WHY RETAILERS NEED TO FOCUS ON COST STEP CHANGE

Many retail banks have slashed costs dramatically over the past decade by promoting digital services, closing physical branches, and taking a hard look at the activities done in head office. Mobile telecoms operators in Europe have cut more than a third of their costs per subscriber, by reducing non-essential activities and improving the efficiency of the remaining tasks. In both cases, the motivation was to remain profitable even as individual customers brought in less revenue, and market growth was low.

Retailers are facing the same problem, and it is time now for them to do the same. Though retailers have always been cost conscious, they have traditionally focused on incremental reductions to shave low-single-digit percentages off overall cost levels. Now, however, they need to take big, radical steps that will slash costs by between 20 and 40 percent.

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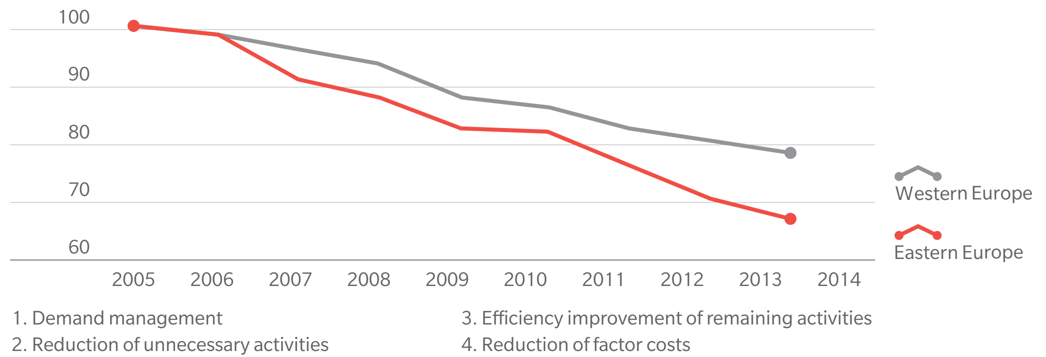
Exhibit 1: Other industries have faced similar challenges already: Telcos responded to revenue decline by cutting costs by 20 to 30 percent or more in 8 years

European telco cost reductions in opex per subscriber, in percent



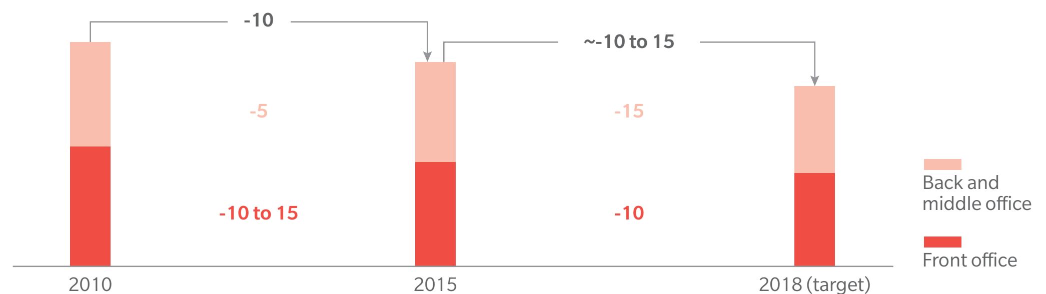
1. Demand management
2. Reduction of unnecessary activities
3. Efficiency improvement of remaining activities
4. Reduction of factor costs

Source: UBS, Wireless Matrix (BoA, Merrill Lynch), Informa Telecoms & Media, CISCO, IEEE, Oliver Wyman research. Only IP traffic included in Fixed BB

The mentality needed is a "green-field" or "zero-based" approach. Instead of tweaking and optimizing existing structures and ways of working – anchored by the idea that "this is how we have always done it" – they need to rethink their businesses from scratch. That means keeping only what they absolutely need to do – tasks that are truly critical or have a real business case – and eliminating "nice to have" activities and elements of the proposition. For example, the HR department may consider building an employee brand as critical, but the rest of the business only views it as "nice to have." Bread baked from scratch may have always been part of the store proposition, but customers may not notice the difference to a more efficient bake-off alternative.

Exhibit 2: The banking industry has cut costs due to regulatory pressure and digitization, with more to come over the next few years

Wholesale banking cost reductions 2010–2020 target, in percent



Note: The range on front office spending is broader than for back and middle office functions, driven by a greater ability to flex compensation; it is also performance dependent

Source: Company filings and annual reports; Oliver Wyman proprietary data and analysis

The difficulties retailers are facing range from flat or slowing consumer demand, increasing labor costs, and excess space, combined with the rapid rise of new disruptive challengers in the shape of e-commerce and discount players. Variations of these problems have struck other industries, for example: deflating profits from low interest rates combined with new FinTech disruptors in retail banking; squeezed revenues via regulation combined with voice over IP in telecoms; and digitization combined with a sustained drop in print advertisement levels in the traditional media business. These industries have been transformed over the past decade, with incumbent firms that have not changed either shrinking or being taken over, and only those who act fast and change fast surviving.

TO SUCCEED, RETAILERS CAN DEPLOY THREE TYPES OF TOOLS

DIGITIZATION AND AUTOMATION

Newcomers, including the new breed of digital retailer, provide incumbents with some valuable lessons in how to change. There are now online-only retailers turning over in excess of $1 billion that operate with as few as 200 full-time equivalent staff in the head office. While being mindful of the competition they pose, incumbents can learn from their approach, which at its heart involves automating decisions – such as in category management – with smart analytics, leaving far fewer, more highly skilled people setting the parameters for and adding human insight to the machines. In one study, we found that Amazon managed its business with a ratio of 10x products per person within category management by using this approach.

There are also lessons from other industries. One traditional personal insurance company in Europe revived itself through digitization and automation. It was losing customers to new digital rivals, one of which was able to update its prices every 15 minutes. Another needed only 30 customer service staff on 750,000 policies – radically leaner than the incumbent's model.

These disruptive benchmarks helped the insurer realize the need for radical change. They started by introducing new low-cost digital services, such as letting customers log and track their claims online. It also created a digital one-stop shop for its claims suppliers. Finally, a custom analytics engine looked at 8,000 risk factor combinations, 750,000 data points, and over 200 million individual quotes, and delivered weekly risk assessments of its clients. Changes such as this enabled significant head office cuts, with the insurer reducing annual costs by over €100 million in 18 months while boosting profit margins by over five points. The company also began to react more agilely to competitors' price changes.

SIMPLIFICATION

Another powerful tool is simplification. In some product categories, retail customers do not value a broad choice – for example, in basic areas such as household goods or commodity cooking ingredients. Removing some of the "tail" can simplify the business and reduce costs. This needs to be done carefully, by focusing on duplicative products and avoiding low-selling products that do actually fulfill a unique customer need. Simplifying the range in this way enables efficiencies in supply chain and store operating models: It reduces the number of picking slots, simplifies depot operations, and makes in-store replenishment faster, easier, and cheaper. Narrow ranges can still serve customer needs incredibly well if they are well designed. For example, in Spain, low-cost retailer Mercadona delivers a hugely successful supermarket model with about 9,000 carefully selected products rather than the 30,000 (approximately) of a traditional supermarket.

Thinking about cost in an integrated way can reduce overall costs. For example, faster checkouts were achieved by placing bar codes on fresh products to ensure that they scanned first time. The checkout counter was raised so that items are slide directly through the bar code scanner and into the shopping cart. This all improved "time per customer," reducing cashier costs. The retailer reduced the number of products in a typical store by a quarter, helping to cut supply chain costs by 20 percent, store labor costs by over 30 percent, and other store costs – such as utilities, maintenance, and cleaning – by over 5 percent.

CHALLENGING SUPPLIER RELATIONSHIPS

Retailers can simplify their operations by reducing the number of suppliers they work with (often linked to the range simplification mentioned above), and generate more value from these relationships by collaborating more closely with a smaller number of suppliers. Supply chain processes are often based on historical ways of working, making them ripe for optimization, particularly in fresh categories where small amounts of lost time radically affect shelf life.

Retailers and suppliers can, for example, rationalize delivery, by using less-busy windows or alternative routes, pooling delivery services with others, using third-party logistics providers, and centralizing certain steps such as packing and picking. A crucial aspect of successful relationships with suppliers is information and data sharing. There must be a clear mutual understanding of which pieces of information are critical at each stage of the supply chain. This can make it easy to speed up the most important steps. In some situations, an approach of working closer with a smaller number of key vendors can release cost savings of up to 10 percent.

A RADICAL ZERO-BASED APPROACH

Simplifications to the proposition and supplier relationships also need to be used to enable simplification and reduction in the size of overhead departments. And this is where a "zero-based approach" can be powerful.

The first step in a zero-based approach is to identify a "survival minimum" for each department or administrative area. They will need to continue essential administrative tasks, such as regulatory reporting, and to maintain standards for health and safety. But beyond this, the survival minimum should eliminate frills and comfort.

Second, they need to identify the "strategic minimum." This adds some key strategic priorities onto the survival minimum – only activities that are supported by a strong business case, for example, because they support a key aspect of the customer proposition. In the HR department, for instance, the survival minimum may only include staff who are crucial for legal requirements, whereas the strategic minimum would include a key training function responsible for customer service in the stores.

Then, the "optimization target" becomes the difference between today's level of cost and the strategic minimum. Retailers should watch carefully how other industries have dramatically improved their cost position and look at what online retailers are doing. However, they will only be able to emulate some of their success if they think big. If they redesign their products and services for a low-cost model, retailers can follow those other industries into a profitable future. It will not happen overnight, but the possibility is there for retailers who want to take it – and want to survive.

Exhibit 3: Amazon can make better decisions more quickly and with fewer people

Note: Estimated using products listed on Office Depot and Amazon websites, excluding third-party resellers; Based on analysis from Profitero

Source: Amazon.com, Officedepot.com, ZDnet.com/Profitero, Oliver Wyman analysis