

How to survive in the retail wilderness

A TALE OF BEARS, SHARKS, AND SALMON

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KEY TAKEAWAYS

Thinking about the history of retail, there is a group of characters engaged in a drawn-out struggle for survival. Just as animals compete for food and water, retailers compete for customers and the money they spend. This article reveals how retailers win, how they evolve, and what can be done to survive in the long term.

HOW RETAILERS EVOLVE

All successful concepts begin with design and innovation: These companies are format innovators learning to survive in the retail wilderness. If successful, they first conquer new territory by adding stores and driving rollout growth. Eventually, once all new markets are conquered, they become mature retailers who must survive by constantly driving like-for-like sales gains. At some point, even this growth is not enough, and these sharks must start new innovations themselves, finding new concepts to drive growth outside of the core business.

We call these shifts "life stage transitions," where retailers need to change their business model to survive, and a significant focus of this article is examining what it takes to successfully navigate such changes.

HOW INCUMBENTS CAN SURVIVE

Surviving and thriving in the ever-changing retail wilderness comes down to four key themes:

- Anticipating the next competitive threat
- Understanding the reality of your starting position across your store estate
- Investing in capabilities to win
- Making bets on reinvention

Changing from a bear to a shark in the animal kingdom is impossible. Changing business models for a retailer is difficult, but doable. Much of this document focuses on these transitions.



FORMAT INNOVATORS

Disruptive entrants with a new format that steals significant share from incumbents. They grow by adding more stores and disrupting new markets.

Surviving their arrival does not require outrunning them – only outrunning the other incumbent retailers.



GROWING INCUMBENTS

Constantly making small improvements to drive consistent like-for-like sales gains in the markets where they operate.

They must constantly swim forward to survive.



LAGGARDS

Low or negative-growth retailers who are under pressure from format innovators and growing incumbents.

The slowest-moving laggards will become prey to both sharks and bears.

PART 1: THE TWO WINNING MODELS

In the long run, retailers are only able to raise prices in line with inflation, whereas wages (and often input costs from suppliers) grow at a faster rate. This creates a headwind that must be confronted every year to maintain profit levels. In the US, this headwind equates to approximately 40 basis points (bps) per year. This is why retailers must grow to survive, and there are two fundamentally different approaches to that challenge.

Most retailers grow at first with a new winning format, which makes them a disruptive new entrant. Growth comes from opening new locations that take share from incumbents. These retailers are bears. You don't have to outrun the bear if you are an incumbent – you just have to make sure that the other incumbents get eaten first.

Incumbent retailers who successfully drive growth are like sharks. If they stop swimming forward, they die. These retailers grow by driving more sales from their existing footprint.

If you are neither shark nor bear, you are salmon, the prey of the successful models. Exhibit 1 shows the sharks, bears, and salmon of the US market in 2014. It is worth noting that the sharks and salmon of today were bears at some point in the past.

Walmart, for example, was a bear during the 1980s and 1990s; Walgreens was a bear until about 2008; Home Depot was a bear until the late 1990s; and Kmart was a bear into the 1990s.

The most recent bear to arrive on the scene is Amazon. Amazon has driven phenomenal growth, beginning with category dominance in books and expanding to one adjacent category after another. With still more room for growth, food, apparel, and business supplies are among the categories being targeted next.

Exhibit 1: The evolving retail ecosystem in the US

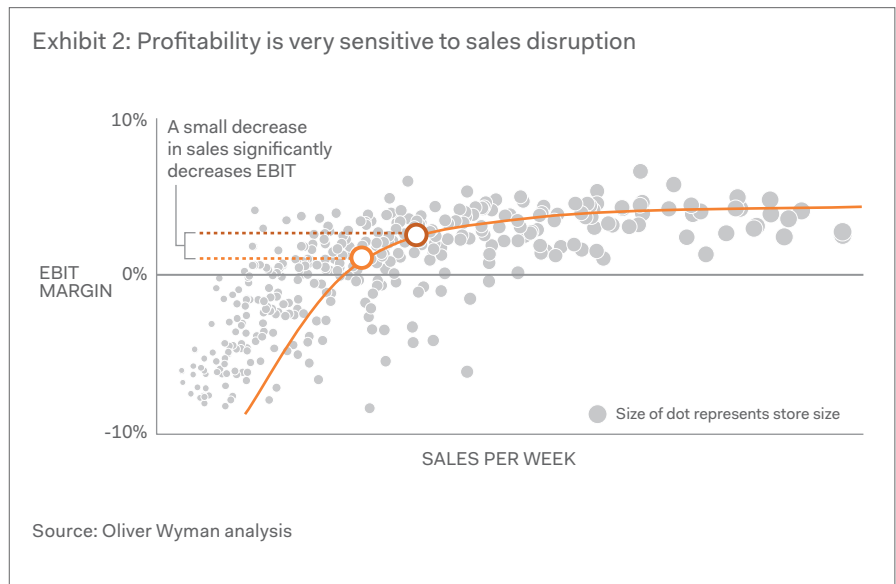
	RETAILER	1980	1990	1999	2008	2014
LAGGARDS	Kmart	3	2 ↑	6 ↓	x	x
	A&P	7	9 ↓	26 ↓	49 ↓	x
GROWING INCUMBENTS	Kroger	5	5 ↔	2 ↑	2 ↔	3 ↔
	Walmart	15	3 ↑	1 ↑	1 ↔	1 ↔
	Home Depot	x	43 ↑	4 ↑	4 ↔	4 ↔
	Costco	x	39 ↑	10 ↑	3 ↑	2 ↑
	Walgreen Co.	x	20 ↑	15 ↑	6 ↑	7 ↓
FORMAT INNOVATORS	Amazon.com	x	x	x	25	5 ↑

INNOVATORS ARE DISRUPTIVE BECAUSE INCREMENTAL LOSSES AND GAINS MAKE A DIFFERENCE

Retail is a high fixed-cost business. For any format and physical location, there is a minimum sales level required to break even, and near that limit, profitability is very sensitive. For stores that are just over the threshold, a small decrease in sales dramatically reduces profitability, as illustrated in Exhibit 2.

This is why innovators are so disruptive. They take small amounts of share rapidly, tipping many stores below the break-even point. Most of today's large

retailers have many stores on the steep part of the curve. A small decline in sales will push many of their stores into loss-making territory; an even smaller decline will make many stores sink assets, incapable of delivering enough return on capital to justify investment. For this reason, it is critical for incumbents to find a way to keep growing; however, this continued growth often comes at the expense of a direct competitor who slides down the curve.





CASE STUDY 1: STAPLES AND THE US OFFICE SUPPLIES MARKET

Outside of food retail, Amazon is already the disruptor in many segments, and the US office supplies market provides a good illustration of how the ecosystem has evolved.

In the office supplies business, macro trends such as declining printing plus the threat from Amazon have created extremely challenging market conditions. Despite this, Staples has performed well, becoming the shark that has consistently been able to swim faster than the competition. By contrast, Office Depot and Office Max have become Staples' prey.

When the market started getting tougher, Staples was already operating from an advantaged position with a better real estate portfolio, a better brand, better price perception, a stronger online presence, more efficient operations, and a structurally advantaged portfolio of B2B customers. These advantages meant that Staples' stores were much further away from negative profitability than those of their competitors, as illustrated in Exhibit 3.

Exhibit 3: Starting from an advantaged position

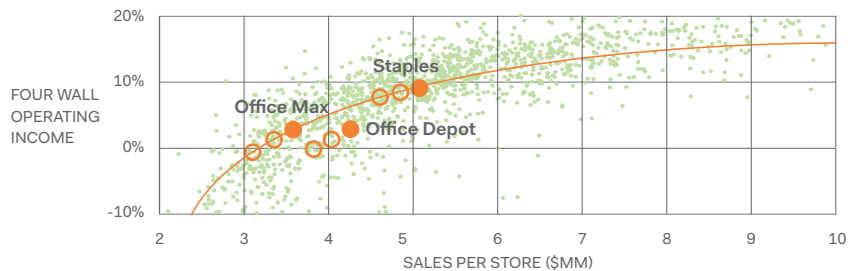
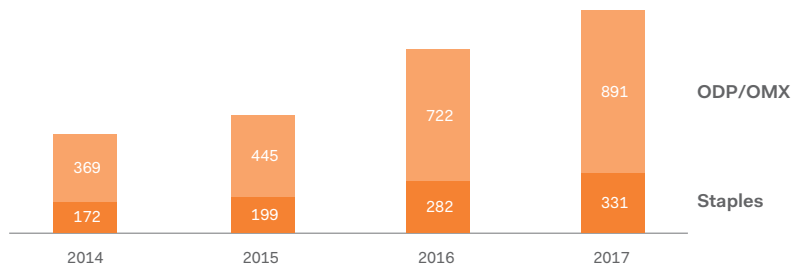


Exhibit 4 shows a projection we made in 2013 about store closures through 2017. We saw the beginning of this trend in the lead-up to the announcement of Staples' planned acquisition of Office Depot. Though the acquisition was blocked in an antitrust lawsuit, Staples still clearly holds the lead in the race to survive – for now at least.

Exhibit 4: Cumulative store closures for Office Supply



However, as Best Buy learned in the years after Circuit City went bust, such a win does not guarantee success for long. (See Exhibit 5.) Staples will need to continue to look for new sources of growth so it can keep swimming to survive.

Exhibit 5: Best-Buy stock performance, 2006–2013



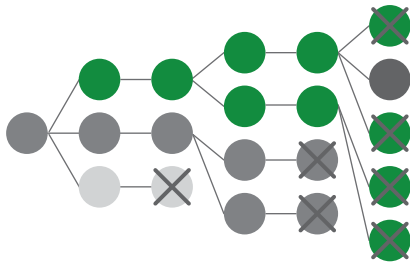
PART 2: HOW RETAILERS EVOLVE

Staples has not always been an incumbent shark and Office Depot has not always been a salmon. If you look back in time, both pioneered new formats and were stealing share from other market segments. Indeed, retailers transition roles frequently, and retail formats evolve through a clear set of life stages as they mature.

Each life stage requires a different set of capabilities, and managing the transition from one stage to another is challenging. We will focus on two areas:

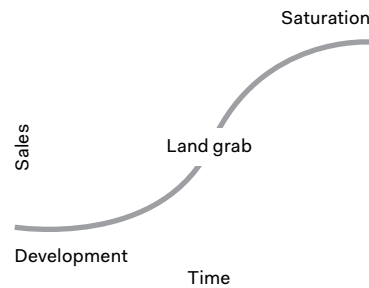
1. Challenges faced by retailers reaching maturity
2. Challenges faced by retailers who need to turn to reinvention

1. Design and innovation



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

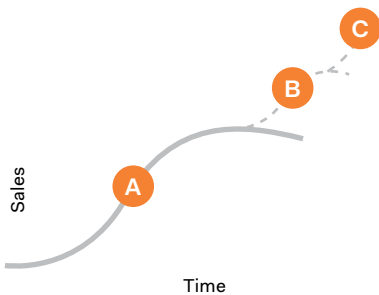
2. Rollout growth



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

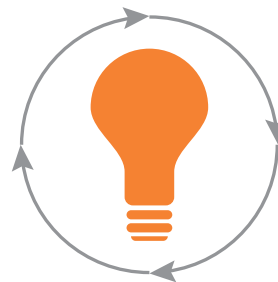
These are the innovative players, the bears, creating havoc in their marketplace.

3. Maturity



Third is maturity, where the primary challenge – usually a difficult one – is to grow sales based upon the same geographic footprint. The best retailers make massive improvements in both delivering their core proposition and deriving value from it, reaping large rewards in the process. These retailers are consistently moving forward, like sharks who will die if they stop swimming.

4. Complete reinvention



Finally, retailers reach the stage where reinvention is needed. This life stage 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 are forged. Success in this life stage requires a higher tolerance for risk than the culture of most mature organizations will allow for.

1. CHALLENGES FACED BY RETAILERS REACHING MATURITY

In the rollout stage of life, the innovative bears succeed by driving economies of scale. This requires speed, standardization, and operational excellence. In contrast, the mature sharks succeed by developing superior skills and capabilities, incrementally improving the proposition using superior insight to tailor the offer to each store or each customer, and squeezing operational improvements out of the business year in, year out.

So, to successfully transition, the balance of power, capability, and culture of the organization need to shift – from operations and property, to marketing and merchandising; from people who can execute, to people who can analyze; and from standardization, to flexibility and experimentation. Delivering this change is really difficult.

The first sign that a retailer is approaching the transition is that new store openings begin to drive diminishing returns. As a result, sales per store start to flatten or decline. Many retailers falter at this point, sometimes continuing to expand store count beyond what the market will bear. Those who recognize these new pressures early and react quickly have the best chance of making the transition successfully.

2. CHALLENGES FACED BY RETAILERS WHO NEED TO TURN TO REINVENTION

At some point, even the most effective businesses find continued growth challenging.

Earlier, we used Staples as an example of an incumbent shark “eating” its competitors. Eventually, Staples will need to find other sources of growth beyond its current core business, such as new channels, formats, product lines, or services. This marks the transition to the reinvention life stage. The challenge, though, is that these new sources of growth can be hard to find for a mature retailer.

Reinvention requires retailers to take risks and innovate in the way they did years back in the design and innovation life stage, while still driving the core business forward with the same discipline and focus of recent years.



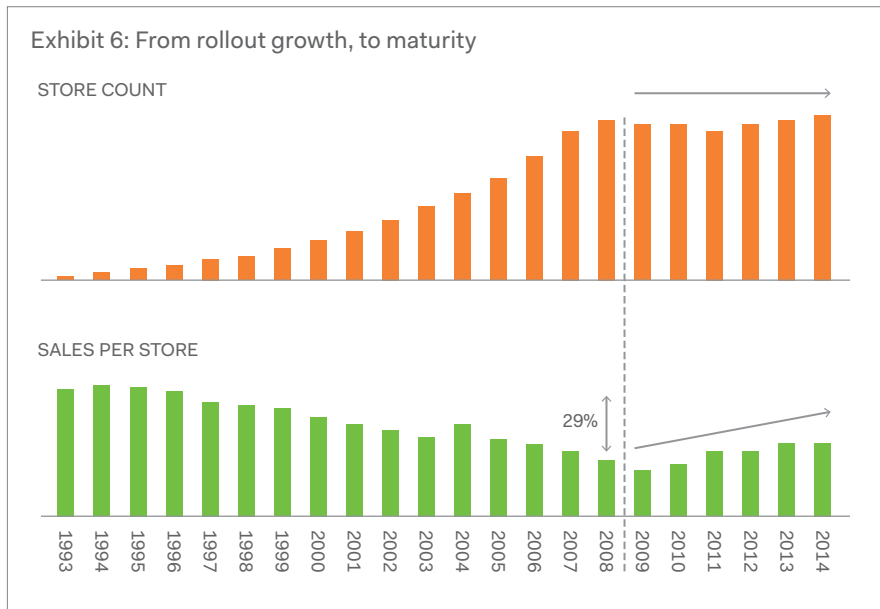
CASE STUDY 2: STARBUCKS: FROM RAPID GROWTH, TO MATURITY

Starbucks faced the end of rollout growth in 2008. Overexpansion, combined with pressure from the financial crisis, had caused same-store sales to decline. They had also moved away from some of their core values, losing focus on service, quality, and value for money. Many initiatives focused on efficiency, compromising customer experience at a time when lower-priced competitors such as McDonald's were improving quality.

When CEO Howard Schultz returned, he drove a multi-year plan to return Starbucks to growth, recognizing they were now in the maturity life stage. He began the turnaround by reversing some of the mistakes made toward the end of rollout growth – closing 600 stores and taking some distracting food items off the menu.

Next, Schultz laid out an agenda of initiatives to enable Starbucks to grow sales without adding stores; he focused on service, quality, experience, and customer loyalty. Many of these initiatives exploited better data and an ability to test and learn, and they aimed to harness the creativity of the whole organization.

The result (shown in Exhibit 6) was a return to sustainable growth in sales per store – and an engine for innovation that may help as Starbucks enters the reinvention life stage.



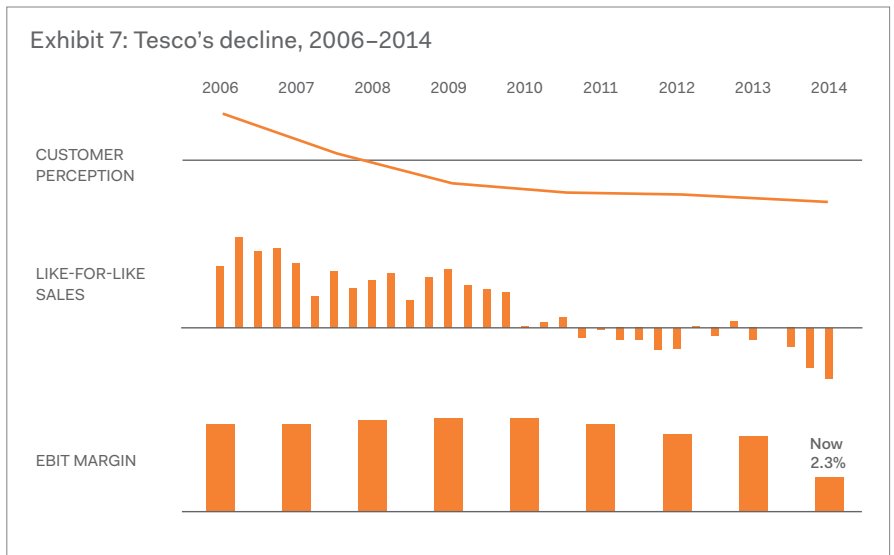


CASE STUDY 3: TESCO'S REINVENTION

Tesco was long viewed in the UK as a customer's champion on both brand and value. To deliver, they had built a highly efficient operation, producing steady sales growth and taking share from the rest of the market.

Things started to go wrong when the innovative bears Aldi and Lidl entered the marketplace and began to take share. Rather than respond aggressively, Tesco's management was too strongly focused on financial performance, which led them to allow prices to drift up and increase supplier-led promotions.

The effects showed up first in customer perceptions, which started to decline in 2007. By 2010, like-for-like sales turned negative. Even then, Tesco squeezed hard to maintain EBIT until being forced to accept a slight decline in 2012 and a massive decline by 2014. (See Exhibit 7.)



One of Tesco's earlier plays had been to bet on new formats and international expansion. This worked well in some countries. However, one of their biggest bets was on Fresh & Easy in the US.

Fresh & Easy was a reinvention bet that failed to deliver, largely because the network density was too high for a format that had niche customer appeal. What went wrong with Fresh & Easy is characteristic of one of the key challenges facing retailers in this life stage: Tesco bet big, making the cost of failure high and making it difficult to rapidly change course. This was a classic "big company" way of doing things. A true entrepreneur would have opened one store at a time, learning when density was reaching saturation. Indeed, a lack of capital would have forced them to expand in this way.

Major retailers trying to innovate can learn from this example – making sure that individual bets are designed to fail fast – reducing the costs of the inevitable risks of innovation, and by making more bets overall, thus maximizing the chance that one succeeds.

CASE STUDY 4: STARBUCKS' ITALIAN SODA AND VIA

Developing a viable growth vector in the reinvention life stage requires a lot of time, energy, and often many rounds of failure. Therefore, starting to place reinvention bets when you are still growing is important; if you wait until growth has stopped, then it may be too late.

Starbucks is an example of a company that got this right, making a number of reinvention bets at about the same time they began their transition to maturity. Tellingly, they made not one, but a series of bets, and monitored the progress of each, allowing for earlier course correction if required.

For example, one of CEO Schultz's passion projects was Italian Soda. However, relatively soon into the rollout, it was clear that the project wasn't delivering, and even though it was driven by the CEO, Starbucks made a rapid yet painful decision to stop the initiative.

Another bet was on instant coffee, an underserved segment in the US and a big part of the international coffee market. Starbucks first invested in significant R&D to make sure the product was better than alternatives and really could change deep-seated consumer skepticism about instant coffee. When it was ready, they fully supported the launch with a major in-store effort, and the result was an extremely successful product called Via and a new stream of growth that did not cannibalize the core business. Via also gave Starbucks a product that they could sell in other channels outside their stores, expanding the business' reach without expanding the footprint.

CASE STUDY 5: NESPRESSO

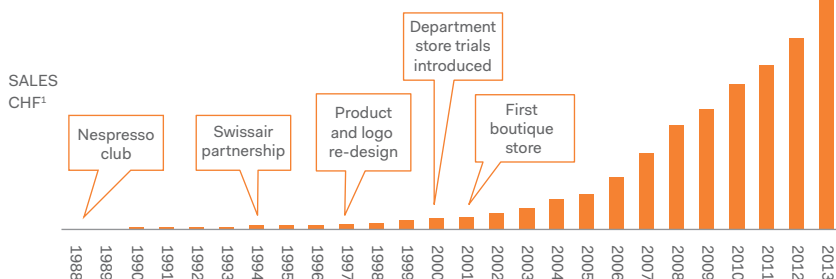
Food manufacturers frequently face the same challenge: how to innovate while still running the core business. Nestlé is a good example of a manufacturer that tackled this challenge in an interesting way, creating Nespresso in the late 1980s.

In order to foster the spirit of innovation at Nespresso, the new business was established in a separate headquarters away from Nestlé's main facilities, and an outsider was brought in to run it.

Nestlé was patient with its new innovation, enduring 10 years of unremarkable sales before seeing any significant success (see Exhibit 8). Throughout this early period, they kept the spirit of experimentation alive, constantly testing new ideas until they hit on an approach that worked. Getting consumers to try the product turned out to be the key to overcoming skepticism about single-serve coffee. A partnership with Swissair – who served Nespresso coffee in first class – was an early win.

From that partnership, Nestlé added trials in department stores and eventually their own boutique outlets. The result today is more than 10 years of over 30 percent annual growth.

Exhibit 8: Nespresso growth trajectory, 1988-2013



1. At constant exchange rate
Source: Nestlé investor seminar 2014



PART 3: WHAT YOU CAN DO TO WIN?

To survive and thrive, we suggest incumbent retailers take four key steps: anticipate the next competitive threat; understand your starting position across your store estate; invest in capabilities to win; and make bets on reinvention.

STEP 1: ANTICIPATE THE NEXT COMPETITIVE THREAT

Innovative bears, both big and small, pose a threat. Depending on the EBIT of your sector, it doesn't take much to erode profitability. For example, a typical food retailer would start to lose money with as little as a 10 percent share loss.

We see three types of innovative bears on the horizon.

Online formats. If an online format hasn't already begun to steal share in your sector or market, you can bet there is one coming. In some retail sectors, an online business model makes these disruptors cheaper from the start. They also have other advantages, such as more customer data, different shareholder expectations, and (in some ways) increased customer convenience.

Leaders on customer experience and offer. We see customer experience and offer leaders – such as Apple, Kiehl's, and Wegmans – driving growth in a range of retail sectors. Many of these are niche rather than mass-market businesses. However, they can still damage incumbents by taking enough share to tip them into negative profitability.

Low-cost operators. Highly efficient value-focused operators continue to take market share, especially in markets where the economic recovery is weak or non-existent. Examples include the hard discounters in food (particularly Aldi and Lidl) and fast fashion discount retailers in apparel (such as Primark). These formats have a fundamental cost advantage that incumbents can't match. See Exhibit 9 for an example from food retail.

STEP 2: UNDERSTAND YOUR STARTING POSITION ACROSS YOUR STORE ESTATE

If your business is under threat, it is worth being realistic about what you can defend. There are some store locations where you are unlikely to win, no matter what you can invest. For those stores, you should manage exits in a way that reduces costs. There are other stores where you already have an advantage. For these stores, you want to invest just enough to maintain that advantage, but not throw money at them. The rest of the stores are where the risks and opportunities lie; these are the stores that merit the most investment dollars, because they are where investment can make the difference between success and failure. Segmenting your estate in this way will give you an advantage against other incumbent players who take a more averaged approach.

Exhibit 9: Cost advantage of grocery hard discounters

	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 labor costs	-13.5%	-12.5%	-8.0%	-4.0%
Central costs	-14.0%	-12.5%	-10.0%	-8.0%
EBITA*	3.5%	1.5%	6.0%	7.0%

* EBITA: earnings before interest, taxes, and amortization

STEP 3: INVEST IN CAPABILITIES TO WIN

The fundamental difference between the incumbent, surviving sharks, and the at-risk salmon is that the former have developed more sophisticated management capabilities, enabling them to drive greater returns from every store and every aspect of the business.

One of the most important levers is usually improving the efficiency of merchandising decisions. Where a simple pricing strategy may have sufficed in the past, you now need a different strategy in every store. Where a single range used to be enough, you now need a different one for each customer segment and store cluster. Where you used to count on increasing scale to drive improved supplier terms, you now need to learn how to drive money from big suppliers while working with a wider range of smaller suppliers.

Similarly, in operations, running stores on gut-feel and instinct is no longer good enough. Store staff members need new tools to improve forecasting and ordering and drive gains from shrink and availability. Store labor needs to be planned more accurately to match service to customer needs. And, in retail sectors where consultative sales add value, sales assistants need customer intelligence at their fingertips.

STEP 4: MAKE BETS ON REINVENTION

To grow long term, innovation is needed. Either launch your own initiatives, or become an investor in the next bear. Remember, the odds of success are low, so you need to place more than one bet, innovating and adapting rapidly. One way to make this happen is by creating a separate part of the business where an innovation culture can thrive. In this new startup unit, insist on incremental progress to force concepts to fail fast and help you recognize promising early stage innovations. You can also invest in other innovations, scanning the landscape to turn would-be competitors into your own future source of profits.

PART 4: GETTING STARTED

To honestly review their current position and plan for future changes, we advise retailers to start thinking about these questions:



CONCLUDING REMARKS

Whether you think about retailers as bears, format innovators, sharks or growing incumbents, to be a successful leader it may be necessary to transition back and forth between these 'states' – sometimes over years or decades. To survive, it is important to recognize where you and your competitors are in this cycle, identifying where vulnerabilities and opportunities lie. Those who do not innovate will become the prey of more successful and agile companies in the future.

