can require mobilising and energising thousands of employees, a much more complex organisational task than aligning the few dozens who lead the design of a product. Secondly, experience innovation requires mastering competencies that many organisations lack.

Improving the experience is usually thought of as an operational process, not one revolving around ethnographic insights, creative ideation, and blue sky visioning. On the other hand, innovating the product is often a focused exercise – how do we make the thing we make better? And thirdly, experience innovation requires thinking differently about your business, reimagining things that may be taken for granted. Experience innovation requires a new mind-set and a new process, with four guiding principles.

1. It's about creating delight, not just better products

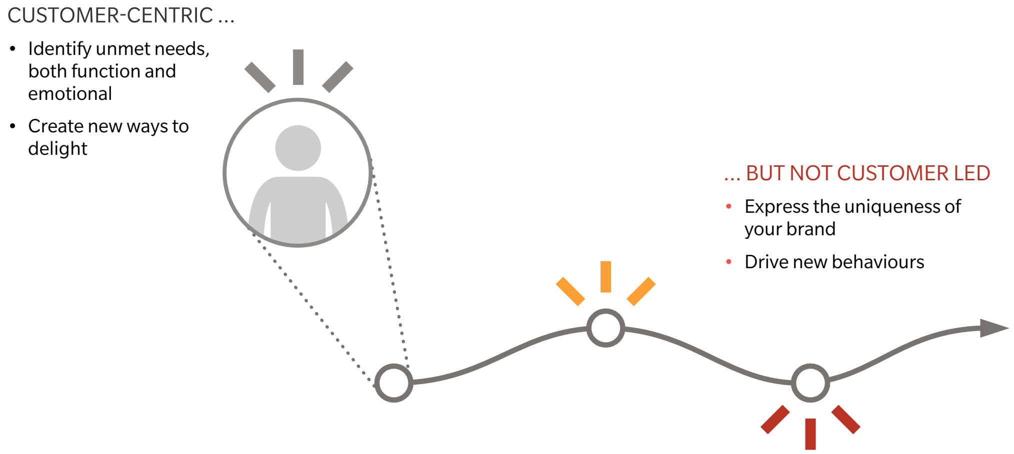
When companies focus on winning in the customer experience sweepstakes, they often fall into one of two traps: targeting specific touch points (such as customer call centres) instead of addressing the holistic end-to-end customer experience; or thinking in terms of operations and process efficiency instead of brand engagement, customer delight, and growth. Efforts can quickly devolve into mechanistic touch-point optimisation exercises: choose the most important touch points, benchmark the competition, pick key performance indicators, and execute and monitor operational improvement.

Experience innovation is as much about how to delight as how to deliver, how to identify the true emotional drivers of connection and loyalty. You remember the first time you got picked up by Virgin Airlines, the first time you walked into an Apple or Nike Town store, the first time you rented a Zipcar for an hour to get groceries, the first time you ordered a tall latte at Starbucks. You remember because the experience was totally new and different and fun, and made the product or service more appealing than the competition. These experiences are emotional markers for these brands.

2. It's about looking at the whole customer "ecosystem," not just where you play today

Finding innovation opportunities often requires looking beyond your narrow product category. Consider Apple, the poster child for product innovation. Apple's innovation is not so much in the product realm as in its focus on building a lucrative array of services to surround its products, and that has been the major driver of its success and growth. The iTunes ecosystem envisioned the entire music experience: innovating how music content was purchased, organised, and managed. And taking a product company into the retail space allows customers to engage with the product and its people – to feel the energy of the brand – as Apple captures the retail margin. Thinking about the larger ecosystem – the opportunities to meet customer needs in the spaces surrounding your core product or service offering – allows you to expand your base and opportunities for growth.

Exhibit 1: The difference between a customer-centric and a customer-led approach to experience innovation



Nike and Starbucks also see the world this way. Nike has surrounded its performance products with fitness clubs, tracking apps, social media, and community give-back programmes. Starbucks has now developed a larger ecosystem that extends beyond morning coffee into day-long “moments of connection” across multiple food and beverage categories. New formats include a wine bar concept with mobile payment and reward apps to enhance loyalty.

3. It’s about being customer-centric, but not customer led

Experience innovators recognise that consumers can’t tell you about the things they really need but haven’t yet imagined (Exhibit 1). And consumers can’t articulate how they will do things differently in the future. When Delta brought the lounge directly to the gate, it created a new experience among frequent travellers who had never thought of the gate as a café and social destination. The space takes advantage of Delta’s ability to deliver on its essence of “21st-century graciousness” in a way consumers might never have articulated in a focus group – and provides an opportunity for a new revenue stream.

4. It’s about connecting the total experience together under the brand, not just delivering “a breakthrough idea”

Finally, great experience innovation isn’t coming up with a single idea, but delivering a connected journey from one brand. The iTunes store, the Genius bar, and in-store education tie together to create a uniquely Apple experience. Disney delivers magic with bracelets that optimise your waiting time in the park, a reimagined cruise experience, vacation packages with a Disney twist in European cities, and carefully curated apps that bring the experience to life for kids. One distinct idea, even a big one, is usually not enough. Product innovation might rely on one-off improvement; experience innovation ties together multiple moments and experiences.

EXPERIENCE INNOVATION PAYS OFF

Experience innovation may be more complex than product innovation, but the rewards can be significantly greater. Focusing on the experience can create returns regardless of your degree of ambition.

At a basic level, you can create a series of connected unique brand moments – such as Starbucks' barista's ritual, personalised mobile app, and unique merchandising and store environment. Secondly, there is the opportunity to drive real preference with major signature experiences that differentiate and delight, such as BMW's distinctive vehicle delivery service and exclusive driving school. Finally, and most impactful, taking a broader view of the customer can unlock entirely new avenues for growth and business models. Hotel company Hyatt is opening an entirely new revenue stream by innovating the all-inclusive resort category with the new Hyatt Zilara and Hyatt Ziva brands, which offer a truly engaging and tech-enabled resort experience. The website allows you to plan differently, a chip-enabled wristband serves as the key to your room, and you can order a drink or lunch by the pool using your smartphone or tablet.

Innovating the experience finds untapped sources of differentiation to drive loyalty, preference, and margin. Behavioural science research shows that buying an experience, such as a vacation or a concert, is more rewarding than buying a product alone. The more pleasurable the experience, the more people are willing to pay. And great experience innovations create meaningful switching barriers – witness Nespresso's capsule subscription model or Uber's automatic payment capability.

It's often much easier to find differentiation to drive loyalty from an experience than a product

With one of our recent technology clients, we found 50% of customer renewals to be driven by the software's quality, ease of use, and functionality. But the other 50% was driven by the sales and needs identification process, the contracting, the education programmes, and the ongoing service. These experience elements could be improved almost two-fold with creative thinking and hard work, whereas product improvement had a ceiling of 10 or 20%.

The business models are more efficient. Investing in experience innovation does not mean higher costs. Many customer experience innovators reduce the cost to serve customers as they create better, more endearing experiences. Streamlining the process of buying glasses reduces selling costs for Warby Parker, allowing the company to offer more for less. Healthcare innovators such as US companies CareMore and Iora Health initially add costs by engaging wellness coaches who proactively engage patients to head off health problems. But this experience innovation saves orders of magnitude more than it costs by reducing downstream acute care costs.

The opportunities for growth are more abundant. Thinking about end-to-end customer ecosystems enlarges the "sandbox" in which a company plays and creates significant adjacent opportunities for new growth. The activities and services associated with using a product are often ten times the size of the market for the product itself. In the Apple example, iTunes attracts millions of downloads a day, and iCloud and AppleCare offer peace of mind for its customers. These ancillary services strengthen Apple's customer relationships, and they represent $12BN a year in incremental revenue. Nike's move into Nike Plus has opened up a whole new business beyond shoes and apparel. Experience thinking can dramatically expand the addressable market.

Given these payoffs, the shareholder value gains from experience innovation can be significant.

EXPERIENCE THINKING – A ROADMAP TO INNOVATION

The process of designing a truly innovative experience is complex. It can neither rest on the "process excellence" of classic customer experience improvement efforts nor the "creative brilliance" of the marketing team. Hard work, collaboration, and new tools and processes are required. In our experience, successful customer experience innovation needs to be grounded in these key elements.

1. Map your customers' world, broadly

Start with a broad and detailed exploration of the customer journey – and how it could be different. Don't ask customers what they need, but observe how they behave and what makes them happy or sad. Build a fact-based case: watch how customers behave and react at every step in the product experience, and use it to help you imagine new opportunities. Push yourself to think of new spaces where you could play.

2. Find points in the journey to change the game and make an emotional connection

Looking at the map of what people do (their most frequent touch points), assess what people could do. Think about what they will notice and what they will remember. Look for the big moves: can you take entire steps out of the process, change the sequence, add new value in unexpected places? But also look for the little moves, as they can be surprisingly powerful emotional drivers. (Disney unexpectedly opens the park gates five minutes in advance, feeding off the "I'm about to be at Disney world" thrill.) Focus on defining signature experiences that deliver not just functional enhancements but also emotional connections.

3. Connect experiences to each other and to the brand

Create an integrated vision for the future of your brand experience that is bold and forward-looking as a way of inspiring internal teams and setting a broad direction for innovation. Use a clear and proprietary set of guiding principles to make sure every moment tells your story and connects to your brand in a unique way. Think in terms of a portfolio approach in execution by balancing simple changes that build momentum with longer-term investments that require more radical changes and resourcing.

4. Engage the whole team

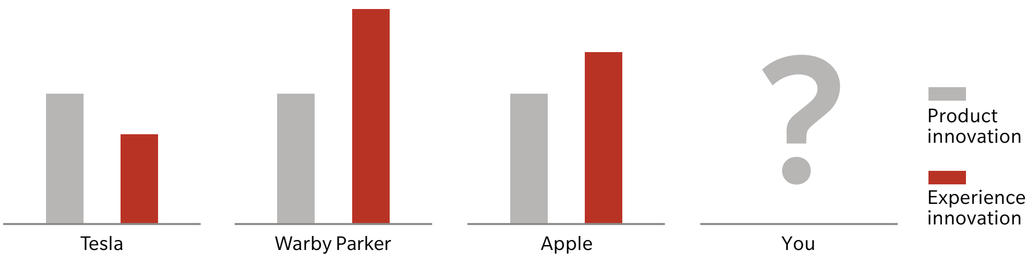
When broad-based, interdisciplinary teams take these steps together, surprisingly powerful results can ensue. Drawing on expertise across functions is essential to push the thinking on what is possible and to forge connections across operational silos to enable real-world success. But, beyond getting the strategy right, thoughtful organisational engagement is essential to execution. Successful experience innovation requires inspiring and training thousands of employees. The early involvement of leaders and frontline champions begins a process that should expand to inspire and transform the company.

EXPERIENCE INNOVATION IS A DIFFERENTIATOR

Experience innovation should not be viewed as a creative exercise or a new marketing gimmick. It is a new approach to business, with the aim of finding significant new avenues for differentiation and growth. Experience innovation gives you the opportunity to look at a spectrum of ideas – from category evolution to disruption – to maintain vitality and differentiation, as you redefine the ecosystem or restage your brand and drive new growth.

Ask yourself how much time and money your company devotes to thinking about how to innovate on the broader customer experience. If you're like most companies, 95% of innovation focus and resources goes into traditional product innovation. Shifting even a fraction of this effort and resource to experience innovation can yield big results (Exhibit 2).

Exhibit 2: Ratios of product innovation versus experience innovation in companies winning the hearts of consumers



Your brand is the sum of thousands of impacts and experiences that make or miss a consumer connection. How critical is a focus on customer experience innovation for your company? Ask yourself these questions:

- Do you innovate around key touch points to engage and delight your customers?
- What is the experience around your core offer?
- How must you define your brand to stay vital and relevant?
- What opportunities will create growth through experience innovation? How big is your potential ecosystem?
- What exciting signature moments can you create across the customer experience? Do you innovate around key touch points to engage and delight your customers?
- Do you meet as a group across functions and silos to talk about the customer experience and how you can improve it?
- Does your entire array of experiences connect together – and to your brand?
- What is your vision for your future?

To find out more about how Lippincott combines strategic thinking and creative excellence when turning brand possibilities into business results, visit lippincott.com or contact the head of Lippincott's Experience Innovation Practice, Randall Stone, at randall.stone@lippincott.com.

GOODS NOT FOR RESALE

How much value are you leaving on the table?

In tough times, retailers are always looking to increase operational efficiency and reduce costs. But there's one place they seldom look hard enough: goods not for resale (GNFR). GNFR typically represents around 25% of a retailer's total operating cost, meaning that it accounts for 6–8% of revenues. Despite its importance, GNFR is rarely scrutinised in the same way as other costs such as in-store labour – making it a major source of untapped savings, even for retailers who have already tried clamping down on spend.

The simplest way to deal with GNFR is through temporary cost cuts or simplistic budget adjustments: "no travel and entertainment for the time being," "take 10% out of the marketing budget," or "no new computers this year." These approaches are often perceived by employees as arbitrary, and they don't generate sustainable savings. Because ways of working and patterns of spending remain unchanged, costs creep back and, in some cases, even increase.

Even for retailers that have run significant GNFR programmes or built dedicated groups to address GNFR, the untapped potential often remains considerable. How can this be? In simple terms, this is because many purchasing categories are not covered or only the basic performance levers are pulled.

Only a small number of retailers have successfully set up a holistic GNFR operating system, adopting best practices from leading manufacturing companies. This capability gives these retailers a real competitive edge, generating substantial and sustainable savings, while at the same time leveraging supplier innovations to improve commercial effectiveness and the customer experience.

WHAT ARE GOODS NOT FOR RESALE?

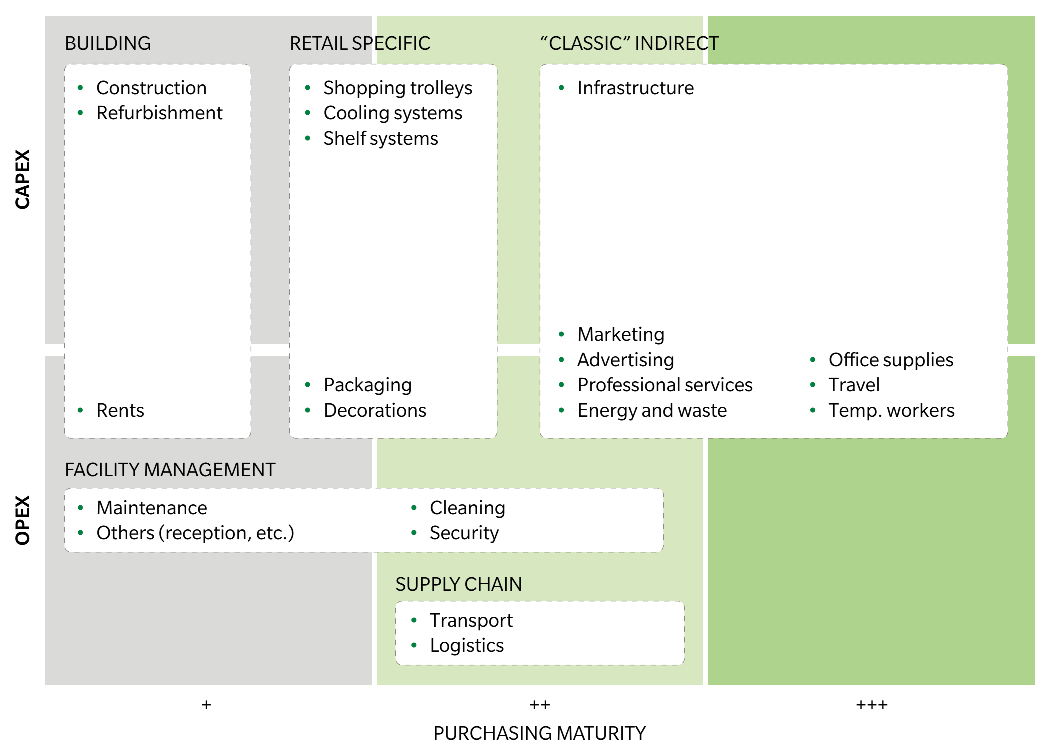
A common belief is that GNFR consists only of simple products and services, such as bags and cleaning, and that it's simple to manage. This is wrong in a number of respects.

Firstly, GNFR has various segments that require different approaches, and where retailers' cost management capabilities tend to be at very different levels of maturity, as shown in Exhibit 1:

- **Consumables** (for example, checkout bags, packaging for fresh products, anti-theft devices) characterised by low unit prices, high purchasing volumes, a fragmented supplier base, and high volume purchase orders. In some ways these can be similar to goods for resale (GFR) when it comes to procurement
- **Equipment** (for example, store shelves, cooling systems, power equipment) requiring a comprehensive and often complex total cost of ownership (TCO) view, detailing several cost dimensions such as installation, maintenance, spare parts, and energy consumption
- **Services** (for example, IT services, cleaning, security, temporary labour) requiring complex standardisation and volume pooling arrangements across stores

Secondly, GNFR covers both operating expenses and capital expenditures, both of which require specific budgeting constraints and dedicated decision processes. This complexity makes it difficult to see the integrated financial picture: if real estate purchases elevators but operations pays for their maintenance and repair, it can be hard to know what they really cost.

Exhibit 1: GNFR macro spend categories and typical maturity levels



Thirdly, some GNFR categories can be considered as highly sensitive, making them "exceptions to the rule" when it comes to managing costs. This can be because of:

- Internal organisational prerogatives: IT, marketing, and logistics, for example, are often "protected areas" outside the scope of procurement
- HR considerations: some policies may impact on employee morale (for example, travel and entertainment, company vehicles)
- Visibility to customers: cutting spend in customer-facing areas (such as store cleaning, checkout bags, cooling equipment reliability, or checkout systems) can translate into lost revenue

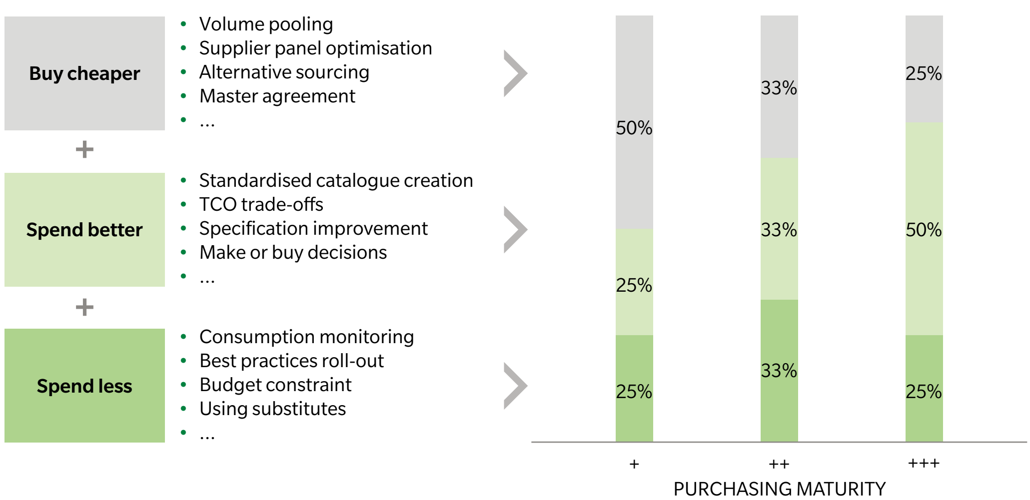
And finally, GNFR is characterised by large numbers of prescribers and users scattered throughout the organisation, meaning that decision-making processes are highly decentralised. This in itself gives rise to some major challenges. What this means is that retailers' scope is usually too narrow when it comes to managing GNFR expenditure. In general, the spending being considered accounts for less than half of the total cost base, and the ways retailers think about reducing it are too limited. As a result, most of the available value remains untapped.

WHAT'S AT STAKE?

GNFR is a significant cost item, typically representing 6–8% of a retailer's total revenue. In our experience, there is scope to reduce GNFR spend by between 10% and 15% of savings over three years: a total cost reduction of 50–100+ basis points. In any retail sector, the value at stake is enormous. But achieving these results takes much more than simply optimising procurement transactions through renegotiation or volume pooling. Fundamentally, there are three ways to manage GNFR costs: buy cheaper, spend better, and spend less – Exhibit 2 shows the savings potential of each. To get the most from GNFR optimisation, all three must be applied in a coordinated way.

Exhibit 2: Three performance macro lever types to be leveraged

GNFR SAVINGS POTENTIAL



Buy cheaper

Most retailers focus their GNFR cost reduction efforts on a subset of the things they buy, and on buying cheaper: in other words, purchasing essentially the same products or services for a lower price through enhanced competition, pooled volumes, or renegotiation with suppliers. Of course, this is often where quick wins are found and where there will be the least friction between procurement and the rest of the business. But innovative or alternative levers can offer additional savings: for instance, some retailers have set up disruptive anti-theft devices or more creative sourcing schemes, leveraging low-cost countries sourcing price opportunities combined with their GFR import structure to optimise total costs.

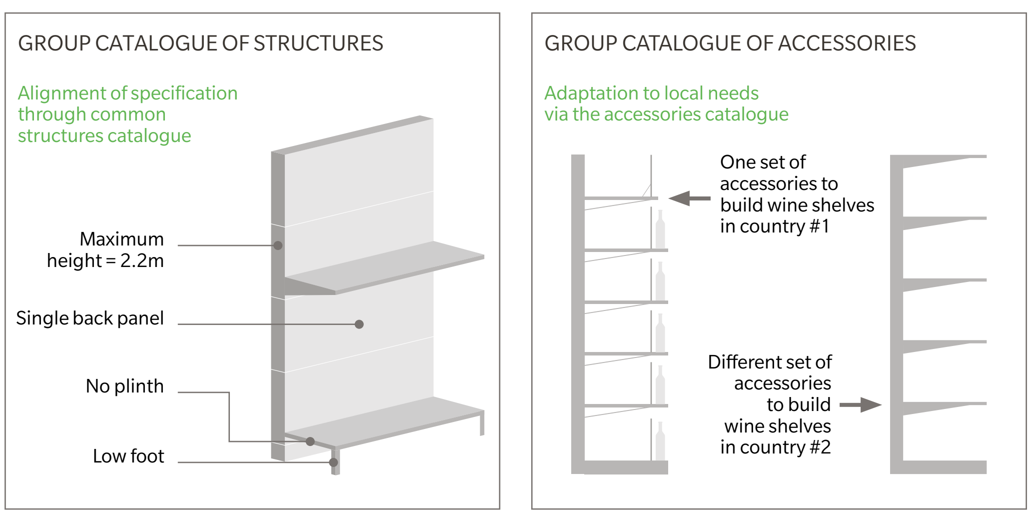
Spend better

Spending better is about shifting the focus from the product being bought to the business need it satisfies. This might mean challenging specifications or ensuring the actual "need" conforms to catalogue standards; in all cases, the aim is to have an impact on the procurement activities downstream.

For instance, when specifications for store shelves are managed locally in different countries and for different formats, the final number of SKUs purchased can easily total several thousand, and this naturally constrains the buyers during negotiations. To reduce this complexity, some retailers have set up a common standard for shelf structures based on corporate rules combined with a catalogue of accessories, as shown in Exhibit 3. This enables them to take into account all local variations: each country can "rebuild" its own store shelves by using different accessories, and buyers can pool volumes based on simplified and common standard catalogues.

Exhibit 3: Store shelves spend optimisation example

How to limit SKU proliferation while keeping local market specificities



Spend less

Spending less – in essence, reducing volume – is conceptually simple but tricky to implement. In many cases it isn't worth optimising costs by buying cheaper and/or spending better unless consumption volumes are also tightly monitored. Spending less requires that consumption monitoring metrics are developed, shared objectives are defined, consumption rules and policies are set, and a culture of cost control is established – for every procurement category across the entire organisation.

Take in-store energy use, for example. Here there are several tactics a retailer might employ to reduce consumption. Energy consumption labels can encourage more efficient behaviour by store employees. Sub-area energy meters can monitor energy consumption profiles (areas, hours, seasonality) and be used to create action plans for optimisation. New, lower energy consumption target levels can be set. And communication programmes can be set up to enable sharing of best practices across stores and to create awareness among employees.

Moreover, optimising GNFR in these ways typically has positive side effects:

- Performance initiatives can reinforce the eco-friendly image of a retailer, such as energy consumption optimisation, biodegradable checkout bags, waste management optimisation
- Performance initiatives can also encourage more innovative solutions from suppliers, support the development of sales, or improve in-store productivity
- Finally, a GNFR costs initiative also has a positive "social" perception as it targets cost reductions without impacting on the labour force

UNLOCKING THE POTENTIAL OF GNFR

In our experience, there are five different things a retailer needs to do to unlock the untapped value of GNFR cost optimisation:

1. Support the programme starting from the top – and go all the way to the bottom

CEO and CFO involvement is essential not only to create momentum and buy-in throughout the organisation, but also when objectives are being defined and cascaded down to the operational management layers of the company (for example, when setting store budgets). If the objectives are not aligned across the company as a whole, GNFR optimisation goals are never likely to be achieved. Making sure targets are cascaded down to the different business owners is therefore essential.

2. Invest 5% in strategy and 95% in execution

The fragmented nature of GNFR spend means that optimising entails managing a programme that covers several thousand individual performance actions – by country and region, by store, and by category. Getting the details right is essential, because savings don't come from a handful of key initiatives that deliver 80% of the benefit but from a very large number of small initiatives, some global, some local. Delivering a programme of this size, scope, and complexity requires strong project management capabilities, and the establishment of tools and methods to prioritise appropriately, allocate resources, and monitor progress.

3. Drive change through words and deeds

Change management is essential for such initiatives. To convince sceptics, recommendations need to be supported by fact-based business cases and tangible analysis. And when it comes to changes in usage or specifications, management need to be exemplars, championing the shift in culture required. A coordinated communication plan will be needed to support the change process, and this is a major commitment in itself. It might require a "roadshow" to visit every store, highlighting how proposed changes affect the bottom line and explaining how they have been arrived at – with particular attention paid to any changes that will be visible to customers.

4. Set up a new operating model for GNFR

Bringing GNFR costs down significantly – and keeping them down – always requires a new, holistic approach. This means hiring professional buyers for each category, paired with a lead prescriber to define shared technical and procurement strategies: these buyers need a career path that offers similar opportunities as for GFR buyers, and there should be opportunities to move between GFR and GNFR. It requires striking the right balance between the level at which a procurement category should be managed (worldwide, national, or regional) and the way internal clients (prescribers and users) are organised. And it means securing rigorous and systematic provisioning processes that extend right down to store level to track user satisfaction, monitor spend, and ensure compliance with master agreements.

5. Secure bottom-line impact

Making sure that the impact of cost reduction really does make it to the bottom line is vital for demonstrating success and sustaining support for the programme. Savings targets must be embedded in the budgeting process to avoid them simply "evaporating," and there needs to be a detailed reconciliation between expected procurement savings and actual financial impact to ensure buy-in from all parties involved. Building an e-procurement tool is one way to ensure effective contract enforcement and track consumption evolution.

CONCLUDING REMARKS

To get the most from GNFR optimisation, it needs to be much more than just "another project from the procurement department" and to go far beyond "cost cutting" or "negotiations." If a leadership team really wants to maximise the value of such a project, and systematically explore and exploit all cost levers, this will mean mobilising and engaging with the entire organisation.

When GNFR optimisation projects are addressed in this way, they can generate enormous benefits, greatly improving a retailer's overall profitability and freeing up funds to invest in new growth opportunities. Capturing the savings available is a real challenge – but the value at stake makes it one worth meeting head on.

REDUCING FOOD WASTE

How can retailers help?

Sustainability is a high priority for most retailers, and food waste is a problem that attracts significant political and media attention. Many individual retailers have launched programmes aimed at addressing it, and some retail leaders have been particularly vocal: for example, in a 2013 article carried in the Telegraph, retail giant Tesco declared "war on food waste." And the industry as a whole has also responded: associations such as the Food Waste Reduction Alliance in the US, the Waste and Resource Action Programme (WRAP) in the UK, and the Retailers' Environmental Action Programme (REAP) in Europe have all been established with waste reduction as their primary goal.

In a debate where emotions can run high, the supermarket chains have often been cast as the villains. This characterisation is unfair: over the past few decades, large retailers have achieved huge improvements in supply chain efficiency, and the proportion of food thrown away by today's supermarkets is small and getting smaller. Waste generated by retailers today is dramatically lower than it was a decade ago. Even so, there remains room for improvement, and much that can still be done. But waste at the retailer level is only part of the problem – in fact, it is the smallest part of the problem.

Food moves from "farm to fork." Broadly, it makes a journey in two steps: from the farm to the retailer, and then from the retailer to the customer. At the "farm" stage, overproduction, poor supply and demand balancing, and inefficient supply chains all contribute to significant waste. Although these losses can be large in volume terms, the fact that the product is at the beginning of the value chain means economic losses are less pronounced (although still considerable).

Upstream losses are substantial, but by far the greatest waste takes place at the "fork" stage. The fact is that the biggest wasters of food are consumers themselves. Losses in the homes and refrigerators of ordinary consumers have grown relentlessly over time, as disposable incomes have increased and lifestyles have changed. And because consumers are at the end of the value-added chain, the economic cost is enormous.

Of course, food retailers can't dictate customer behaviour – but they can still influence how much ends up in the bin. This article discusses some ways retailers can reduce not only the food waste they themselves generate but also help their suppliers and their customers to do the same.

THE FOOD WASTE PROBLEM

Food waste is a significant problem. The United Nations Food and Agriculture Organization estimates that one third of human food production is lost or wasted globally,[1] around 1.3 billion tonnes per year. Waste occurs in all parts of the value chain, from post-harvest processing through supply chain to stores and consumers. Exhibit 1 highlights the leading causes.

It's important to acknowledge that not all food waste is equally costly, since a tonne of produce lost immediately after harvest has much lower value added than the same tonne of produce thrown away by consumers. **The further down the value chain that food is wasted, the more costly it becomes, both in monetary and environmental terms; the economic impact of food loss at the consumer stage is a multiple of losses that occur upstream**.

Exhibit 1: Typical causes of food waste

IMMEDIATELY POST-HARVEST

- Improper storage (temperature, humidity, vermin)
- Spillage
- Grading

PROCESSING, PRODUCTION, DISTRIBUTION

- Disposal of product not meeting quality or cosmetic standards
- Overproduction
- Malfunctions
- Spillage
- Damaged or improper packaging

RETAILER SUPPLY CHAIN

- Improper sales/ demand forecasts
- Overstocking of ultra-fresh products
- Improper storage
- Improper handling (e.g., temperature)

RETAILER STORES

- Improper sales/demand forecasts
- Improper storage/ presentation
- Improper handling
- Quality/cosmetic standards of products without best-before date
- Nearing of best-before date
- Visual stocking criteria (full shelves)

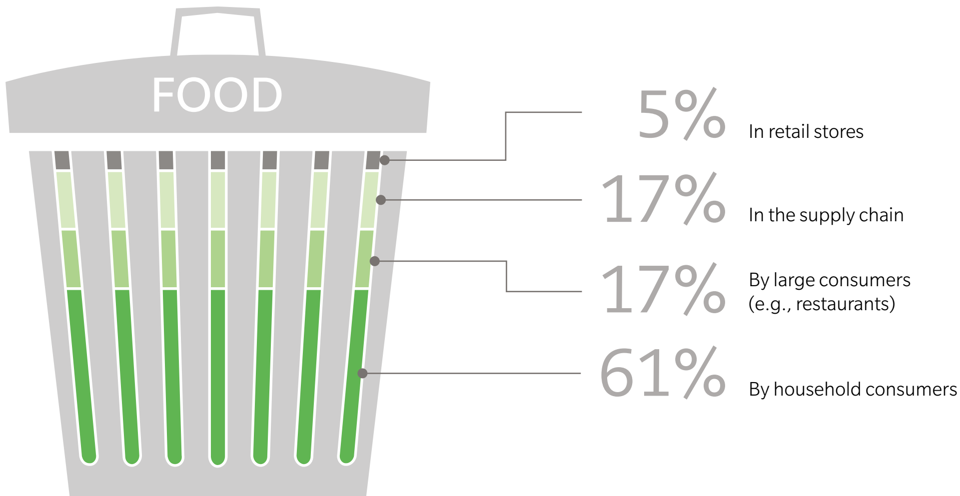
HOUSEHOLDS

- Overstocking
- Not consuming in first-in, first-out order
- Improper storage
- Misinterpretation of best-before dates
- Elevated quality/ cosmetic standards
- Misjudged preparation volumes
- Preparation mistakes

1.3 billion tonnes of food waste per year

1 Food loss is defined as the mass of edible product meant for human consumption that is redirected from human consumption upstream of retail in the food chain, whereas food waste is the loss occurring at retail level and downstream; for simplicity, we have subsumed both types under "food waste."

Exhibit 2: The majority of food wastage in Germany is by household consumers



Source 2012 Study by Stuttgart University, sponsored by German Federal Ministry of Food and Agriculture.

And in developed economies, the fact is that the majority of the waste (both in value and volume terms) occurs at this level. In 2012, UK households wasted 19% of all food and drink brought into the home; 60% of this waste was avoidable.[2] Total food waste in Germany is estimated at 11 million tonnes per year, which amounts to around 130kg per capita. As shown in Exhibit 2, 61% of this is accounted for by the end consumer, 17% originates upstream in the supply chain, and only 5% is directly attributable to retailers.[3]

To a large degree, then, food waste is a problem caused by consumers rather than businesses. But although retailers' direct contribution to food waste may be relatively small, they are still clearly in a position to help their customers waste less – a key point we will return to.

DRIVING DOWN TOTAL SYSTEM WASTE

Waste is a problem for retailers, but it is not a retail problem per se: it is a system issue. Each part of the chain from "farm to fork" plays its part, for good or bad. Retailers can take a leadership role, not only by addressing their own shortcomings but also by helping other players in the system to improve. Reducing total system waste is the goal, and retailers are in a unique position to contribute towards achieving this goal – as the rest of this article will discuss.

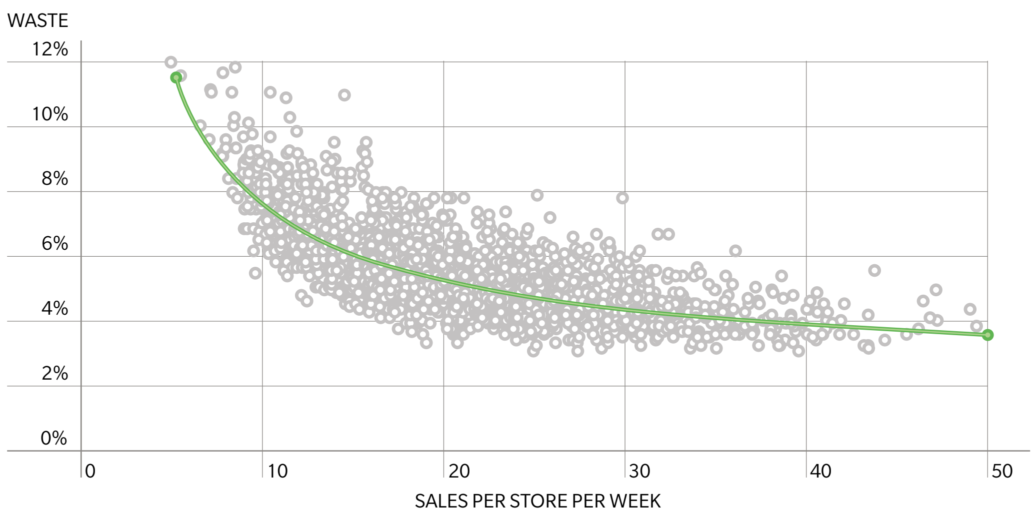
2 Wrap Report: Household Food and Drink Waste in the United Kingdom 2012.
3 2012 Study by Stuttgart University, sponsored by German Federal Ministry of Food and Agriculture.

REDUCING WASTE WITHIN THE RETAILER

As we mentioned earlier, waste at the retailer – either in the supply chain or in stores – is not the primary contributor to total food waste. One reason is that food retailers have grown to a much larger scale. As Exhibit 3 shows, perishables waste decreases dramatically as a function of sales volume: in our experience, a doubling of store sales reduces the proportion of waste by between 20% and 40% (assuming the assortment stays constant). This implies that today's high-volume grocery stores are much more efficient than their smaller predecessors, and underlines the critical role that volume plays in the fresh food business.

Exhibit 3: Higher-volume grocery stores operate at lower waste levels

Examples of waste in fresh categories across one retailer's store estate



But although they achieve high levels of efficiency, most retailers still operate with significant fresh wastage levels. It is difficult to keep an accurate account of all types of waste in the system – known and unknown – and only a minority of retailers have true transparency over the real volume lost. Depending on the product category and store, waste as a percentage of sales can range from the low single digits up to the high teens. For many retailers, then, there remain significant opportunities to reduce waste, and to generate significant profit increases at the same time.

In our experience, there are three changes that can deliver big benefits:

1. Get the right volume into stores at the right time

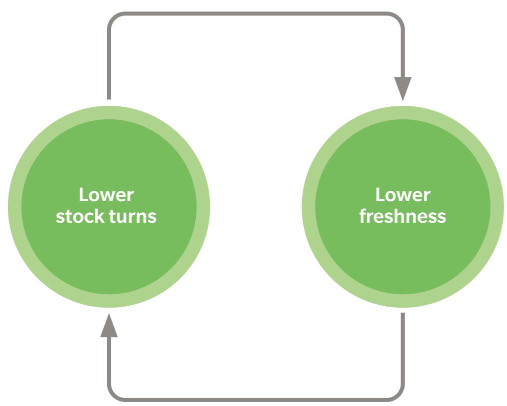
The closer the match between customer demand and the volume of product in the store, the lower the potential for waste. Clearly, all food retailers take forecasting and ordering seriously – but the difference between being "OK" and being "best in class" is very significant. Some retailers still rely upon relatively basic approaches, such as paper-based order books in the stores. This leaves considerable room for improvement – in some cases translating into reductions in waste of up to 35%, with corresponding benefits to earnings, both in the form of reduced losses and the avoidance of lost sales, and the difficult-to-quantify, but nonetheless real, customer perception benefits.

Of course, improving forecasting and ordering isn't easy, and presents some real systems challenges. But it is often possible to make material gains without undergoing radical surgery: for example, by giving stores more accurate forecasts, and better information and guidance when placing orders, or by improving operational practices within the store. Please see the Oliver Wyman article "A Retailer's Recipe: Fresher Food and Far Less Shrink" for more detail on this topic.

2. Consolidate range where this will improve freshness and reduce waste

Retailers always want to offer customers the best choice but, before adding a new stock-keeping unit (SKU), it's vital to consider the freshness and shrink implications for the range as a whole. For a given level of store traffic, there is a limit to the breadth of the perishables range that can be on sale without producing massive increases in waste: the key is to avoid offering so much choice that the rate of sale of slower-selling products drops below a critical level. Getting this wrong initiates a vicious circle, as shown in Exhibit 4, in which lower stock turn translates into worse freshness, and worse freshness translates into even lower stock turn, with disastrous implications both for sales and for the level of waste.

Exhibit 4: Low rates of sale on fresh items initiate a vicious circle



In particular, **adding products that are duplicative with existing choice, products which the consumer sees as interchangeable, is a sure-fire way of reducing overall stock turn and increasing waste**. In retailers with significant waste problems, then, re-examining the range and deleting slow-moving tail products that are highly substitutable will normally drive a significant improvement as sales are consolidated onto remaining lines, driving increased turn, reduced wastage, and increased freshness for customers.

3. Optimise handling of best-before dates

Another source of retailer waste is allowing multiple "best-before" or "use-by" dates on the shelf, which leads to "date sorting" by consumers and an inevitable trip to the bin for the product with the shortest life. This presents a dilemma when it comes to reducing food waste: some of the strategies available might be profitable for the retailer, but effectively just shift the problem onto the consumer and ultimately generate even more waste downstream.

Dealing with forecasting and assortment is a prerequisite for solving the “best-before” conundrum. Better forecasts and a “right-sized” assortment mean that lower levels of safety stock can be held, which means less product and fewer date codes on the shelf. Beyond this, better operational discipline is the key: strict stock rotation, and tight replenishment practices, which ensure that the product is only taken from the back room to the shelf when existing stock has almost sold through.

Another option for managing waste can be in-store production. Where the operating model allows, perishables nearing the end of their life can be transformed into a ready-to-eat product in store, for example through a salad bar or as part of a store-produced convenience range. Of course, in-store production is complex and labour-intensive, and can generate even more waste if poorly implemented but, for some stores, it may offer a significant opportunity.

HELPING SUPPLIERS WASTE LESS

Retailers have only an indirect influence on how much food is wasted by their suppliers but, because the absolute level of waste is usually greater, it can nonetheless be a big opportunity. And, since retailers’ choices can have a strong effect on many of the drivers of waste, they can make a good claim to a share of the cost savings that can be achieved.

In our experience, two initiatives that do not require significant capital investment, but which often produce significant gains, are collaborating on demand planning, and better management of grading requirements and quality control.

1. Collaborate on demand planning

When it comes to demand planning, suppliers and retailers sometimes operate at arm’s length. While not always easy to achieve, closer collaboration can help reduce waste by helping suppliers cope with the volatility of and uncertainty in demand for their products.

There are three reasons that fresh food categories present particular challenges for suppliers. Firstly, underlying demand, and sometimes supply, tends to be extremely volatile – for example in produce, where the weather has a strong effect on both harvests (and therefore product supply) and customer demand.

Secondly, promotions generate demand spikes that create a “ripple effect” throughout the supply chain and cause inventory build-ups, overages, and, ultimately, waste. This affects not only the promoted items themselves but also other products that are “cannibalised” and suffer an unexpected drop in demand as customers switch to the product on promotion.

Thirdly, trading events such as range changes, or changes in which products are distributed to which stores, occur frequently in fresh categories. These often impact on the demand mix of the entire category.

Suppliers therefore face a lot of uncertainty about how much product they will need to provide. To avoid being caught out by changes in volume and to maintain a high service level for the retailer, producers feel the need to keep safety stock on hand, or require long lead times. Both have a detrimental impact on freshness and, ultimately, on food waste.

Reducing this uncertainty can create benefits for suppliers, retailers, and consumers alike. For the supplier, it means lower inventory costs and a better ability to plan production. For the retailer, it means fresher product, less waste, and better in-stock position, resulting in higher margin and more sales. And for the consumer, the product is fresher and keeps longer.

Better collaboration and information sharing is the key to achieving this. Most retailers use forecasting to drive their replenishment: sharing these forecasts in advance with suppliers will take guesswork out for them. And at the same time, systematically measuring cannibalisation during promotions gives both retailers and their suppliers a better idea of which products are likely to be affected, further reducing uncertainty about levels of demand.

2. Manage grading requirements and quality control

Stringent grading requirements are a significant contributor to waste in the supply chain, although they aren’t as disastrously wasteful as is popularly believed: manufacturers of processed foods themselves demand massive quantities of fresh products, so it clearly isn’t the case that every apple or potato rejected by a supermarket on cosmetic grounds gets thrown away. Nonetheless, by loosening such rules, retailers can help their agricultural suppliers sell more of their products, and hence reduce waste.

Managing grading rules to allow more variation has been on the agenda for some time, but there are also opportunities to address genuine quality differences. A tiered range architecture – with entry-range, own-label, branded, and premium products – has long been in place for many product categories. In fact, some retailers already offer different grades of produce, with lower-quality options selling at a considerably lower price point than the premium offer while keeping the overall margin mix of the category attractive.

However, stringent grading requirements are not the only reason that produce gets rejected by retailers. Often, product is sent back at the receiving dock because of process failures. Standards are sometimes not sufficiently clearly defined or communicated. Sometimes changes to quality standards are agreed throughout the season between buyers and suppliers but may not filter through the retailer’s internal communication channels. And in some cases, stores and depots use different criteria when deciding whether to accept or reject a batch.

A best-practice quality control process is key to ensuring that product is never rejected without good reason, whilst maintaining the highest standards of quality and food safety. This requires clearly defined and transparent standards, consistently communicated and applied throughout the entire value chain, from producer via distribution channels to stores and, ultimately, consumers.

HELPING CUSTOMERS WASTE LESS

Most food waste happens at the consumer end of the value chain. But it's important to acknowledge that much of it is the result of deliberate choices rather than simple negligence.

Where this is the case, it may be very difficult, inconvenient, or costly to reduce. For example, shopping for groceries every day would reduce waste but would be a lot less convenient than buying food for several days at a time, even though some of it might then spoil. It's therefore important to distinguish between "structural" waste, where customers' lifestyles and choices make some level of waste inevitable, and "preventable" waste, such as throwing away food after forgetting it was in the fridge and buying something else instead. As retailers look to help their customers reduce waste, it makes sense to focus on the latter – and to recognise that, precisely for the reason that most food waste occurs in the home, there are likely to be real constraints on how far it can be reduced.

Grocery chains are sometimes accused of having a strong vested interest in consumers wasting food. We fundamentally disagree with this view, and see reducing waste as more of an opportunity than a threat for retailers. Any risk of lost sales is small: helping customers waste less will only ever be a slow and gradual process, which will need to be achieved in spite of rising incomes and more diverse lifestyles.

Exhibit 5: Importance of access to quality fresh food

Proportion of consumers that say access to the best quality fresh products is the most important consideration when choosing where to shop

COUNTRY	PROPORTION
United States	70%
United Kingdom	60%
France	52%
Germany	43%

Source Oliver Wyman Fresh Survey and Analysis.

Meanwhile, the demand for fresher, higher-quality food continues to increase, and providing it becomes an ever stronger source of competitive advantage. Exhibit 5 shows how important access to the best-quality fresh products is when customers are choosing where to shop. And although consumers might struggle to waste less food, this doesn't mean they don't acknowledge or appreciate retailers' efforts to help them.

At a simple level, there are two ways in which retailers can help customers reduce waste:

1. Have fresher products with longer life on sale in stores

Consumers often plan meals in advance but their plans can change. As a result, a lot of consumer wastage is driven by insufficient freshness upon time of purchase, not giving customers long enough in which to consume the product and so building inflexibility into their meal planning.

Improving freshness on the shelf usually requires improving product velocity and handling through the supply chain. In fact, **developing a faster, more sensitive supply chain reduces waste not only for customers but also for retailers and their suppliers**. Why? Because there are two fundamental drivers of food waste in the supply chain.

The first driver is the time spent between production and the product getting to the shelf: every hour and every day spent in the chain reduces the life of the product and makes it more likely to end up being thrown away. The second is how the product is treated: many fresh products are highly sensitive to poor handling, so quality can suffer as a consequence of improper treatment in the supply chain. These fundamental drivers have a powerful effect on how much food ends up being thrown away by customers, as well as how much is wasted by retailers and their suppliers.

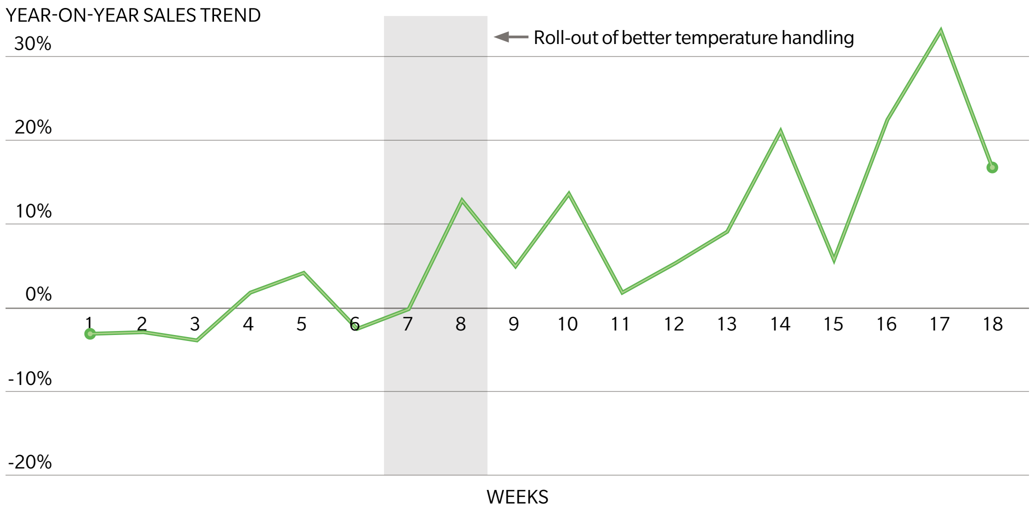
Fresh product can spend too much time in the supply chain for a number of reasons. Too much inventory in the supply chain will mean that product doesn't turn fast enough. The number of distribution tiers in the supply chain also affects its speed: bundling distribution platforms can help consolidate inventory at a single point and reduce it in total. Receiving, picking, and delivery are organised on a recurring schedule, and this can mean time is lost by product sitting and waiting for the next process cycle to start.

Better synchronisation can speed things up and improve freshness: for example, optimising delivery frequency to stores or synchronising warehouse receiving times with suppliers' operating schedules. In an ideal world, a strawberry can be picked from the field in the early morning hours, arrive at a retailer's depot before midday, be delivered to the store in the afternoon, and be purchased by a customer that same evening.

How product is treated in the supply chain is a second key driver of waste. Fresh product can often be very sensitive and when handled improperly, the quality suffers. This can lead to the product ending up as waste either directly, because it becomes unfit for sale, or indirectly, because its life is reduced. Right treatment starts with the right packaging.

Many fresh products have specific temperature requirements: for certain products, such as meat, maintaining a continuous cold chain is legally mandatory and essential from a health and safety perspective. No retailer would risk any compromises here. For items such as produce, however, there are no legally binding requirements in most countries, and retailers often strike a compromise between quality and cost. Often this trade-off is made giving insufficient consideration to quality implications: for example, bananas sustaining damage while being transported or stored too cold, or bread being exposed to moisture condensation as it moves between two temperature zones.

Exhibit 6: Better temperature handling of bananas can dramatically increase sales



Retailers who have focused on treating product the right way have often found that increased sales (see Exhibit 6 for an example) and reduced waste have outweighed any investment in supply chain cost, at the same time as conferring a significant competitive advantage. And the product is much less likely to be thrown away once in the possession of the consumer.

2. Help customers buy only what they will eat

Wastage by customers can be reduced if customers only buy the products they will need. Today this is not always straightforward. Large pack sizes and multi-buy promotions on perishable products can mean customers have little choice but to buy more than they need or, at the very least, arguably can make it so cheap that customers buy food on the off-chance that it might get eaten.

As well as offering smaller packs and reducing multi-buy promotions, retailers can also offer more in-store food counters and loose (rather than pre-packaged) produce, so that consumers can select the quantity they need. Another approach is to construct a product range that explicitly offers different levels of ripeness, for example both a “ready to eat” SKU and a “ripen at home” SKU.

Beyond this, technology may provide additional opportunities to help customers avoid buying more than they need. Smartphones are one example: their widespread use can offer new ways of helping customers reduce waste. Menu planning and shopping apps are still at a relatively early stage of development but, in the near future, they will be much more widely used, especially by customers keen to waste less food.

Many retailers already offer such apps but there remains scope to innovate, perhaps by designing sets of recipes that “plan for leftovers” and suggest flexible ways of using them. Apps that can remind customers about food that will soon need using are another possibility – and not as far-fetched as it might sound, considering the role that smartphones can play in self-scanning and online shopping.

CONCLUDING REMARKS

Food waste is already a hot topic, and its importance is only likely to grow. Jürg Peritz, former member of the Executive Committee of Coop in Switzerland and fervent champion of sustainable grocery retailing, said in a recent interview: "Customers care [about sustainability] today, and will care even more tomorrow. The chance for retailers to differentiate themselves and their brand is enormous."

Retailers have made great strides in reducing the amount of food that is wasted in their stores and distribution networks but there is still more that they can do: better forecasting, more careful assortment decisions, and more discipline around best-before dates can deliver significant reductions in waste. At the same time, retailers can help suppliers reduce waste through closer collaboration on demand planning, and tighter management of grading and quality control decisions.

More importantly still, retailers are uniquely placed to help customers reduce the amount of food wasted in the home: the key here is to improve freshness and quality by increasing speed through the supply chain and by ensuring that food is properly handled at each stage. Retailers can also help customers avoid buying too much food by offering a more carefully tailored assortment and smaller pack sizes, and cutting back multi-buy promotions on perishable items. And in future, menu planning and shopping apps are likely to offer further opportunities to help waste-conscious consumers.

The good news for retailers is that reducing waste in stores and the supply chain usually means lower costs, and can often be achieved with very little investment. Meanwhile, helping customers reduce waste by increasing product freshness and shelf life represents a significant improvement in the customer proposition. Ultimately, then, reducing food waste isn't just the right thing to do – it's often the profitable thing to do as well.

TOO MUCH INFORMATION?

Don't let data come between you and your customers

"Retail is detail" is a cliché: but clichés sometimes highlight important truths. It is the detail of product, store, and website that drives customer satisfaction, and hence retailer performance. In recent years "retail is detail" has increasingly meant "retail is data:" the types and volumes of information available have proliferated, and retailers have spent plenty of time and money trying to figure out how best to use it.

The theory has been that more data means better decision making, and better decision making means a better customer experience. But in practice, becoming data-driven is not as easy as all that. We frequently see two problems:

1. **A flood of data**: category managers and buyers become overwhelmed by a flood of information, hampering their ability to make good decisions because there simply isn't enough time in the day.
2. **Disconnection from the offer**: category managers have become chained to their computers and burdened with endless rounds of meetings. These days, they don't have enough time to visit stores, talk to customers, nor see what competitors are doing, and so become increasingly disconnected from the offer as customers experience it.

This article describes some ways of dealing with both of these problems – using data to strengthen the connection with customers, not weaken it.

1. COPING WITH THE FLOOD OF DATA

In attempting to turn themselves into data-driven organisations, retailers become inundated with a flood of data that is often raw, incomplete, or ambiguous. Instead of making life easier, new data actually makes it more difficult and leads to frustration and overload. Review processes and meetings spring up to discuss what the data means and what it implies for managing the business, cramming yet more work into overcrowded days. The data can also defeat the purpose: instead of enabling faster and better decisions, things slow down and decision quality deteriorates.

Exhibit 1: Tell-tale signs of information overload

- A proliferation of duplicate products which do not command customer loyalty, often because collecting fees from suppliers is a time-efficient way to deliver the numbers in the short term.
- A weak entry-price-point offer, particularly versus other retail formats, as time pressures force category managers to focus too much on direct competitors and directly equivalent lines and not enough on other retailers with competing but not identical products where price comparisons are harder to make. Uncompetitive own-label pricing can have similar underlying causes.
- Distorted price architectures with good competitiveness on key value indicators (KVIs) but large price gaps on secondary lines – because KVI pricing tends to be better tracked and more thoroughly monitored.

Most category managers recognise these problems but how can they solve them? Often they simply ignore the new data and reports that they get – one reason why it is often so hard to change how traders make decisions. And then other departments (marketing, strategy, or insights) may pick up the data instead but, since only the traders understand their categories in depth, this means the subtleties of (for example) range and pricing are neglected, and tensions inevitably arise when someone else tries to tell the traders what to do. Or category managers offload the problem to suppliers who are usually willing and able to help but are not always the most impartial source of advice. And if category managers do decide to use the new information to help them run their businesses better, something else inevitably has to give.

All of this can translate directly into weaknesses in the store offer as category managers miss the signals from customers in the noise of data and reports (see Exhibit 1).

So how can retailers create and maintain analytical rigour without overwhelming those making the decisions? The key is to focus ruthlessly on what's important, not on what's interesting – and what's important is that each decision is made simply, quickly, and well. By directly targeting the decision that needs to be made, the data and insights can be presented in the most condensed and focused form possible. Indeed, an understanding of what decisions need to be made should drive the data and insights agenda in the first place – too often it is the other way round. Therefore decision-support tools need to be designed to really support decision making, and not just give traders yet more data to decipher.

Changes to management processes and systems may also be required. What meetings are actually important? Who needs to be in them? What decisions need to come out of each? Meetings that simply review data or kick around interesting insights but don't directly inform decision making should be eliminated or re-engineered. Of course, it's often worth reviewing whether any of the decisions people make today should in fact be made by someone else or automated.

2. DEALING WITH THE DISCONNECT

The second problem with a data-driven approach to retail – losing a sense of connection to the in-store offer – is a fairly recent phenomenon. "Old school" trading directors were famous for their unannounced store inspections, or for throwing a product down on a buyer's desk and shouting, "What is this doing in our stores?" While this didn't necessarily do wonders for morale, it did ensure that category managers kept closely connected to the concrete reality of what products and prices their customers were seeing and buying (or not).

But these days, category managers and buyers are stuck in head office: this is where the computers and systems are, and where the information they use to run their businesses is made available. This presents a real danger: the role can become narrow and introverted, divorced from the reality of product, store, website, and customer.

Nonetheless, there are several practical ways to blend "old school" values with the best new insight, for example:

- Recreating the customer experience at head office
- Engineering out-of-office time into the cadence of the business
- Cutting the head office technology tether

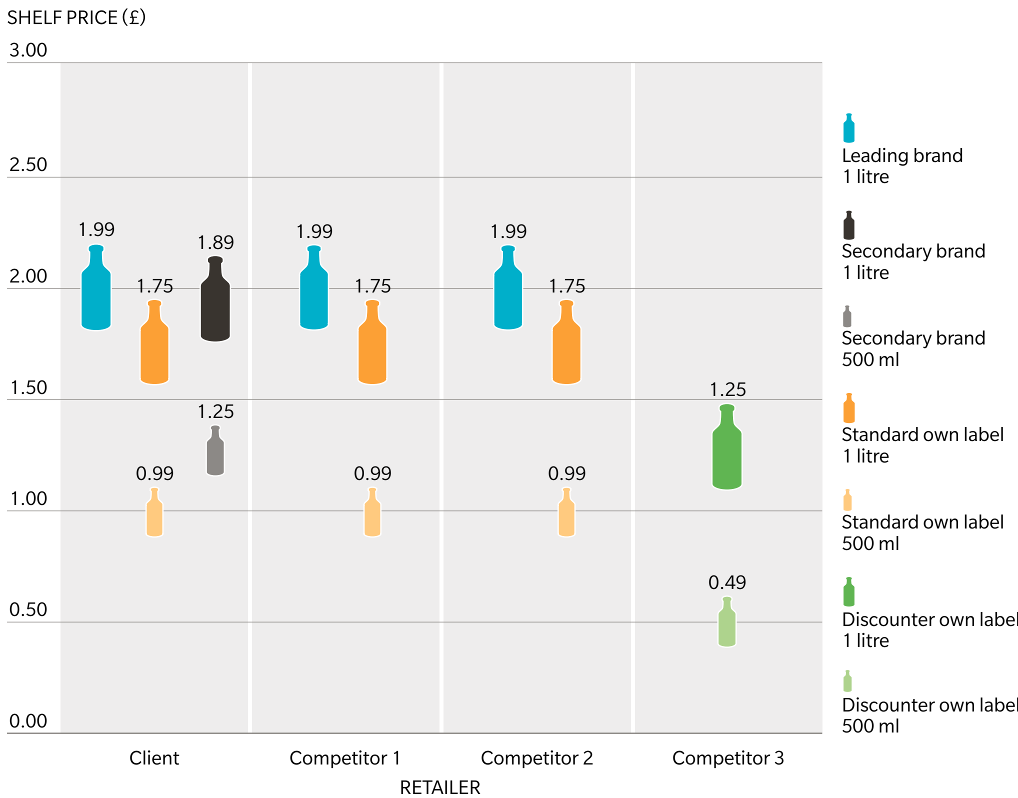
Recreating the customer experience at head office

Something as simple as a "range workshop" can be an effective way of helping category managers reconnect with their categories. Here, entire ranges from all competitors are bought and laid out on the floor, to recreate the way customers experience them and compare them (see Exhibit 2 for an example diagram of how the floor is laid out). Each product is labelled with important economic and customer data: for example, rate of sale, margin, substitutability with other products, and penetration for different customer segments.

Workshops bring the category to life in a visual and tangible way, focusing attention on important issues that are hard to see when they are buried in spreadsheets. Clearly, lab stores take the tangibility one step further. They are particularly powerful when used in conjunction with range workshops, as any changes identified in a range workshop can then rapidly be mocked up and experienced.

Exhibit 2: Category range workshop

Simplified example of typical category workshop insights and ideas: bottled orange juice



REFERENCE	INSIGHTS	IDEAS FOR EVALUATION
	Strong KVI matching pressure at £1.99: unmet trade-up potential over £2.00	Develop new premium own label, £2.20–2.50 retail
	No competitor lists the secondary brand; highly switchable to own label	Delist both sizes, drive volume into own label, hence increase cash per unit
	Discounter delivering lowest price/ml with 1 litre size	Introduce a 1 litre tertiary/price-fighting brand close to £1.25
	Discounters driving strong price perceptions via £0.49 entry price: client needs to defend better	Introduce a new value line, lower specification than standard own label to hit £0.75

Engineering out-of-office time into the cadence of the business

Some companies changed their weekly routine to leave certain blocks of time free of head office-centred activities that could prevent category managers getting out into the market. They start by being very clear about which meetings are going to be used to run the business and make the most important tactical decisions, then set a weekly schedule that leaves large blocks of time empty. This only works if the meetings themselves are decision focused, the data that supports those meetings is well defined and easy to access, and the traders' decision-support tools facilitate simple and quick decision making. Simply banning internal meetings on Fridays can often be a good place to start.

Cutting the head office technology tether

Even when category managers have the time to visit stores, they may still struggle to free themselves from the office as they rely so heavily on their computers. But what if the tools that traders used to run the business worked on tablets from anywhere? What if a trader could review their assortment or pricing while standing in a store or in a competitor's store? We have been building that capability with some of our clients and we think it will soon become the norm. Once category managers can balance the science of data-based decision making with a great merchandising eye and an intuitive understanding of the customer, the promise of a data-driven approach to retail will truly have been fulfilled.

CONCLUDING REMARKS

More data should help retailers perform better but it can have the opposite effect, overwhelming traders and disconnecting them from customers. To avoid this, focus only on what's important rather than trying to analyse everything that seems interesting. This usually means taking a hard look at the way insights are packaged and communicated. At the same time, more time spent in stores and more frequent hands-on comparison of your own and competitors' products can help traders build a stronger connection with the offer. In the end, new data and insights should complement old-fashioned retail wisdom – but they can't replace it.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TAKING CONTROL OF GROSS MARGIN

Which levers should you pull?

Managing gross margin is such a fundamental process for most retailers that it seems like an odd topic to write about. But missing a margin target is a real problem, and often causes a productivity-sapping scramble to figure out the cause. This short article describes a way to better understand gross margin performance – and spend less time on the diagnosis and more on the cure.

When gross margin falls unexpectedly, it can be difficult to identify the root causes. Because the gross margin metric bundles together many different effects, it tells you nothing about where a problem originated: getting to the underlying causes often takes days, or longer. In the meantime, management's only option is to pull the levers it can easily get its hands on – most often promotions and pricing. But nudging prices up or reducing promotional discounts is exactly the wrong thing to do if the real issue is, for example, a mix change as consumers reduce spending in a downturn.

In contrast, a few retailers have figured out how to break gross margin down into its component parts – independent metrics that directly relate to the levers used to run the business – and incorporated these into financial reports, budgets, and targets. It's a simple concept but it can make a big difference.

FINDING THE RIGHT METRICS

The starting point is to identify a small number of metrics that between them account for all significant variation in gross margin: it's essential that these are genuinely independent of each other, otherwise it's impossible to pinpoint the true cause of any change in margin. These metrics need to be actionable so they can be used to steer the business. Four simple metrics – list cost margin, promotional discount, clearance markdown, and supplier funding – are usually enough, and retailers for whom clearance markdown or supplier funding doesn't generate significant variation in gross margin may only need three.

Although the relative importance of these metrics varies across retail sectors, they provide the foundation needed for understanding variations in gross margin, helping identify the places to dig deeper. For instance, promotional discount can be broken down into advertised and in-store-only promotions, and list cost margin can be broken down into mix effects, cost changes, or shelf price changes. The ultimate goal is to allow an appropriate, rapid, and well-targeted response: the case study gives a real-life example.

EMBEDDING NEW METRICS INTO THE BUSINESS

The next step is to embed these new metrics into the core reporting and management systems, including the budgeting process. This gives management teams much clearer visibility and control over the drivers of performance, and has two big advantages for day-to-day decision making.

Firstly, it clears the "fog of war" surrounding the gross margin line. When the new metrics appear alongside sales, volume, and margin in the weekly reports, traders and finance will be using the same information, reducing misunderstanding and avoiding unnecessary disagreements about the drivers of performance.

Secondly, better metrics provide a greater degree of foresight about future performance. Because they're much easier to forecast based on the decisions that the business makes, it's easier to foresee impending problems early enough to avoid them. That same ability to forecast performance also allows traders to break free of the pattern of cycling last year's plan, and provides more strategic freedom.

THE RESULTS

Better understanding and tighter control of gross margin brings many benefits. It gives senior executives a much clearer picture of what's really going on, helping them pull the right levers. Further down the organisation, accountabilities become clearer. Traders waste less time and effort troubleshooting problems and are freed from the tyranny of cycling last year's plan – giving them more room for manoeuvre in day-to-day decision making. Meanwhile, budgeting and forecasting improve, creating fewer surprises for the analyst community.

Ultimately, then, there are many advantages to setting a few simple metrics at the heart of financial governance, and managing them independently. It might look like a trivial difference in approach – but the outcome can be far reaching and can significantly improve how a business is run.

Glossary

List cost margin	Margin made at non-promoted retail price, excluding supplier funding, on total volume
Promotional discount	Promotional or loyalty programme discounts (non-clearance)
Clearance markdown	Markdowns applied to clear excess or expiring stock
Supplier funding	All types of supplier funding (promotional funding, lump-sum funding, etc.)

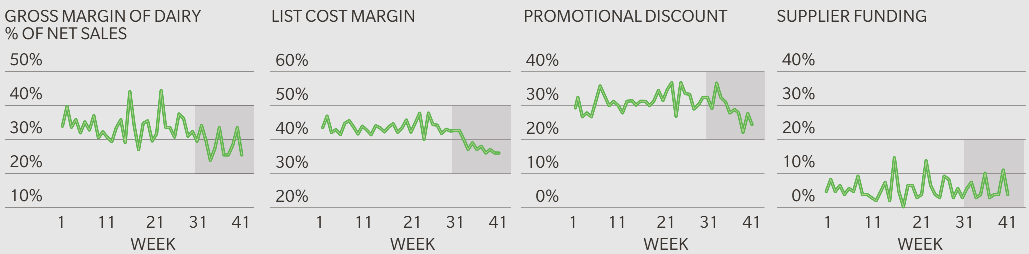
CASE STUDY 1

PRACTICAL APPLICATION IN GROCERY

A North American grocer was in the middle of a turnaround: margin was particularly tight, making it vital that any shortfall was quickly addressed. With this in mind, the grocer set up a new financial management framework. The following example from the dairy category illustrates how it worked in practice.

Dairy gross margin had fallen. The traders had made changes to the promotional programme that they thought would improve margins. Now they were worried they had misjudged this, but it was hard to tell because gross margin was so volatile (see Exhibit 1).

Exhibit 1: Dairy gross margin and its component parts



Note Clearance markdown did not generate significant variation in gross margin, so the metrics used were simply list cost margin, promotional discount, and supplier funding.

In fact, the breakdown showed that the fall in gross margin was attributable to declining list cost margin – and that, once the “noise” introduced by volatile supplier funding was removed, the drop was even starker than suspected. Meanwhile, the decrease in promotional discount had offset some of the list cost margin decline.

The next step was to understand why list cost margin was down: Exhibit 2 shows the potential explanations the grocer considered. The traders quickly established that list costs had risen on a number of lines, but there was no room to increase prices or further reduce promotional discounts without losing competitiveness – they needed to renegotiate with suppliers. This was a pattern they were seeing across many categories, and so the grocer held a supplier conference, followed by a large-scale negotiation programme that turned around the margin decline.

Exhibit 2: Examples of effects seen in metrics

Driving factor, list cost margin is down

Not compensated for in markdown reduction nor funding increase

EXPLANATION	POTENTIAL NEXT STEPS (SHORT TERM)
Costs have risen	• Raise prices if market allows – on unmatched items that won’t disrupt price architecture, or on lines where the market will follow, or where competitive price index rules allow • Reassess the level of promotional discount and markdown, with the aim of offsetting the cost rise • Renegotiate with suppliers
Shelf prices have dropped	• Verify competitive price (before and after promotions) index on products whose price has dropped • Assuming prices have dropped to be competitive on key lines, seek supplier support, reduce promotional activity, or look to raise prices on other lines • Otherwise, reverse the price drops
Product mix has shifted to lower margin products	• Check whether competitiveness on higher-margin products has changed, and address as needed • Review whether assortment or price architecture changes have reduced the appeal of higher-margin products

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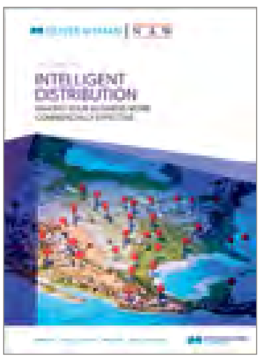

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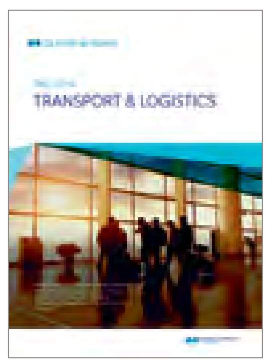

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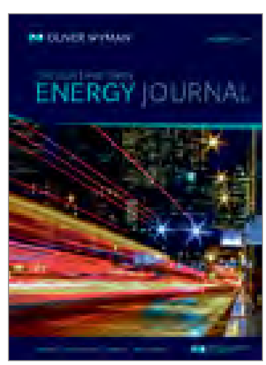

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ВКРАТЦЕ ОБ OLIVER WYMAN

Oliver Wyman – один из мировых лидеров в сфере управленческого консультирования, сочетающий широкий отраслевой опыт с экспертными знаниями в области разработки стратегии, оптимизации операционной деятельности, управления рисками и реструктуризации бизнеса.

Подразделение Oliver Wyman по работе с сегментом розничной торговли обладает глубоким пониманием поведения потребителей и стратегии бизнеса, а также передовым аналитическим инструментарием, что позволяет нам добиваться высочайших результатов для наших клиентов. Мы знаем рецепт успеха в розничной торговле: страсть к обслуживанию потребителей, постоянная нацеленность на результат и непрекращающаяся борьба за расширение возможностей. Мы сопровождаем каждый шаг наших клиентов и уверены, что наш подход по-настоящему уникален: помогая нашим клиентам развивать бизнес, мы тем самым постоянно развиваемся сами на протяжении последних 20 лет.

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