

The Act Vertical[®] Imperative

by Madison Riley and Brooks Kitchel

It's a good thing the government bailout wasn't based purely on the number of industry bankruptcies and layoffs that threaten the economy. If it were, the \$4 trillion U.S. retailing sector would have jumped to the head of the line in front of the automotive and financial services industries.

Nearly a half million retail jobs vanished in 2008—20% of all U.S. jobs—and that pace has increased. However, it would be a colossal mistake to rescue America's biggest merchants with taxpayers' funds. Even a trillion dollars in government loans wouldn't stop the closure of dozens of retail chains, thousands of stores and even whole shopping centers this year.

Why? Too many retail chains don't fully understand the forces that are flattening them. Kurt Salmon Associates recently completed a major study of more than 100 of America's largest retailers and found these forces include more than today's Great Recession. Industry pundits' speculation about tomorrow's retailing specters fill trade and national media, yet the number of retail bankruptcies has been increasing steadily since 2002. (See exhibit below.)

The real trouble began in the late 1990s, when the Internet gave shoppers an unprecedented tool to find the best bargains in minutes (online or in the store). While only about 4% of goods today are purchased over the Internet, its impact on the other 96% is substantial and growing.

Every day, 15% of Americans use the Internet to research products. Last holiday season, the majority of working Americans (55%) with Internet access on the job—some 73 million people—did their shopping research (and some purchasing) online, according to Shop.org.

U.S. Retail Bankruptcies



Research Highlights

Kurt Salmon Associates surveyed more than 100 U.S. retailers and conducted 10 in-depth case studies and found that a select few are achieving superior results through a differentiated strategy we call "Act Vertical." Our research shows:

- > Act Vertical retailers, such as Aeropostale, Coach, Apple, PetSmart and Trader Joe's, have achieved superior financial results without competing on price.
- > On average over the past 10 years, Act Vertical retailers have significantly outperformed the industry and continue to do so—despite the current economic downturn.
- > The hallmark of an Act Vertical strategy is internal and external collaboration with customers and partners to offer unique and compelling products and services in an engaging multichannel shopping experience.
- > Act Vertical retailers align their brand and operating strategies and demonstrate superior performance by integrating seven core capabilities.

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The Rise of Act Vertical Retailers

Increasingly, retailers are called to compete on much more than price and must find the means to lure customers with truly compelling products and shopping experiences that cannot be found at other merchants. Contrary to the common practice of deep discounting in troubled times, competing on compelling products is particularly important when economic downturns force consumers to trade down and cut back on discretionary purchases. Limited dollars make consumers even more discriminating.

Case in point: Apple's iPhone. Despite tough times, most consumers who have their hearts set on the \$300 model are unwilling to settle for significantly cheaper garden-variety cell phones.

All of this is to say that the fundamental retailing model of the last century—acting as outlets for manufacturers that create, design, make and market their goods—is nearly dead except for a few major retailers. Only the mightiest of merchants that can compete on price (Wal-Mart, Costco, TJX, Amazon) or convenience (large grocery and convenience store chains, Amazon and other Internet retailers, etc.) can play that game successfully, and even their ranks have been shrinking.

To survive, all other retailers must be able to give consumers a very special reason to shop with them—by offering truly compelling products and shopping experiences that aren't available at other retailers.

Superior Results

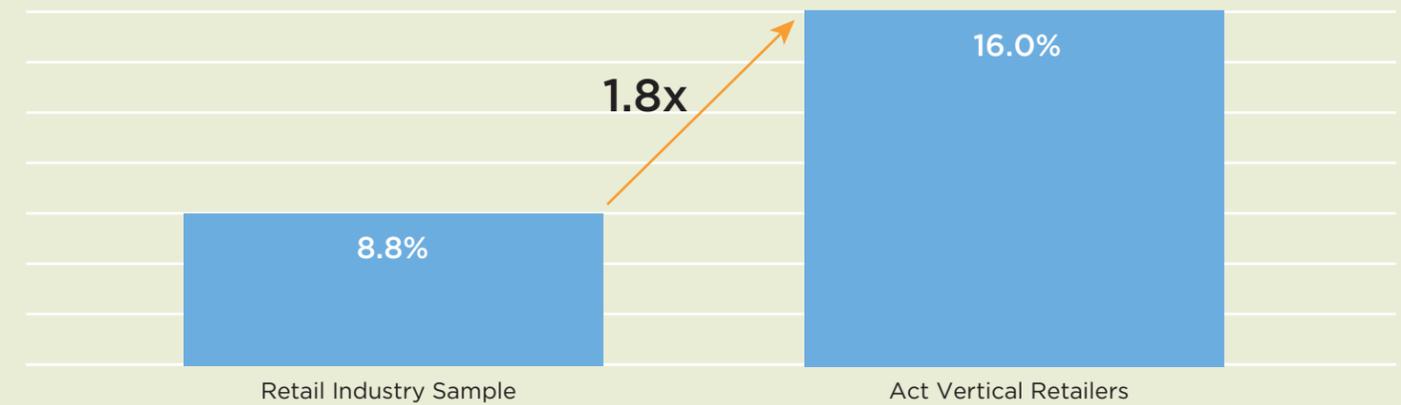
KSA's research identified a small cohort of retailers that have succeeded in offering unique and compelling products and shopping experiences. Further, in analyzing these retailers' performance over the past 10 years, we found they were achieving superior results in doing so.

On average, these retailers realized:

- > 20% greater increase in annual revenue, operating and gross margins and inventory return on assets
- > 40% greater increase in inventory turns
- > Higher performance on customer retention rates, sales per customer and sales per customer transaction
- > Fewer price markdowns

Act Vertical retailers significantly outperform the industry

Average Compounded Annual Growth Rates, 2005–2008



What's their secret? The success of these retailers comes from understanding how the relationship between retailers and their customers has changed dramatically. Retailing has become a particularly brutal business, especially over the last decade, in which it is hard to compete and win financially because of two key forces:

- > Overabundance of undifferentiated retailers driven by overstoring, new retail channels which erode store sales and a rapidly growing secondary market
- > Consumers' intolerance of unfruitful shopping experience driven by consumers who have far less time to shop and, thus, are less compelled to shop and who are smarter about where to shop and what to shop for because of the Internet

To turn these forces to their advantage, these retailers are collaborating internally and externally to create the unique and compelling products and experiences today's consumers are demanding.

As such, we call this select group of successful retailers "Act Vertical" retailers because they are vertically integrating back into the supply chain and designing their own products. Examples of these retailers include Aeropostale, Coach, Apple, PetSmart and Trader Joe's.

But the key here is not to own asset-intensive factories. Instead, Act Vertical retailers tap contract manufacturers but manage them closely, and as such, they are acting vertical rather than being vertical.

An Act Vertical strategy means thinking about "vertical" in a new way; it requires:

- > A brand strategy that differentiates—at least in part—a unique offering and engaging customer experience
- > An execution plan for an end-to-end integration of the value chain through cross-functional means grounded in collaboration, not ownership

Act Vertical Territory

To be clear, Act Vertical retailers set a very high standard for truly differentiated and compelling products and experiences. They offer more than private-label products in their stores and online. Instead, they connect intimately with their core customers to create truly breakthrough products and related services that are accessible in an engaging multichannel shopping experience.

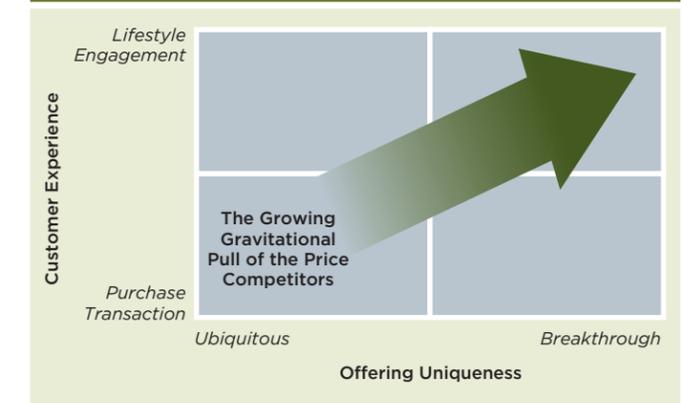
In bringing both these elements together in a relevant and compelling way, Act Vertical retailers connect more deeply with their core customers and, thus, can free themselves from the downward spiral of discounting.

Case in point: PetSmart. The national pet supplies retailer offers not only requisite pet foods and products but an entire suite of complementary services, including pet hotels; doggie daycares; and veterinary, grooming and training services. Further, PetSmart has created a differentiated

shopping experience, which includes its online communities where "pet parents" can create personalized pet profiles to brag about their animals or chat with other pet aficionados about pet needs, experiences and products.

Successfully executing against each dimension, product and experience is key; however, successfully executing against both dimensions creates the truly differentiated and compelling proposition that sets PetSmart apart from its national competitors. And the result is tangible. PetSmart dominates its peers in frequency of customer visits and share of customers' total lifetime pet spend.

Successful Retailers Move Toward Act Vertical Territory



The Rise of Act Vertical Retailers

Seven Core Act Vertical Competencies

An Act Vertical strategy mandates that retailers shift from largely selling other companies' products to creating their own and merchandising them flawlessly. To execute effectively, KSA's in-depth analysis of key retailers shows that the most successful retailers align their brand and operational strategies and strengthen their competencies in seven key areas, which are detailed below.

These seven core capabilities support an Act Vertical strategy specifically but also more generally create the internal intelligence and agility to compete in an increasingly demanding business environment. KSA's experience shows that each capability often requires new business processes, new operational information and information technology, different reporting relationships, measures and rewards that encourage unprecedented degrees of cross-functional collaboration and new cultural norms.

The Seven Core Capabilities

Critical Success Factor

Market research

Defines emerging customer needs, product and service opportunities, customer experiences and lifestyle

Product design and development

Balances creativity and commercial appeal to maximize profit

Consumer testing

Increases the returns on and reduces the risks associated with product innovation and customer experience innovation

Sourcing relationships

Accelerate manufacturing but make key product decisions as late as possible (to better meet fast-changing customer needs)

Assortment, allocation and replenishment

Rapidly shifts products to places of greatest demand and maximizes prices

Multichannel brand experience

Consistently engaging interactions embedded in the customer's lifestyle

Marketing

Communicates the brand promise across all channels and showcases how the offering and experiences enhance customers' lifestyles

To request the Act Vertical report, which details our research and findings, visit us online at www.kurtsalmon.com/actvertical.

Kurt Salmon Associates is the leading global management consulting firm specializing in the retail and consumer products industries. We leverage our unparalleled industry expertise to help business leaders make strategic, operational and technology decisions that achieve tangible and meaningful results.

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