



# SURVIVAL OF THE FITTEST

FOUR STEPS TO PROTECT YOUR  
RETAIL BUSINESS AGAINST THE  
DISRUPTIVE FORMATS OF THE FUTURE



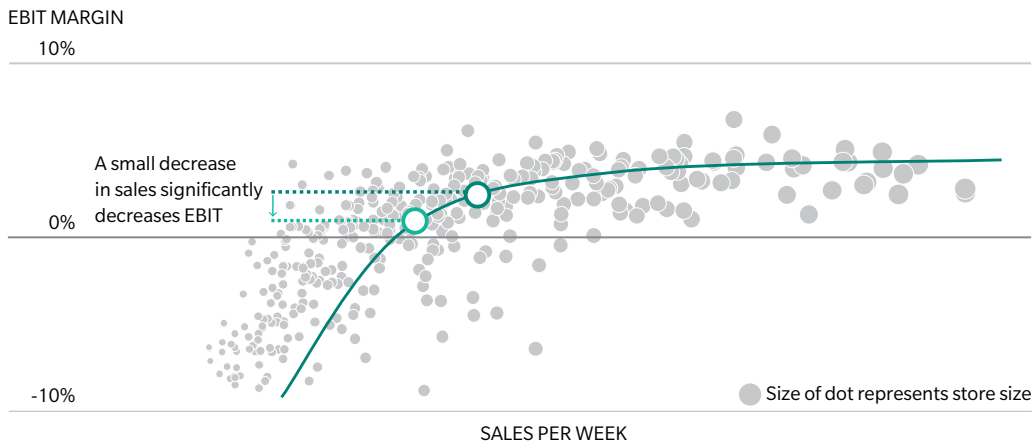
Just as animals compete for food and water, so retailers compete for customers and the money they spend. Retail is a high fixed-cost business, where there's a minimum sales level needed to break even. As you approach that point, profitability becomes very sensitive: For stores that are just over the threshold, a small decrease in sales dramatically reduces profitability. (See Exhibit 1.)

That is why innovators are so disruptive. They take small amounts of share rapidly, tipping many stores below the breakeven 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. That is why it is so critical for incumbents to find a way to keep growing; when they do, however, their growth often comes at the expense of a direct competitor who slides down the curve.

## HOW TO 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; and placing bets on reinvention.

Exhibit 1: Profitability is very sensitive to sales disruption



Source: Oliver Wyman Analysis

# ANTICIPATE THE NEXT COMPETITIVE THREAT

Innovators both big and small pose a threat. Depending on the EBIT of your retail 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 disruptors on the horizon in retail:

**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 areas 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, which incumbents cannot match. (See Exhibit 2.)

Exhibit 2: Cost advantage of grocery hard discounters<sup>1</sup>

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

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

## 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 exit 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; those 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 whose approach may rely more on the average.

## INVEST IN CAPABILITIES TO WIN

The fundamental difference between a successful traditional retailer and one at risk is that the former will have more sophisticated management capabilities. These enable them to drive greater returns from every store and every aspect of the business.

One of the most important tools for success is usually improving the efficiency of merchandizing 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 need new tools to improve forecasting and ordering, and to 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.

## PLACE BETS ON REINVENTION

To grow long term, innovation is needed. Either launch your own initiatives or become an investor in the next innovator. 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.

## CONCLUSION

Competition and change in retail are facts of life. Having survived industrywide disruption in the past is no guarantee of enduring the next time around because the threats keep changing. In the past we saw category killers and hypermarkets elbow their way into the retail market, while more recently it has been online pure-play businesses and discount formats with lean operating models. Keeping a watchful eye on emerging formats and innovations is important, but so is taking an honest look at your own business in order to build up defenses and strike first with your own disruptive innovation. In the future, retailers who follow and react rather than innovate and experiment will likely become prey to more successful and agile competitors.