Leaner Retailing

Overhauling your cost structure for sustainable, long-term effectiveness

by Peter Hsia, Partner

Already industry analysts and experts are calling 2009 a write-off. Amidst a flurry of bad news that amounts to the most challenging retail environment in nearly a century, many industry giants are fighting to survive. Yet history demonstrates that investing in building key capabilities now will likely mean faster, stronger growth once the economy recovers. So what are the right priorities for retailers?

Certainly, cost reduction is critical for all retailers. For healthier retailers, aggressive but prudent cost reduction can fund an investment in key capabilities. whereas a more aggressive approach to cost reduction may be appropriate for retailers facing significant profit or liquidity issues. The key for both groups is to act quickly. Retailers that delay profit improvements run the risk of creating a liquidity crisis, which can result in ruin in the current credit crunch.

EXHIBIT 1: Total Business Inventories/Sales Ratios: 1999 to 2008

Note: Data adjusted for seasonal, holiday and trading-day differences but not for price changes

How Bad is Bad?

Despite some temporary optimism following Black Friday, the 2008 holiday shopping season has proven to be one of the worst in decades. Retailers reported year-to-year revenue shrinkage of at least 5%, with sectors like department stores reporting 10% to 25% declines. Despite massive price reductions for consumers, retailers are unable to clear inventories. In the past six months alone, the average U.S. inventory-to-sales ratio has increased 16%. (See Exhibit 1.) And the news is not going to get any better.

KSA forecasts:

> consumer spending will shrink 5% to 7%

> discretionary spending could likely plummet 20% to 30% over the next two years.

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

Making Cost Reduction Work

Thanks to the example set by Wal-Mart, most retailers are managing costs aggressively. So how can retailers find more places to save? To put it bluntly, this recession is forcing retailers to consider changes that would never have been investigated in the past because of perceived customer, supplier or financial risk.

In today's environment, failing to slay "sacred cows" from the past will likely lead to financial failure. Given current revenue and margin shortfalls, a typical retailer needs to reduce its cost base by at least 5% to 10% to stay cash-flow positive. This means a much more aggressive program than the classic trimming of overhead headcount and costs by a few percentage points.

What are the best retailers doing to manage costs?

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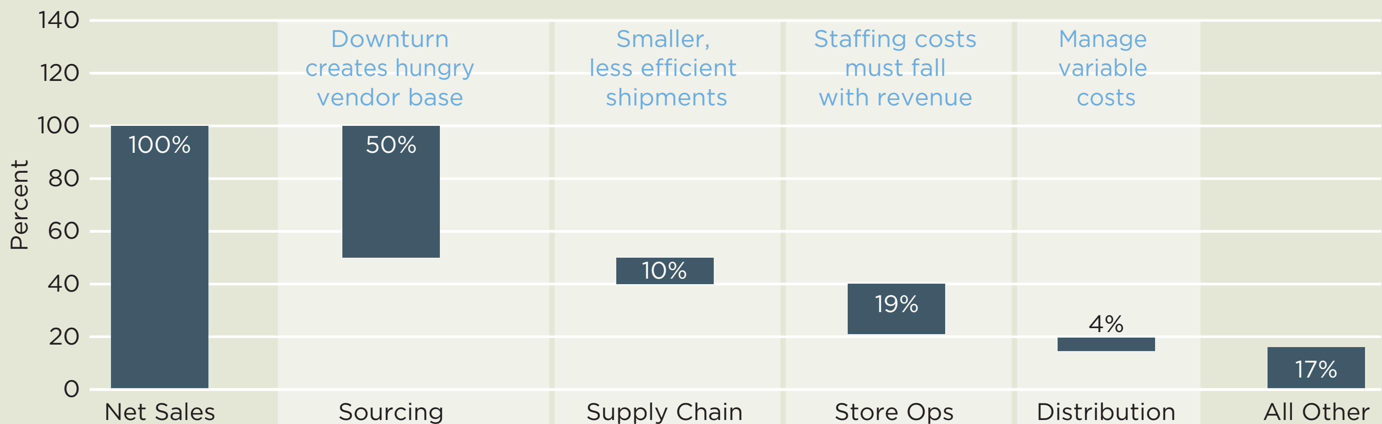
Culling the Asset Base

In good times, retailers see their store base and inventory as assets for generating growth. In bad times, retailers need to pull back to a profitable core of assets. Retailers in a tough financial environment need to do the following:

- **Assortment rationalization.** Assortments expand during times of economic prosperity as retailers add new lines and experiment with derivative products. Narrowing the assortment is necessary to reduce development and management costs. It also allows inventory dollars to be invested in core product offerings. Further, a recession is one of the few opportunities retailers will have to rationalize assortments with a lower risk of alienating consumers.
- **Shrink store network.** Most retail chains have stores that are a financial drain but are retained because they are in underdeveloped markets or show a modest improvement trend. Biting the bullet on store closures now will preserve a more profitable, healthy core to build from in the future. The retail space will be there when they again need it.
- **Optimize inventory service levels.** Most retailers carry enormous burdens of low-productivity inventory due to visual minimums and autopilot buying habits. As shown in Exhibit 1, inventory levels are rising relative to sales. Each piece of inventory creates a coattail of supply chain costs, store backroom costs and working capital costs. Rather than cutting across the board, retailers can strategically target non-core categories with high sales volatility. Hold and flow inventory management techniques can also reduce inventory requirements by keeping more safety stock in (now less crowded) distribution centers rather than store sales floors.
- **Shift asset ownership.** The shrinkage in revenue has created an overabundance of supply chain infrastructure. Retailers need to know how they are going to partner to either improve the utilization of their own assets or leverage someone else's assets.

Making Cost Reduction Work

Exhibit 2: Case Example—Major Retailer's Cost Structure



1. Other costs include depreciation and amortization and interest and tax payments

Focusing Beyond the Big 4 Costs

Retailers have four major costs that make up over 80% of their cost base: Store Operations, Supply Chain, Distribution and Sourcing. (See Exhibit 2.) The remaining costs are easier and less painful to manage (and should be managed!), but even deep cuts will not achieve the required cost base reduction needed in today's environment.

> **Store Operations.** In a shrinking revenue and inventory environment, store staffing models need to be redesigned. In one department store, over 20% of payroll could be saved by optimizing backroom operations and shifting the mix of part-timers. All of this could be completed without affecting the investment in face time with the customer.

> **Supply Chain.** Many retailers have overbuilt their supply chains in anticipation of growth. The supply network needs to be redesigned to reflect the lower-growth environment and more compact store base. And, the current "buyers market" in transportation is creating excellent opportunities for reworking contracts and reducing costs.

> **Distribution.** Downturns are also an excellent time to expand performance-based work standards, since employees can see the need for job-preserving changes. Even retailers with strong labor productivity programs have found that 10—20% reductions in direct labor hours are possible.

> **Sourcing.** Until recently, the primary focus of sourcing has been increasing the mix of direct imported products. Even with mediocre execution, any retailer raising its mix of direct imported products was likely to enhance margins. Advanced retailers are now focusing on the next level of costs: cutting spending on buying offices, optimizing the mix of source countries, standardizing processes and standardizing fabrics/materials.

The mistake most retailers make is managing costs for each cost center while missing the cross-functional opportunities across cost centers. Taking an integrated view across the Big 4 cost centers provides a greater chance of finding untapped cost-reduction opportunities. For example, changing the cadence of product shipments can allow radically lower supply chain costs (e.g., shift to hold and flow) and store operations costs (e.g., prebuilt displays).

Making Cost Reduction Work

Preserving Key Capabilities

Surviving the downturn is useless if it means destroying the heart of what makes a retailer successful. The key is understanding which resources (people, assets, CAPEX programs) are most critical for the long-term business model. KSA's Act Vertical research has shown that a few key capabilities will be the drivers to long-term success in retailing. Creating a strategic framework to the cost-reduction process is critical. For example, one retailer's strategic analysis of IT spending placed 25% of the budget in "continue," 25% in "hold but sustain" and 50% in "cut." Across-the-board arbitrary cost reductions often result in lost capabilities that can take years to rebuild.

Making Changes Fast

In the past, many core processes were not considered as sources for cost reduction because change was considered slow and complex. Merchandising plans were locked 12 months in advance and retraining the organization in a new process took years. KSA has found that quite the opposite is true—change in all areas can be large and fast. Consider sourcing. Historically, it took 12—18 months to see results from changes in sourcing due to the lead time on fashion season purchases. Today the opposite is true. Order sizes and mix can be adjusted within weeks of shipment and everything can be changed within 6 months of a season. With underutilized offshore capacity, flexibility in 2009 will only increase. Key costs can be restructured within 6 weeks in many cases and no more than 12 weeks. (See Exhibit 3.)

Getting Cost Reduction Implemented

Cost reduction is most effectively implemented with a partner. Only an objective third party can bring the outside experience from other companies to credibly overcome resistance to eliminating sacred cows. Partnership also provides focused and temporary resources during a period when existing staff is stretched thin. While using a third party has costs, the risk can be mitigated by tying fee levels to results.

Exhibit 3: Cost Reduction Opportunities

	Description	Time to Savings
Retail Operations	Store labor productivity Compensation and pay rules Customer services and policies	1–3 months
Supply Chain	Transportation Reverse logistics Network optimization	2–4 months
Sourcing	Country of origin Component costing Business model	2–12 months
Distribution	Process improvement DC labor productivity Labor management systems	3–4 months
Inventory Management	SKU rationalization Markdown analysis Minimum presentation	1–6 months
Organizational Design	Staffing productivity Span of control Benefit review	2–3 months
IT Spend	Outsourcing and offshoring Contract renegotiation Data center consolidation	2–6 months
Other Corporate Spend	Corporate space Finance costs MRO sourcing	2–4 months

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Appendix:

Opportunities for rationalizing supply chain and corporate service costs

Supply Chain (Revenue, GM and SG&A)

Inventory Effectiveness	Supply Chain	Distribution	Retail Operations
Category, assortment, SKU rationalization	Sourcing business model	Process improvement	Store labor productivity
Inventory position/performance	Lean process	DC labor productivity	Labor scheduling practices
On-order/OTB Review	Vendor structure analysis	Labor management mystems	Compensation and pay rules
Markdown analysis	Transportation cost optimization	WMS applications	Field management structure
Allocation/replenishment effectiveness	Reverse logistics	MHE upgrades	Inventory flow and control
Minimum presentations	Product flow analysis	Network optimization	Customer services and policies
Organizational effectiveness	Organizational effectiveness		Facilities and service management

Corporate Services (G&A)

Organizational Design	Marketing Spend	IT Spend	Other Corporate Spend
Functional headcount review by area, spans of control, leverage models, duplication across areas	ROI trends across channels	Outsourcing and off-shoring	G&A cost benchmarking (review trends/existing budgets, compare to growth)
Span of control	Cost benchmarking	Contract renegotiation	Corporate space
Value added assessment	In-store marketing and event economics	Organizational restructuring	Finance spending
Benefits and compensation levels review	Website economics	Data center consolidation	Outside services review
	Catalog economics	Application portfolio rationalization	MRO procurement review
	Brand spending		
	Loyalty programs review		

Appendix:

Inventory Effectiveness

	Description	Time to Savings
Category, Assortment, SKU Rationalization	Reduce or reinvest inventory to optimize the assortment	1–2 months
Inventory Position/ Performance	Identify and implement improvement plans by category/dept (via sales trends, turns, GMROI analysis)	1–2 months
On-Order/OTB Review	Eliminate, delay or reduce order quantities based on category/ assortment/SKU rationalization and inventory position analysis	2–3 months
Markdown Analysis	Improve markdown cadence and decrease markdowns	1–2 months
Allocation/Replenishment Effectiveness	Implement alternate approaches for allocation and replenishment	2–3 months
Minimum Presentations	Revise presentation minimums to optimize inventory performance	6–9 months
Organizational Effectiveness	Align organization for optimized span of control/efforts	2–3 months

Supply Chain

	Description	Time to Savings
Sourcing Business Model	Develop optimal mix of in-house, overseas offices, agents and/or factories Reduce redundancy and align activities to strategic needs across these areas	8–12 months
Lean Process	Cycle time review Assess workflow and data management Reduce internal costs due to lack of standardization in color, fit, fabric and product approvals	1–2 months
Vendor Structure Analysis	Ensure vendor-based is appropriate for sourcing business model Rationalize the number of suppliers Assess vendor performance	1–2 months
Freight Contract Bidding	Bid out freight contracts for all modes Use updated freight contract process	2 months
Reverse Logistics	Streamline reverse logistics process	3 months
Product Flow	Change product flow (e.g., increase flow and hold, vendor shipments, pre-packs, floor ready)	2–3 months
Organizational Effectiveness	Optimize span of controls Alignment, productivity	2–3 months

Appendix:

Distribution

	Description	Time to Savings
Process Improvements	Vendor: Coordinate ticketing, store packing, case packing, pre-packing etc. DC: Conduct process, flow, and capacity analysis to improve product and information flow Store: Coordinate the disposition and timing of product shipments to stores	2–3 months
DC Labor Productivity	Implement engineered work standards and incentives for direct labor Improve tactics for managing labor utilization	4–5 months
Labor Management Systems	Implement LMS – either integrated into WMS or stand-alone system Utilize LMS output to manage and improve labor productivity	3 months
WMS Applications	Upgrade WMS through vendor's conversion plan	3 months
MHE Improvements	Evaluate areas of storage or throughput capacity shortfalls Analyze alternative equipment usage or configurations to determine payback	1–2 months
Network Optimization	Redesign network to reduce demand and lower cost Balance network capacities to reflect current business plans	2–3 months

Retail Operations

	Description	Time to Savings
Store Labor Productivity	Selling and non-selling payroll effectiveness and management	2–3 months
Labor Scheduling Practices	Alignment of payroll to workload and customer traffic, assessment of work rules, hours of operation and payroll control	1 month
Compensation and Pay Rules	Employee wage rates, incentives, compensation and pay rules	3 months
Field Management Structure	Realign organization to appropriate management layers and span of control	1 month
Inventory Flow and Control	Physical product movement door to floor, stock management, floor recovery and systemic inventory control	2–3 months
Customer Services and Policies	Customer service policies and procedures, service desk, front end, and value-added offerings	1 month
Facilities and Service Management	Asset management, utilities and store services such as housekeeping, maintenance, other contracted services	1–2 months

Appendix:

Corporate Organization

	Description	Time to Savings
Staffing Productivity	Align to industry benchmark	2–3 months
Span of Control	Bring supervision staffing to industry standards	2 months
Value Added Assessment	Review key corporate activities for cost/benefit	3 months
Benefits Review	Consolidate/simplify benefits program	3–4 months
Compensation Levels	Align with industry norms	2–3 months

Marketing

	Description	Time to Savings
In-Store POS	Reduce frequency and depth of in-store banners and POS refreshes	2–3 months
Loyalty	Simplify loyalty program and reduce cost of recruiting/rewards	2 months
ROP/FSI	Reduce quantity and cost of newspaper advertising	3 months
Brand	Reduce image spending on TV, events, charity	3–4 months
Catalog	Reduce production costs (pages, quality) Improve mailing productivity	3–4 months
Internet	Improve order acquisition costs Change promotional offers Improve shipping recovery Reduce site maintenance costs Integrate buying with stores	3–4 months

Appendix:

Information Technology

	Description	Time to Savings
Outsourcing and Off-shoring	Target specific functions/applications for third parties Pilot quick-win opportunities to solidify appropriate model	6 months
Contract Renegotiations	Renegotiate contracts associated with telecommunications, IT staff augmentation, facility hosting, maintenance, hardware procurement, etc. Increase/maintain service levels	1 month
Organizational Restructuring	Identify redundancy and rationalize Eliminate staff inefficiencies Align compensation with industry Structure to optimize existing governance model	3 months
Data Center Consolidation	Simplify the environment and ease manageability Reduce overall staff/data center count/server count Optimize support structure Increase/maintain service levels	6 months
Application Portfolio Rationalization	Sunset underutilized/duplicated systems Consolidate and optimize associated infrastructure Eliminate support and maintenance costs	2–3 months

Other Corporate G&A

	Description	Time to Savings
Corporate Space	Exit unneeded office space	2–3 months
Finance	Simplify financial processes to reduce transaction costs	2 months
Outside Services	Exit unneeded purchased services	3 months
MRO	Centralize purchases and increase controls	3–4 months