Competing on a Unique Offering and Distinctive Experience

The Rise of Act Vertical® Retailers

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Executive Summary

The historic relationship between retailers and their customers has changed dramatically this decade. The mounting disappearance of many stores and whole chains testifies to the fact that a growing number of retailers have failed to respond to a new set of customer expectations and growing competition for share of wallet. The shakeout began long before the current economic downturn. Driving it is the fact that customers have many more places to buy the same products: an overabundance of retailers selling the same items from the same brands, a proliferation of online retailers and online auction sites that have made a large and growing market for used goods.

The result: The traditional retailing model of being just a purveyor of national product brands is failing to inspire the customer to purchase. Customers demand much more of the retailers they choose to deal with—products and brands they can't get anywhere else, the ability to shape those products to meet their needs, and much different ways of interacting with the retailer, i.e., the customer's retail experience. Retailers that ignore this shift risk sliding into irrelevance with obsolete models.

A few retailers have recognized this sea change. They have developed a new operating model to differentiate themselves and deliver much greater value to their customers and shareholders. This operating model has been used by a small number of retailers including PetSmart Inc., Aéropostale Inc., Coach Inc., Trader Joe's Co., Target Corp., and Apple Inc. Each has grown rapidly despite the shakeout of retailers in its segments.

We call this operating model "acting vertical" for two reasons. First, these retailers realized the need to become serious product innovators and not just merchants. They collaborate on the front end of the supply chain, i.e., with their customers, and design and develop a number of compelling products with their brands on them (or national brand exclusives), in some cases, everything they sell. But, second, they aren't manufacturing these products. On the other end of the supply chain, they are working in a highly collaborative way with a smaller number of manufacturers. These retailers have control over quality without owning manufacturing. Hence we call the operating model they employ acting vertical.

A number of Act Vertical retailers are able to provide a unique offering by looking beyond products to creating complementary services that have greatly improved their customers' lifestyles and generated a significant profit. These services generate much higher product sales because they help customers satisfy their larger emotional needs, lifestyle demands and aspirations. Such services also enable a retailer to gain a much richer understanding of its customers' needs—insights it can use to continually create new and compelling products and services.

Executive Summary

However, bringing unique and compelling products and services to market isn't the only part of the Act Vertical model. The Act Vertical retailers we studied also designed and executed engaging customer experiences around their offerings: store, Web, catalog and other environments that showcase their unique offerings and demonstrate their differences. By providing compelling products and services through engaging customer experiences, the best Act Vertical retailers create a virtuous circle that continually strengthens their bonds with customers. Some of the retailers we studied (Apple, Recreational Equipment Inc. (REI) and Trader Joe's among them) had turned their customers into passionate advocates—people who not only liked shopping at those retailers but also enjoyed congregating with one another in and outside the stores. In this way, these retailers had created a "tribe" of people with common passions, values and aspirations.

So how were the Act Vertical retailers that we studied able to create and execute distinctive and compelling offerings and customer experiences? Exactly what did they do to achieve superior financial performance? First, they had a clear retail-brand strategy, a sharp articulation of their target customers and the kind of offering and experience they would deliver to them. Second, these retailers developed seven core capabilities that enabled them to deliver unique and compelling offerings and customer experiences:

- Market research that identified emerging customer needs
- Product design and development that balanced creativity and commercial appeal
- Consumer testing that shaped the offerings and customer experiences
- Sourcing relationships that accelerated manufacturing but also delayed key product decisions
- Assortment, allocation and replenishment that rapidly shifted products to places of greatest demand and maximized pricing
- Design and execution of an engaging and consistent brand experience across all channels
- Marketing that communicates the brand promise across all channels and showcases how the retailer's offering and experiences enhance customers' lifestyles

Despite their rapid and highly profitable growth, none of the retailers we studied had mastered all seven Act Vertical components. In our view, this means considerable opportunities for retailers that pursue an Act Vertical model, as well as for retailers that are already operating this way.

Key Findings and Today's Challenges

In March 2008, Kurt Salmon Associates (KSA) launched research that used quantitative and qualitative methods to deeply explore the trend of vertical integration in retailing. On the quantitative side, we conducted an extensive 28-question survey with 101 retailers (all of which were more than $500 million in annual revenue). On the qualitative side, we conducted in-depth case studies on 10 retailers, eight of which came through on-site and phone interviews with a range of executives at each retailer. The other two case studies came from extensive literature searches and discussions with KSA subject-matter experts.

The following are our key findings:

Finding No. 1: The shakeout in U.S. retailers began long before the recession of 2008, and it will most likely extend long after the economy rebounds. The number of retail bankruptcies and mergers began accelerating in 2002, long before the latest recession started. Stores have been especially vulnerable given an excess of retail space in the United States (up 31% per capita over the last 25 years in the 54 biggest markets) and diminishing growth in sales per square foot at many retailers, even at Wal-Mart Stores Inc. Despite the first annual drop in 20 years in occupied retail space, the retail construction boom this decade has left the United States with too many stores competing for the same customers. (See Chapter 3.)

Finding No. 2: The core driver of the retailing shakeout is that the historic relationship between retailers and their customers has changed dramatically this decade. Our survey research indicates that customers see an overabundance of retailers—both bricks-and-mortar and direct—selling too many of the same product brands to consumers whose tastes are changing faster and thus demand products that meet those needs. Furthermore, consumers are far less tolerant of unfruitful shopping experiences, and they have a much better ability to avoid them. That is because they are increasingly using the Internet to determine where to shop, whether or not they make the purchase online. As a result, the traditional model of most retailers—largely, one of being purveyors of national product brands and providing little information about and assistance with those products—is failing to inspire many customers to shop with them. Today's consumers demand much more of the retailers they choose to deal with: products they can't get anywhere else, the ability to shape those products to meet their needs, more product information, and much different ways of interacting with the retailer, i.e., the customer's retail experience. Retailers that ignore this shift risk sliding into irrelevance with obsolete models. (See Chapter 3.)

Key Findings and Today's Challenges

Finding No. 3: To try to differentiate their products and customer experiences, many retailers have been selling a larger number of private-label or exclusively distributed items, as well as providing more store and website information on what they sell. However, these retailers have had mixed success. About one-third of retailers we surveyed (36%) generated the majority of their revenue from products unique to their chains. By 2013, 41% planned to generate the majority of revenue from their own products. However, only a minority (43%) said they had been highly or very highly effective at getting customers to embrace and purchase products that were unique to their chains. And less than one-third (30%) said they were highly or very highly effective at helping store customers secure the right products. Even fewer (20%) said their websites were highly effective at this game. (See Chapter 3.)

Finding No. 4: A minority of retailers have successfully introduced distinctive products and have enjoyed huge success. Retailers such as PetSmart, Aéropostale, Coach, Trader Joe's and Target realized the need to become serious product innovators and not just merchants of national product brands or sellers of their own knockoffs. They collaborate on the front end of the supply chain, i.e., with their customers, and design and develop a number of compelling products with their brands on them, in some cases, everything they sell. But they aren't manufacturing these products. On the other end of the supply chain, they are working in a highly collaborative way with a smaller number of manufacturers. They have control over quality without owning manufacturing. (See Chapter 3.)

Finding No. 5: Besides developing their own compelling products, some retailers went beyond products to provide a unique offering, creating complementary services that greatly improved their customers' lifestyles and generated a significant profit. Retailers, such as PetSmart and Best Buy Co. Inc., that have been offering more of their own products also moved aggressively into selling their own services. These services generated much higher product sales because they help customers satisfy their larger emotional needs, lifestyle demands and aspirations. Such services also enabled these retailers to gain a much richer understanding of their customers' needs—insights they can use to continually create new and compelling products and services. (See Chapter 3.)

Finding No. 6: The retailers that were the most successful in competing on the basis of unique and compelling offerings also designed and executed engaging customer experiences. They had store, Web, catalog and other environments that showcased their unique offerings, demonstrated their differences and made a greater emotional connection with customers. By providing compelling products and services through engaging customer experiences, these retailers created a virtuous circle that continually strengthened their bonds with customers. We refer to this strategy as Act Vertical. Retailers that use an Act Vertical approach create not only distinctive offerings, but they also deliver distinctive customer experiences that make their offerings even more compelling.

Key Findings and Today's Challenges

Several Act Vertical retailers (Apple, REI, PetSmart and Trader Joe's among them) created truly engaging customer experiences that have set them apart from competitors. They have turned their customers into passionate advocates—people who not only liked shopping at those retailers but also enjoyed congregating with one another in and outside the stores. In this way, these retailers had created a tribe of people with common passions, values and aspirations. (See Chapter 4.)

Finding No. 7: The ability of Act Vertical retailers to create and execute distinctive and compelling offerings and customer experiences requires a) a clear retail-brand strategy that is aligned with its operating strategy (the offering and customer experience to deliver) and b) seven core capabilities: market research that identified emerging customer needs; product design and development that balanced creativity and commercial appeal; consumer testing that shaped the offerings and customer experiences; sourcing relationships that accelerated manufacturing but also delayed key product decisions; assortment, allocation and replenishment that rapidly shifted products to places of greatest demand and maximized pricing; design and execution of an engaging and consistent brand experience across all channels; and marketing that communicates the brand promise across all channels, and showcases how the retailer's offering and experiences enhance customers' lifestyle. (See Chapter 5.)

Finding No. 8: Over the last 10 years, Act Vertical retailers significantly outperformed retailers that were unsuccessful at this game on a number of key measures of performance: revenue increases, operating profit margins, gross margins, same-store sales, sell-through rates, inventory turns and inventory return on assets, among others. (See Chapter 3.)

Despite their rapid and highly profitable growth, none of the retailers we studied had mastered all seven Act Vertical components. In our view, this means considerable opportunities for retailers that pursue this emerging trend, as well as for retailers that are already operating this way. We believe all retailers—from apparel to convenience stores—will have to adopt an Act Vertical operating model to some degree over the next few years to differentiate themselves in a retailing landscape of more-demanding customers and fiercer competition.

Key Findings and Today's Challenges

The Evolution of Vertical Integration in Retailing

This decade has been a tumultuous one for numerous retailers, and many have sought much greater differentiation in their product offerings. Some retailers began shifting from selling mostly national product brands to a model in which they design and brand their own products, controlling the entire value chain, from manufacturing to retail distribution. It is a model that fueled the ascent of Gap in the early 1980s, when a new CEO, Millard "Mickey" Drexler, began refashioning a merchant of Levi's jeans into a retailer that would sell only one brand of a broader line of products: its own. Over the next 20 years (1983 to 2003), Gap's revenue soared more than 30-fold to nearly $16 billion, before flattening out the last five years.

Today, many retailers control the value chain from concept to consumer—creating, commercializing and retailing their own products. This model has spread to every retail segment. From convenience stores and mass merchandisers to department stores and grocery chains, retailers have adopted vertical models to attract shoppers to their channels. One gauge of this is the rapid increase in private-label sales. Private-label sales in U.S. grocery stores are now about 18% of total revenue, and growing nearly 10% annually, according to Nielsen Media Research. Drug stores generate 13% of revenue from private labels, and that number is growing 15% a year. And although private label accounts for only 1.5% of convenience-store sales, it has been climbing 18% annually. Even manufacturers like Apple, Nike, and Coach have backed into retailing, becoming vertical players in reverse.

But is it working? Do retailers that create and brand many of the products they sell have a substantial edge against retailers that don't? If so, which retailers are winning with such strategies? By how much are they winning—that is, how much are they outperforming their competitors and on what measures? And most importantly, what separates them from the retailers that have struggled with their own vertical integration strategies? What can retailers in every sector learn from the retailers that have been the best at vertical integration?

Before looking at this, we first explore the factors that have been driving an increasing number of retailers to sell more of their own products.

Key Findings and Today's Challenges

The Decade-Long Shakeout in Retailing

It would not be hyperbole to say that over the last decade, retailing in North America has become a brutal business. Statistics paint a bleak picture for today's retailing environment, yet it is one that began long before the recession of 2008.

While the headlines in recent months have been filled with the bankruptcy announcements of such retailers as Circuit City, Mervyns, Boscov's, and Linens 'n Things, the number of retail bankruptcies has been increasing steadily since 2002. (See Exhibit 2-1.) Financial pressure has forced many more retailers into the arms of other retailers. The number of merger and acquisition closings among U.S. retailers also increased between 2002 and 2007. (See Exhibit 2-2.)

EXHIBIT 2-1: RETAIL FAILURES RISE

Source: Capital IQ bankruptcy database of retailers (including Internet retailers)

EXHIBIT 2-2: RETAIL OWNERSHIP SHIFTS

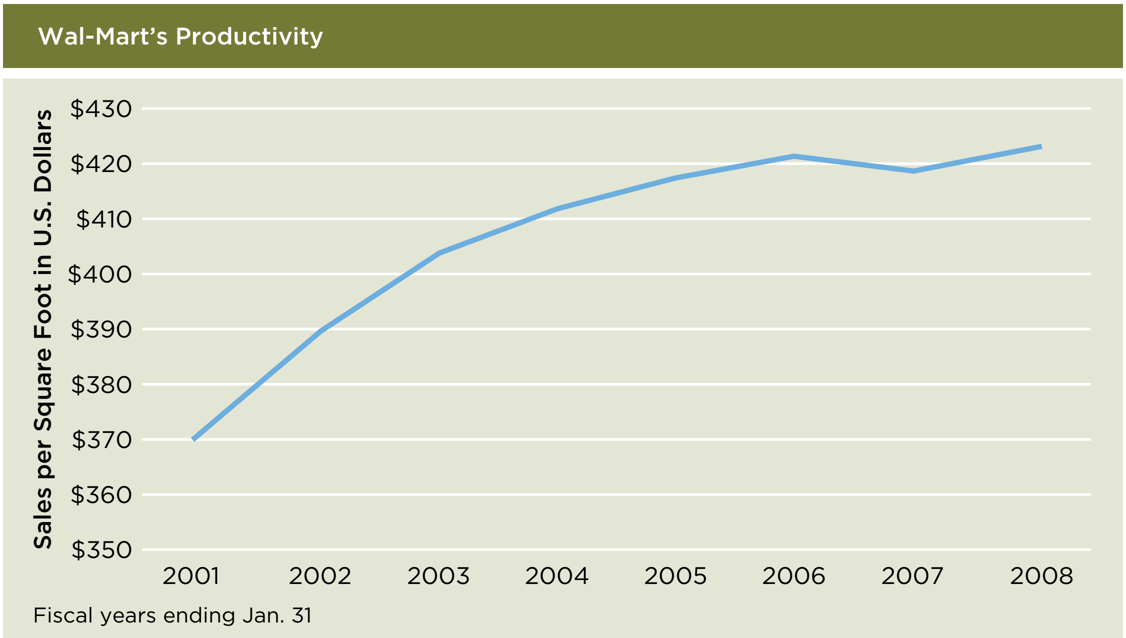
Source: Capital IQ

The statistics on new retail space also reflect the retail slump. After building 1 billion square feet of new retail space from 2000 to 2008, the construction of new space in America's 54 largest markets was expected to plunge 40% in 2009 vs. 2008.[1] And retail construction in 2010 is projected to fall another 34% from 2009. In 2008, for the first time in nearly 20 years, the amount of occupied retail space in these same markets fell by 1.2 million square feet, after increasing about 61 million square feet in 2007.

Key Findings and Today's Challenges

Apparently, there are far too many stores and not enough customers. Over the last 25 years, the amount of retail space per capita in the biggest U.S. markets has climbed 31%.[2] Driving greater sales growth from stores has become difficult for many U.S. retailers, even for the world's largest, Wal-Mart. Since 2005, the company's sales per square foot in the United States—$423 in 2007—have essentially been flat (not including 2008 data). (See Exhibit 2-3.) Wal-Mart's U.S. store sales had increased 5% to 6% annually from 2000 to 2002, but rose only 1.9% in 2006 and 1% in 2007.

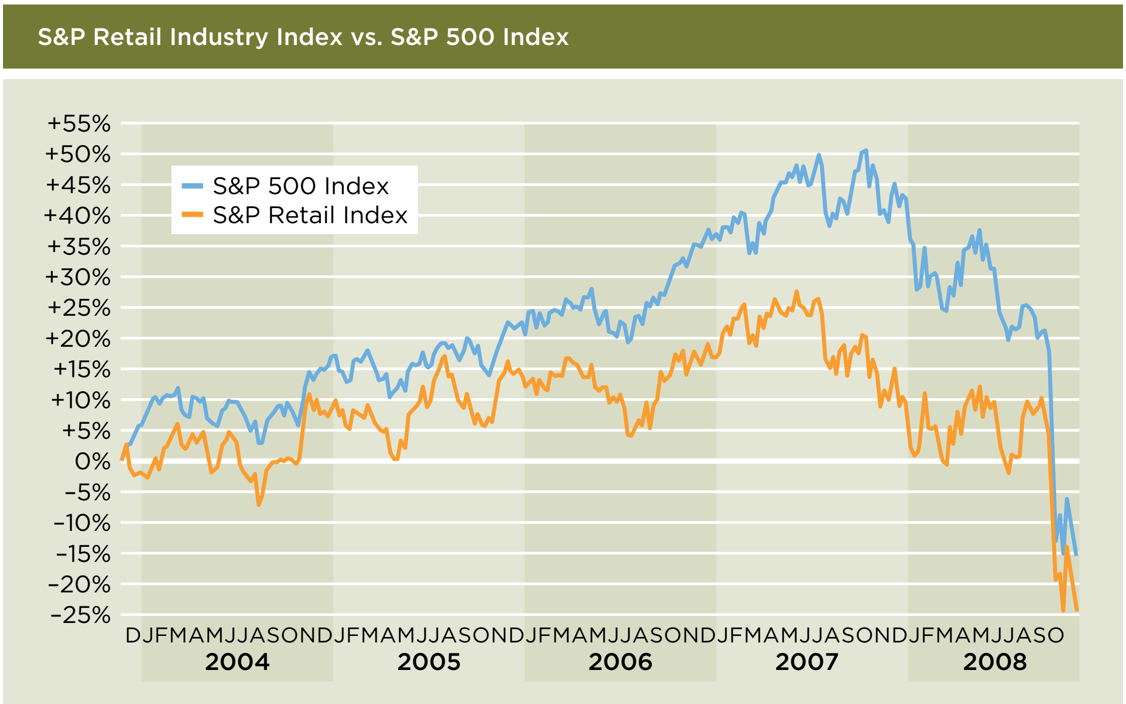
EXHIBIT 2-3: THE WANING SALES PRODUCTIVITY OF U.S. STORES



Key Findings and Today's Challenges

In light of such statistics, stock market investors have been sour on publicly held U.S. retailers as a sector. Since the end of 2004, the stock performance of U.S. retailers has trailed that of the largest 500 U.S. stocks, with the gap widening significantly at the beginning of 2006. (See Exhibit 2-4.)

EXHIBIT 2-4: U.S. RETAIL STOCKS LOSE THEIR LUSTER



According to KSA's analysis of 225 publicly held U.S. retailers, the precarious retail environment can also be seen in the lackluster financial results of the majority of these companies in the last 10 years. About 60% could generate only single-digit increases in average annual revenue and profit between 1998 and 2007, including 15% whose average yearly profit declined. In fact, 27% saw profits fall in 2007 vs. 2006.

Key Findings and Today's Challenges

So Many Retailers, So Little Differentiation

The accelerating shakeout signifies how difficult it has become for retailers to differentiate themselves in the minds of customers. In fact, we believe two factors more than any others are responsible for the growing shakeout, particularly for the demise or contraction of many store-based retailers:

1. An overabundance of undifferentiated retailers. The cutback in new retail construction, the decrease in retail sales per square foot, and the decline in occupied retail space in the major metropolitan markets all are signs of too many stores vying for consumers' tightened purses and wallets. But keep in mind that stores and catalogs are not the only way to sell retail products. Store and catalog retailers didn't have to compete against Internet retailers until 1993, when firms like Amazon.com Inc. were launched. Online retail sales in 2007 reached $136 billion, accounting for 3.4% of all U.S. retail sales, according to the Census Bureau. Internet retailers like Amazon (2007 revenue of about $15 billion) have cut into the retail pie once controlled by chain stores and catalog retailers. Additionally, retailers today must compete against garage sales that the Internet has made global in nature. Internet auction firms like eBay have created a robust national and global market for used products. In 2007, an estimated $26 billion in goods were sold on eBay alone in the United States. Assuming that every dollar spent on eBay to buy a used good took away, say, $3 from the purchase of a new good at a retailer, that would mean one online auction house (albeit the largest) had taken about 2% of the U.S. retail pie in 2007 (about $80 billion out of $4 trillion). Whether or not the estimate is on target, the impact of online auction houses on retailers cannot be ignored.

2. Consumers who are far less tolerant of unfruitful shopping experiences—and much better able to avoid them. Numerous studies show that consumers have less time to shop and enjoy shopping less and less. One study of U.S. apparel shoppers in 2007 found only 34% shopping monthly, compared with 46% in 2006.[3] A U.S. government study in 2007 found that more U.S. consumers viewed shopping as something they "just have to do" (48%) vs. something they enjoy (42%).[4] More importantly, because of the Internet, consumers today have far greater ability to spare themselves of disappointing shopping experiences, e.g., after trekking to stores, coming up empty or settling for less (i.e., paying a higher price or choosing a product that doesn't fully meet their needs). Every day, 15% of Americans go online to research products. In fact, the clear majority of Internet users (81%) have used the Web to research products before they buy them. A Shop.org study found that 55% of Americans with Internet access at work (73 million people) were planning to shop online for the 2008 holiday, up 45% from three years earlier.[5] Another study estimated that by 2011 40% of all offline retail sales in the United States will be influenced by consumers conducting research online beforehand.[6] By lowering the cost of gathering product information, the Web has dramatically reduced consumers' transaction costs of shopping.

Key Findings and Today's Challenges

In turn, lower shopping transaction costs mean consumers can be far more directed in their shopping and weed out unnecessary trips to the store. We believe this, too, has contributed to the decline in stores' sales productivity.

The growing commoditization of retailing and increasing power of consumers to make shopping more efficient spell danger for retailers that lack very special reasons to shop with them, i.e., compelling products and distinctive shopping experiences that cannot be found at other retailers.

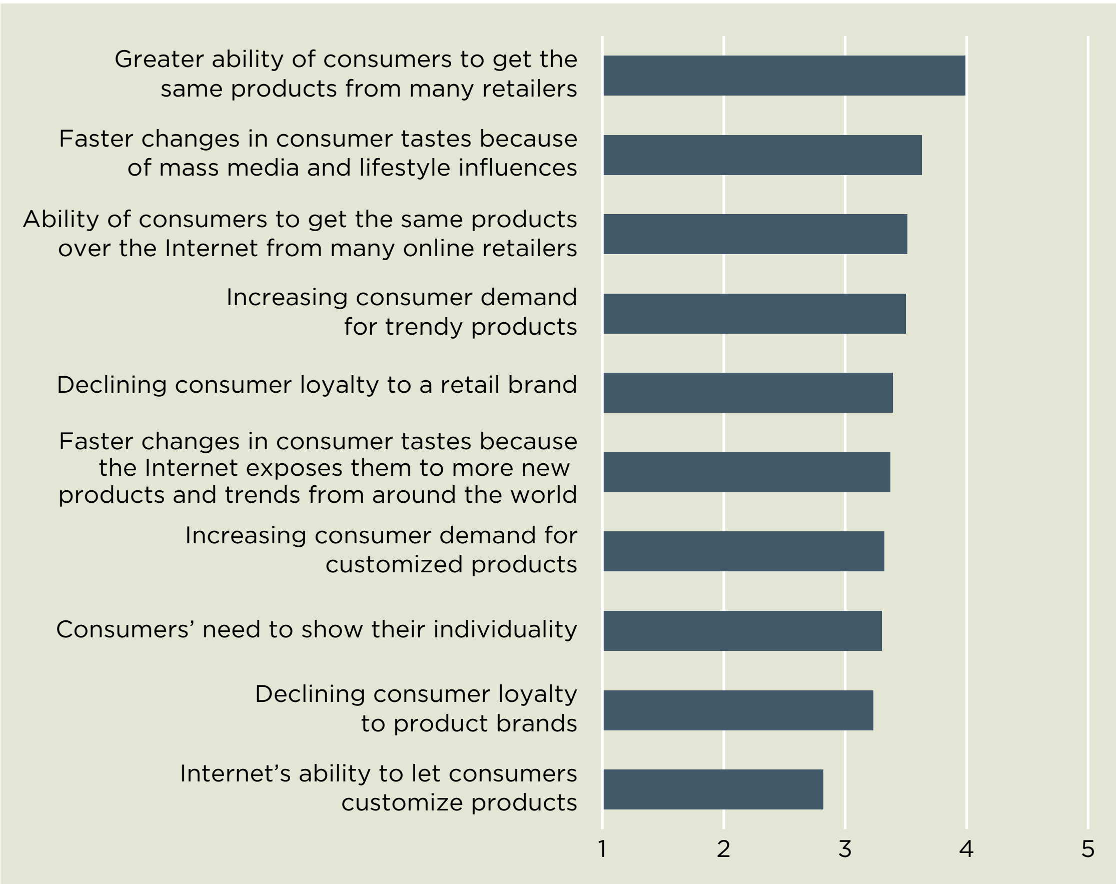
Drivers of Unique Products and More-Engaging Customer Experiences

While we have our own views about what has forced retailers to better differentiate their offerings and customer experiences, we wanted to hear what retail executives felt were the most important factors. In our survey, we asked executives to rate the importance of 20 factors that have driven many retailers over the last 10 years to increase the number of differentiating products they sell, as well as to provide more-engaging consumer experiences.

The highest-rated factor behind many retailers selling a greater number of differentiated products was consumers' greater ability to get the same products from many retailers. (See Exhibit 2-5.) The second and fourth most highly rated factors were about faster changes in consumer tastes. The third most highly rated factor was consumers' ability to get the same product over the Internet from many online retailers.

EXHIBIT 2-5: UBIQUITY DRIVES DEMAND FOR UNIQUENESS

What's Driving Retailers to Increase their Number of Unique Products?

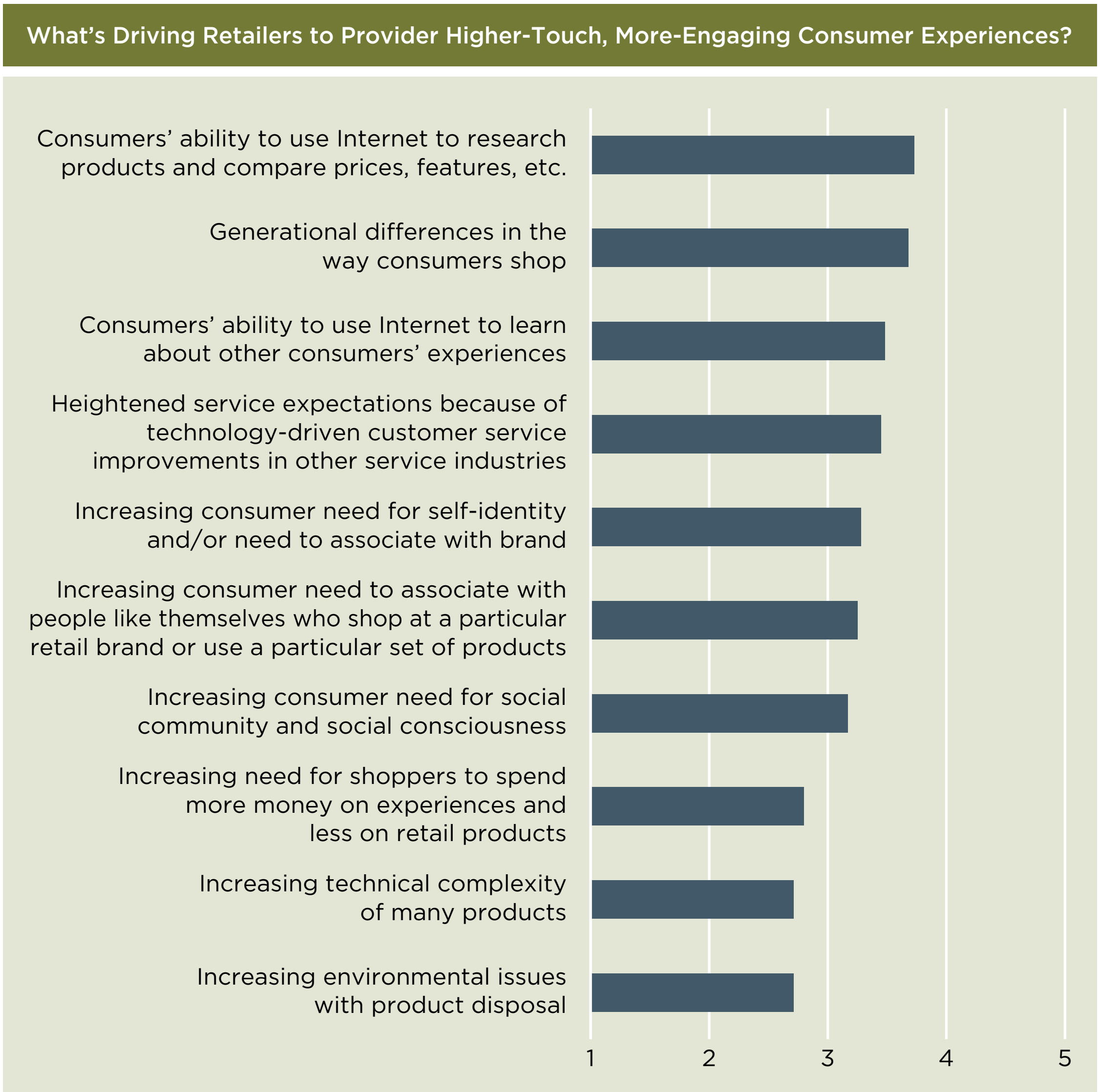


Scale of 1 to 5, 1=Not at all important, 3=Moderately important, 5=Very highly important

Key Findings and Today's Challenges

What's driven some retailers to invest in higher-touch and more-engaging customer experiences? (Note: In the survey questionnaire, we defined higher-touch and more-engaging customer experiences as those providing "greater assistance in helping consumers select and use products or in other ways form stronger relationships with the retailer.") Two of the three highest-rated factors were Internet-related. Consumer use of the Internet for product research and comparison shopping was rated more important on average than the other nine factors we provided. (See Exhibit 2-6.) If the same products can be purchased from many more retailers, then retailers must differentiate themselves on another basis: customers' experience in dealing with them. The third most highly rated factor was consumers using the Internet to share their experiences with other consumers about retailers and the products they sell. Respondents rated generational differences in the way consumers shop as the second most important factor driving improvement of retailers' customer experience. The fourth most important factor was increasing service expectations driven by improvements in other service businesses. And the fifth was consumers' need for self-identity, to associate with a retail or product brand.

EXHIBIT 2-6: THE INTERNET INFLUENCES DEMAND FOR COMPELLING SHOPPING EXPERIENCES



Scale of 1 to 5, 1=Not at all important, 3=Moderately important, 5=Very highly important

Key Findings and Today's Challenges

The Limitations of Current Approaches to Retail Improvement

With these forces of change in mind, we asked survey respondents about the effectiveness of 54 approaches to improving a retailer's financial performance. We did so by asking them to rate the effectiveness of the approaches they may have implemented over the last 10 years, providing a 5-point scale. We grouped these improvement initiatives into seven areas:

> **Product-related:** accelerating new-product introductions, increasing the number of store brands, etc.

> **Brand experience:** improving the website and catalogs, creating better integrated and pre- and post-sales customer service, etc.

> **Launching new retail brands:** creating new retail concepts and bringing them to market

> **Stores:** increasing the number of stores, increasing or decreasing store labor, increasing store training, etc.

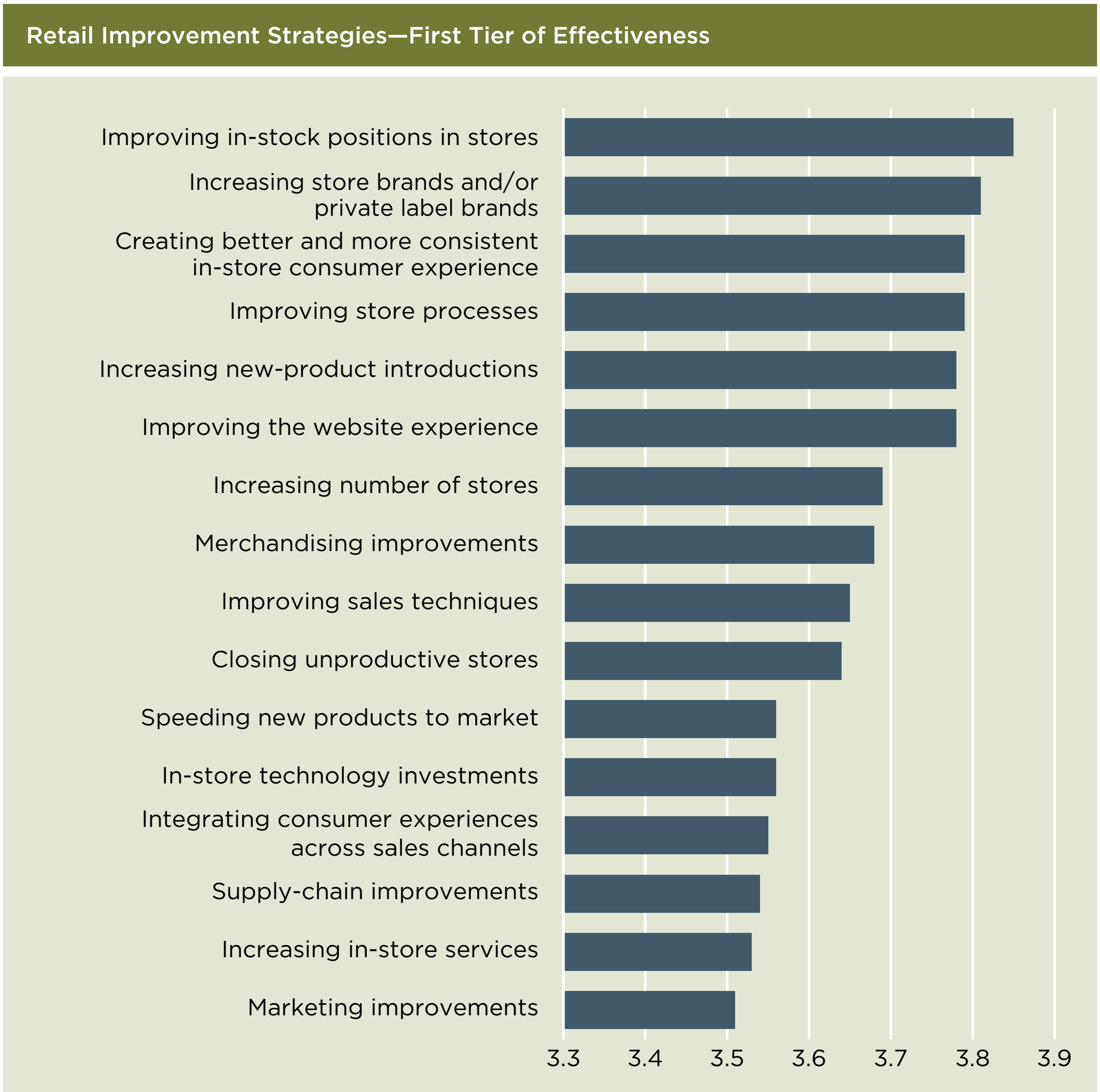
> **Technology:** website and online marketing, supply-chain technology, markdown software, and seven other categories of technology investments

> **Non-store operations:** improvements in planning, marketing, supply chain, etc.

> **Measurement:** new metrics for individual performance, supplier performance, customer value, etc.

As a whole, these retailers do not see each improvement technique as a driver of strong performance. The technique with the highest average rating—creating better in-stock positions in stores—commanded only a 3.85 on our scale of 1 to 5. (Note: A "4" equaled "highly effective.") The second highest was increasing the number of store brands. Tying for third were making better and more consistent in-store consumer experiences (better store design, displays, sales clerk training, etc.) and making improvements to store processes. In all, 16 improvement approaches received average ratings of between 3.50 and 3.85, i.e., more than moderately effective but not highly effective (and nowhere near being viewed as "very highly effective"). We refer to these as the first tier of retail improvement approaches. As a whole, nine of the 16 first-tier approaches centered on store or product improvements. (See Exhibit 2-7.)

EXHIBIT 2-7: CURRENT RETAIL STRATEGIES CENTER ON STORE AND PRODUCT STRATEGIES



Improvement Approaches Receiving Ratings of 3.5 to 4.0
Scale of 1 to 5, 1=Not at all effective, 3=Moderately effective, 5=Very highly effective

Key Findings and Today's Challenges

The ratings of these 54 improvement approaches do not negate their merit. We suspect that many retailers see each approach as important at a point in time but perhaps limited in impact over an extended period. Other data show that combining some of these approaches appears to have bigger benefits than implementing them piecemeal.

The effectiveness ratings may also reflect less on the viability of each improvement technique and more on the ability of retailers to execute them well. Nonetheless, these findings indicate that the retailers we surveyed did not find a silver bullet to generating superior performance over the last 10 years. In particular, the survey respondents' answers showed that four strategies that we've seen as among the most popular ones over the last decade were not panaceas:

> **Accelerating new-store openings** (average effectiveness rating of 3.69): This was the fifth-highest-rated strategy, yet it still received largely modest ratings. Focusing on accelerating new-store openings can greatly increase overall revenue, but it doesn't necessarily arrest declining customer loyalty and falling prices, and thus can erode overall profitability. This was the story of apparel innovator Gap stores between 1994 and 2003. Revenues increased more than fourfold (from $3.3 billion to $14.4 billion) as the company more than tripled the number of its Gap, Banana Republic, Old Navy and other stores in this period. However, sales per square foot fell 25% between 1994 and 2003, which helped reduce the company's net margin (net income as a percentage of sales), which dropped from 7.8% to 3.3%. Since 2003, the company has shut about 1,000 stores, 25% of its total.

> **Launching new retail brands** (average effectiveness rating of 3.21): The investments (and thus the risk) to create and bring to market a whole new retail chain can be even greater than the investments to expand an existing chain whose business model is largely working. Of course, launching new retail brands can be lucrative. Even the Gap's struggle with its core Gap stores was somewhat offset by its 1994 launch and subsequent success of the Old Navy chain. However, launching new retail concepts doesn't always work that way. Apparel retailer Abercrombie & Fitch Co. (2007 revenue of $3.7 billion) has opened two new retail brands (RUEHL and Gilly Hicks) since 2004. However, overall sales and profit growth has receded since 2006 (after doubling between 2003 and 2006). Sales per square foot fell 2% in 2007, with only the flagship Abercrombie & Fitch chain posting an increase (3%). RUEHL's sales per square foot plummeted 22% in 2007.

> **Reengineering within a retailer's four walls:** The survey respondents rated cross-functional process improvements only slightly higher in effectiveness (at 3.22) than they rated launching new retail brands. Such operational change can dramatically improve a retailer's productivity and make substantial cost reductions that align revenue with payroll. But it does not increase customer loyalty or differentiation.

Key Findings and Today's Challenges

> **Increasing the number of private-label knockoffs:** While the survey respondents rated "increasing store brands and/or private-label products" the second-most-effective improvement strategy out of the 54 we provided (receiving an average rating of 3.81), we have seen many retailers execute this strategy in just one way: increasing the number of knockoffs of national product brands. During economic downturns, when consumers trade down in many categories, this can boost retailers' margins. Yet knockoffs still leave retailers whose store brands are primarily knockoffs with a largely undifferentiated offering—products that are no different from other retailers' products except on price. With too many private-label brands, drugstore giant Walgreen Co. in 2007 formed a 10-person department known internally as the "private-brand police" that reduced the number of company and exclusive brands by 50%. About 20% of Walgreens' merchandise revenue is from private-label products, nearly double the amount in 2000.[7]

How Retailers Are Faring at Creating Unique Products and Engaging Experiences

To give consumers additional reasons for visiting their stores, websites and catalogs, many retailers have made substantial investments in differentiating their offerings and customer experiences. Across many retail sectors the importance of private-label products is clear. More than one-third of the 101 retailers we surveyed (36%) were generating more than 50% of their sales from private-label and exclusive brands. They also intend to increase it over the next five years.

We gathered this trend data by first asking respondents to indicate the revenue they would generate in 2008 from private-label and exclusive products by choosing from a range of responses (e.g., 0%-10%, 11%-20%, etc.).

We refer to the group of retailers for which private-label and exclusive products are more than 50% of revenue today as being "highly unique" in products. A nearly equal percentage of respondents (37%) were "minimally unique" in products, generating 20% or less of total revenue from private-label and exclusive brands. The remainder (27%) generated from 21% to 50% of revenue from unique products, a group we refer to as "moderately unique" in products.

To understand the overall direction retailers planned to go with such unique offerings—whether they planned to sell more or less of them—we also asked respondents to project the percentage of revenue from unique products in five years (by the year 2013). The answer was clear: Overall, they planned to increase their percentage of revenue from unique offerings. The percentage of retailers that are highly unique in products is projected to grow from 36% to 41% in five years. The percentage of retailers that were moderately unique is projected to grow from 27% to 34%. And the percentage of retailers that are minimally unique will shrink from 37% to 25%.

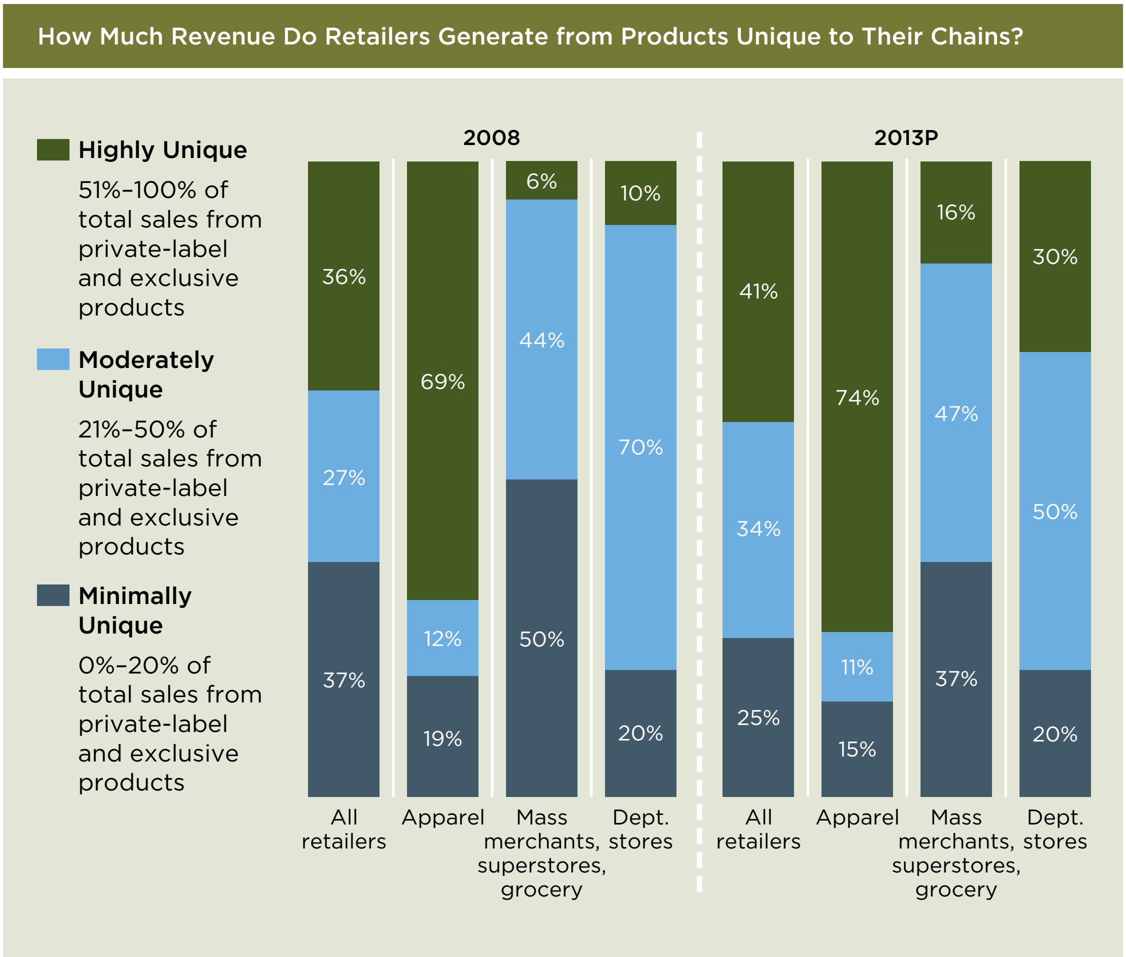
Percentage of Unique Product Revenue Varies Greatly by Retail Sector

The percentages of revenue from unique products across our entire survey group—now and in five years—mask some substantial differences by retail sector. For example, apparel retailers generate a much higher percentage of revenue from unique products than do mass merchants, grocery stores and department store chains. More than two-thirds (69%) of the apparel chains (including shoe stores) that we surveyed were highly unique in products, while only 6% of a category that included mass merchants, superstores and grocers drove more than 50% of their revenue from unique products. Half this group was minimally unique, and 44% were moderately unique. Only 10% of the department store chains we surveyed were highly unique. Some 70% of the department stores were moderately unique, while only 20% were minimally unique.

How Retailers Are Faring

Three times the number of department stores (a retail sector whose share of the total retail pie in the United States has shrunk in half from 12% in 1995) say they'll generate more than 50% of revenue from unique products by 2013—30% vs. 10% today, from our sample.

EXHIBIT 3-1: RETAILERS EXPECT REVENUES FROM UNIQUE PRODUCT TO GROW



Percentage of revenue generated from private-label and exclusive products, 2008 and 2013 (projected)

How Retailers Are Faring

Customer Experience: Low-Touch Is the Norm Today, but Greater Engagement Is the Goal

In addition to quantifying the degree to which retailers' offerings were unique to their chains, we also sought to assess the experiences they provided their customers, especially the amount of information and guidance they provided about their offerings. To be sure, we weren't scientific about this. We did not poll their customers about their experience with these retailers, nor did we ask retailers to complete an extensive checklist with dozens of attributes on the retail experience. Instead, we asked these retailers to rate the customer experience they provided in five critical areas:

> **The website:** before customers made a purchase, the degree to which the site explained the retailer's products in words and pictures, and thus helped customers determine whether they are the right products to purchase

> **The stores:** the degree of guidance provided to customers about the products the retailer sold; guidance could come from sales clerks, kiosks, in-store computers or other means

> **Websites and call centers:** after customers purchased products, the amount of information the retailer's website and call centers provided on how to use the products it sold

> **Targeted marketing channels:** the degree to which they used email, direct mail, and telemarketing to let customers know specifically about products that might interest them

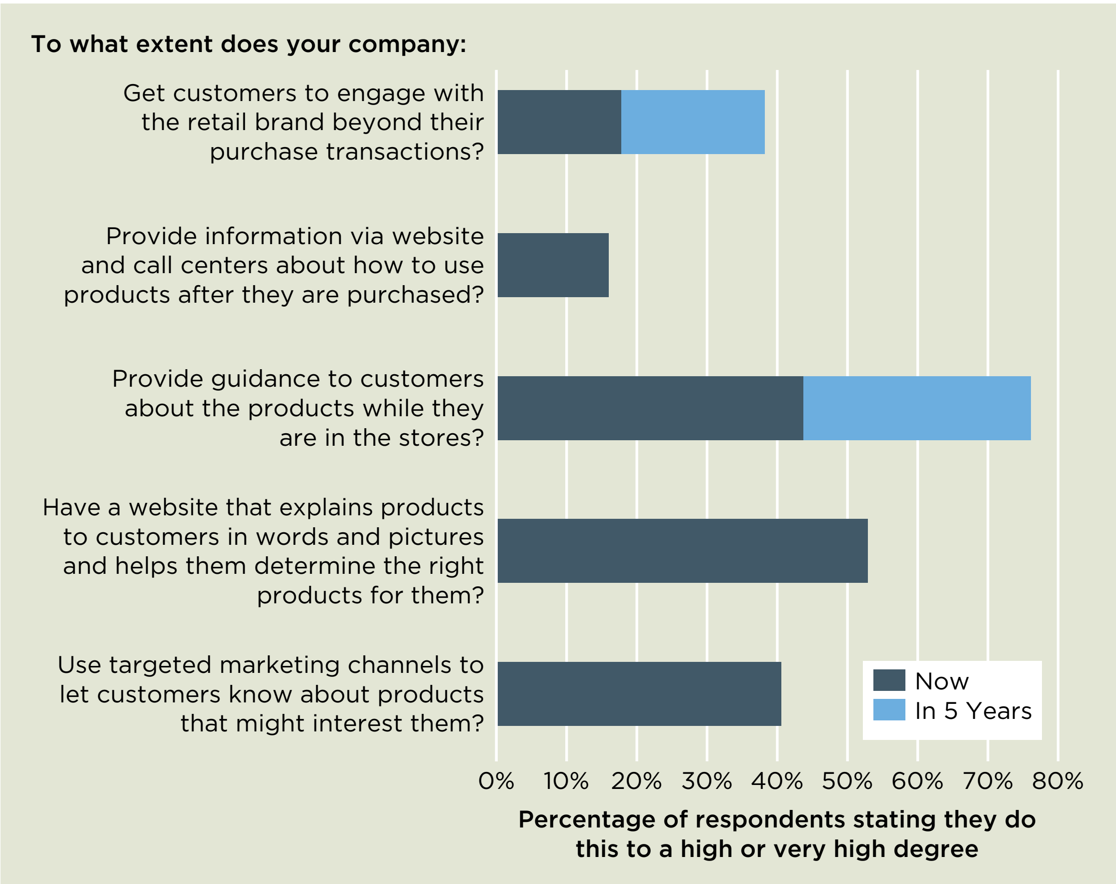
> **Customer "engagement" outside the sales channels:** the ability to get customers to engage with the retail brand, e.g., to attend store events, socialize with other shoppers, and so on

The responses to these questions told us a lot: most retailers' websites today provide higher degrees of product information than provided in the stores themselves. However, retailers' websites and call centers provide much less product usage information to customers after they purchase products. More than half the respondents (53%) said their websites provided high or very high degrees of information on their products that helped customers determine whether to purchase them. A smaller number of respondents (43%) said their stores provided high or very high degrees of product information. But only 16% said their websites and call centers provided information on product usage after a customer purchased the goods.

Engaging strongly with customers outside the purchase transaction also appears to be the exception rather than the rule. Half the respondents said they had no or low degrees of customer engagement outside of purchase transactions, and only 17% had high or very high degrees of such customer engagement.

EXHIBIT 3-2: RETAILERS RECOGNIZE THE NEED FOR GREATER ENGAGEMENT WITH THEIR CONSUMERS

How Much Guidance Do Retailers Provide Customers in the Overall Experience?



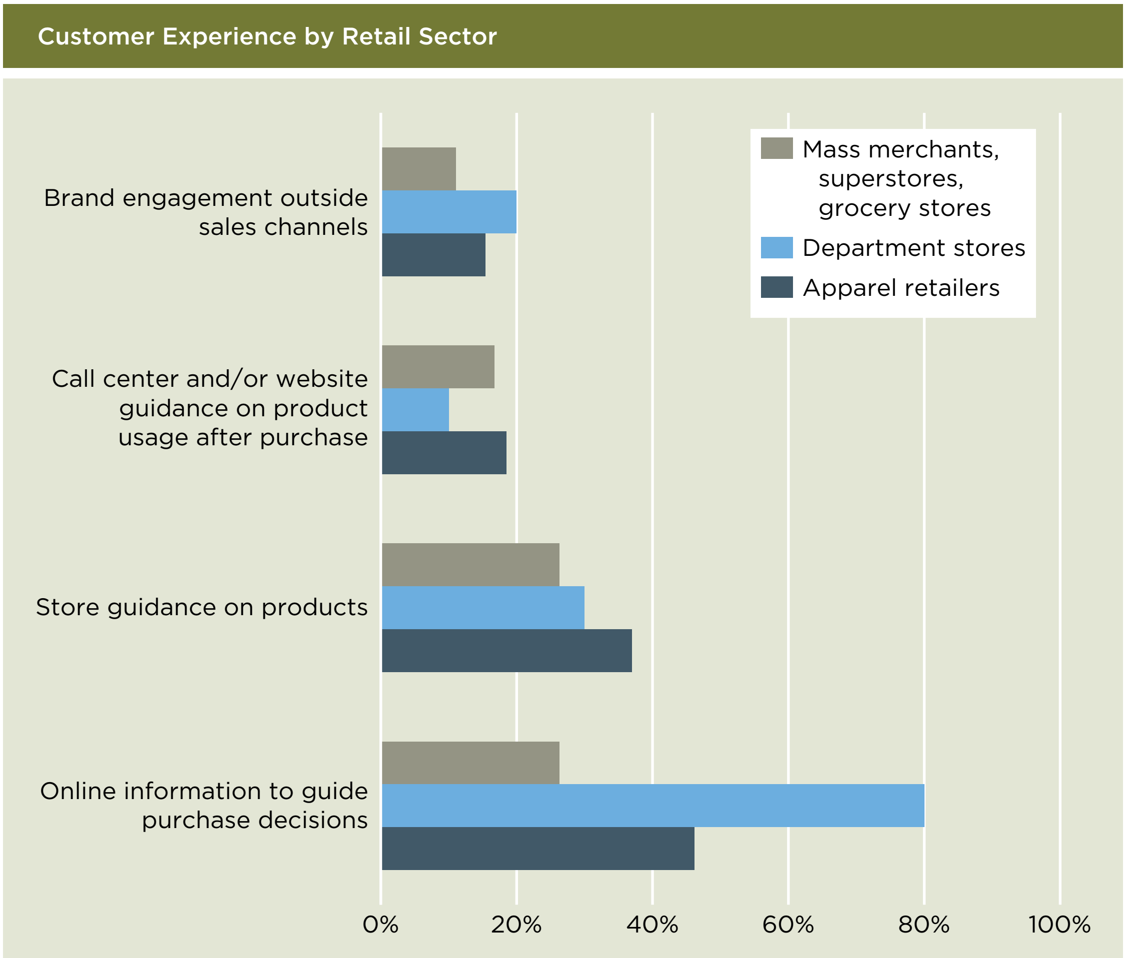
Percentage of retailers saying they provide high or very high degrees of help to customers on their websites and in their stores and call centers

How Retailers Are Faring

Judging from the survey responses, customers were likely to get much higher levels of guidance on products from department store websites (80% of them said they provided high or very high degrees of product information on their websites) than from stores in other retail sectors. Surprisingly, department stores were less likely to provide high or very high degrees of in-store guidance than apparel retailers: 37% of the apparel retailers said they did so vs. 30% of the department stores.

However, all three sector groupings were low on the brand engagement dimension. No more than 20% in all scored themselves as providing high or very high degrees of customer engagement outside of purchase transactions.

EXHIBIT 3-3: RETAILERS STRUGGLE WITH BRAND ENGAGEMENT OUTSIDE THE SALES CHANNELS



Percentage of retailers in three sectors that provide high or very high degrees of guidance and customer engagement

How Retailers Are Faring

Customer Engagement Expected to Grow by 2013

Despite these low measures of customer experience, the retailers we surveyed said they would improve it by 2013. Across all retail segments, 76% of the respondents said their chains would provide high or very high degrees of in-store guidance on their products, compared with 43% in 2008. More than twice the number of respondents planned to provide high or very high degrees of brand engagement by 2013, 38% vs. 17% in 2008. About half the department stores and apparel retailers said they would have high or very high degrees of brand engagement by 2013, while less than one-quarter (22%) of the retailers in the mass merchants, superstore and grocery sector said so.

Most Retailers Are Not Highly Effective at Creating Compelling Products *and* Engaging Experiences

In addition to surveying retailers about the revenue they generated from products unique to their chains and the degree of customer information, experience and engagement they provided, we asked them how effective they were at creating unique products *and* better experiences. Unique products are not necessarily successful products. Likewise, higher levels of customer guidance and engagement are not necessarily more effective. Furthermore, even retailers that are effective at one of the two are often not effective at both.

We asked them to rate their effectiveness on four counts over the last five years—one about their success with product innovation and the other three about the effectiveness of the customer experience at:

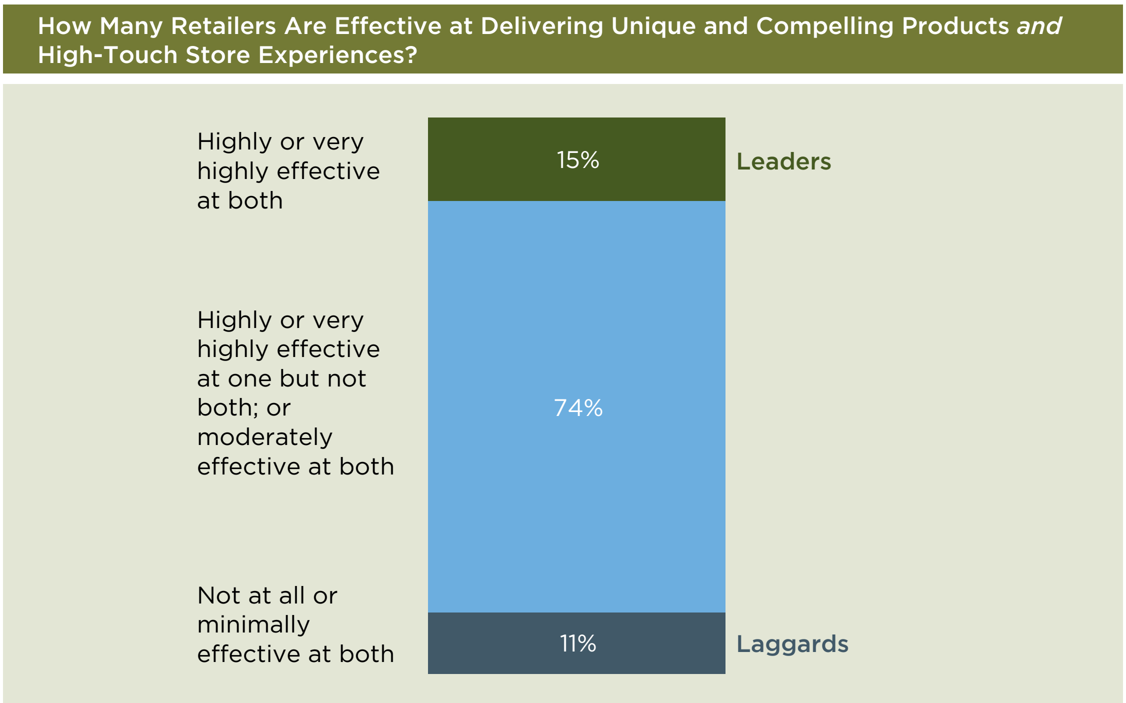
- Introducing unique products that consumers embrace and buy
- Providing high-touch experiences in the stores that help customers choose the right products and/or tailor products to their needs and/or understand how to use them
- Providing high-touch experiences on their websites that help customers choose the right products and/or tailor products to their needs and/or understand how to use them
- Providing an engaging consumer experience with their retail brand outside of the purchase transaction

On all four measures, the majority of retailers said they were not highly or very highly effective. More claimed high or very high effectiveness at introducing unique *and* compelling products (43%) than claimed success at the three measures of customer experience. Less than one-third (30%) said they were highly or very effective at high-touch store experiences, and only one-fifth (20%) said their websites provided high-touch experiences. Even fewer (16%) said they provided engaging consumer experiences outside of any purchase transactions.

How Retailers Are Faring

The number of retailers that were highly or very highly effective at both creating successful new products *and* store experiences was even smaller: only 15%. In subsequent mention, we will refer to this group as the "Leaders." (See Exhibit 3-4.) At the other end of the spectrum, 11% had no or very low effectiveness in both creating new-product successes *and* providing high-touch store experiences. We will refer to this group as the "Laggards." Comparing the way the Leaders and Laggards answered many other survey questions helps explain their differences. The vast majority of retailers (some 74%) were in between these extremes, highly or very highly effective on one but not both dimensions or moderately effective at both.

EXHIBIT 3-4: VERY FEW RETAILERS ACT VERTICALLY



How Retailers Are Faring

How Much Do Successful New Products and High-Touch Store Experiences Matter to Retailers? A Great Deal

From our survey research, we found that retailers that were superior at creating unique and compelling products and having strong customer experiences (especially in the store) had significantly outperformed other retailers between 1998 and 2007 on all of the 14 key financial and operating measures we surveyed, including:

> Annual revenue: Over the 10-year period, the Leaders' average increase was between 61% and 80%, while Laggards averaged a 41% to 60% revenue gain.

> Operating margins: Leaders' average increase was within the 41% to 60% range while Laggards' gain was in the 21% to 40% range.

> Gross margins: Leaders averaged a 41% to 60% increase while Laggards averaged a 21% to 40% increase.

> Inventory turns: Leaders were far better than Laggards on this metric, with a 41% to 60% average gain over the 10 years vs. an average 0% to 20% gain for the Laggards.

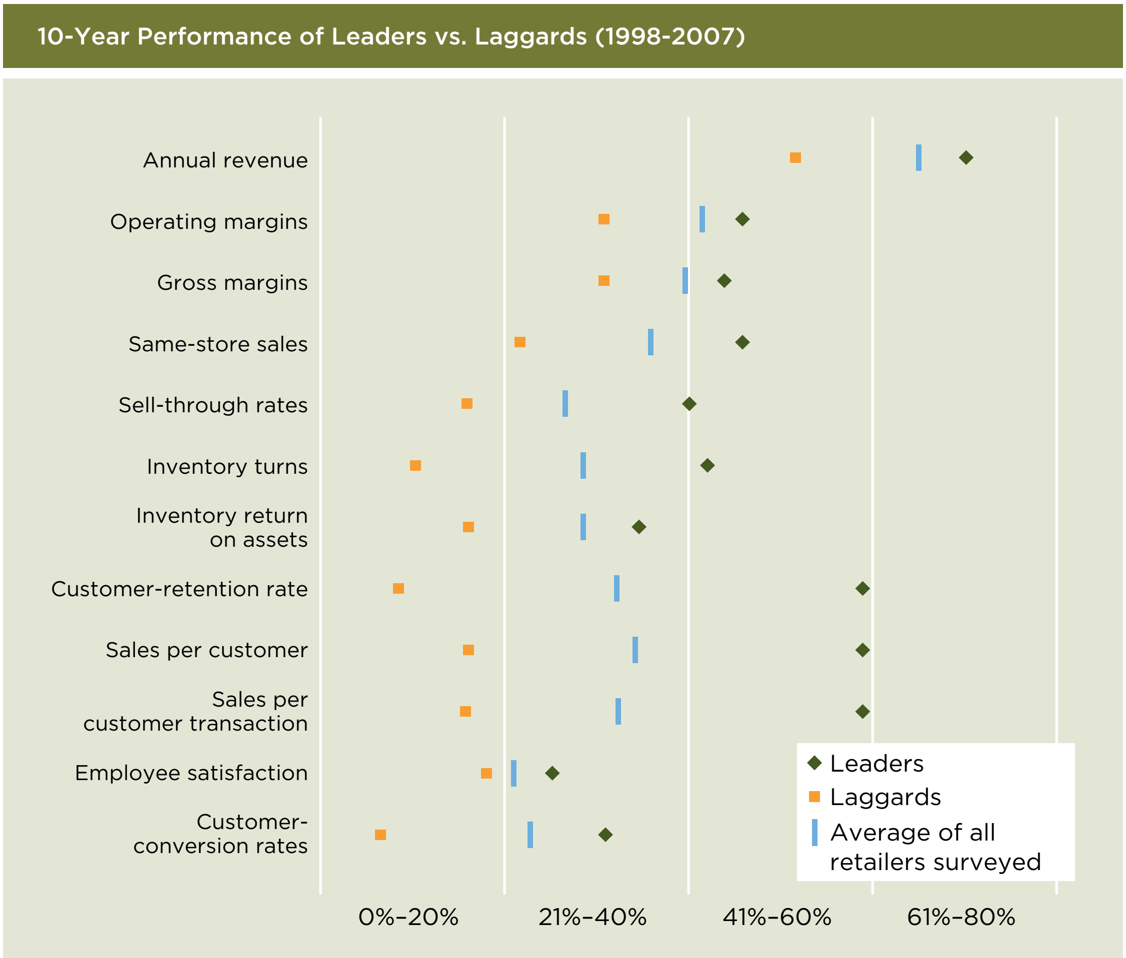
> Inventory return on assets: Leaders averaged 21% to 40% improvements while Laggards averaged 0% to 20% gains.

> Customer retention rates, sales per customer and sales per customer transaction: Leaders significantly outperformed the Laggards on these three measures.

> Price markdowns: Leaders took fewer markdowns than did Laggards.

The full results—as well as the average result for all survey respondents, including Leaders and Laggards—can be seen in Exhibit 3-5.

EXHIBIT 3-5: THE PAYOFF OF EXCELLING AT UNIQUE PRODUCTS AND ENGAGING STORE EXPERIENCES



How Retailers Are Faring

In our case study research, we found similar outstanding financial performance over an extended period of time at a number of retailers: Aéropostale, PetSmart, Coach, Trader Joe's, Apple and Target. All carry a significant amount of unique and compelling products, and all provide a distinct customer experience (at least in their stores). Their success over the last 10 years is inarguable. (See Exhibit 3-6.)

EXHIBIT 3-6: SUCCESSFUL ACT VERTICAL RETAILERS

A Look at Some of the Most Successful Retailers

Retailer	Sector	10-Year Performance (U.S. Dollars, Millions)				Comments
		Revenue 1998	Revenue 2007	Net Income 1998	Net Income 2007	
Aéropostale	Specialty apparel	$152	$1,600	$6	$129	• Gross margin of 35% in 2007 and 28% in 1999
Apple Stores	Computers and consumer electronics	$19[1]	$6,300	$875[2]	$1,300[3]	• Sales per square foot of $4,032 in 2007, more than four times that of Best Buy and 50% more than that of Tiffany & Co. • Revenue has grown tenfold since 2003
Coach	Accessories	$522	$3,200	$21	$783	• Gross margins have risen from 55% in 1998 to 65% in 2001 to 75% in 2008; they had reached 78% for FY 2006
PetSmart	Pet products and services	$2,100	$4,700	$23	$258	• FY 2008 revenue up 56% and net up 91% in last five years • Gross profit margin of 31% in 2008 vs. 25% in 1998
Target	Mass merchandiser	$23,000	$63,000	$935[4]	$2,850	• Revenue up 68% and net up 108% in last five years
Trader Joe's	Grocery	$2,000[5]	$6,500[6]	N/A	N/A	• 80% of products are private label vs. 16% for rest of grocery industry • Sales per square foot of $1,300, twice the grocery industry average • Average annual sales growth of 23% from 1990 to 2004 • Named second-best U.S. supermarket chain (after Wegmans) by *Consumer Reports* in 2006

[1]Estimated revenue in 2001 when stores were launched
[2]Operating income for FY 2007
[3]Operating income for FY 2008
[4]Includes retail chains later spun off
[5]Estimate for 2003
[6]Estimate

How Retailers Are Faring

The Strategy Behind Their Success: Act Vertical

What's behind the success of these retailers? Why have they outperformed their sectors during good economic times and bad? These retailers act vertically. What do we mean? The term "vertical retailing" has been applied to retailers starting with Gap in the 1980s that reached back into the value chain to design and manufacture their own products. But the most successful retailers that we studied were not only great at bringing their own compelling offerings to market. They also designed highly engaging customer experiences—store, Web and other interactions that helped consumers get even more value from their unique offerings.

The retailers we studied design many of their own products (and in some cases, all of them). But they are loath to own manufacturing plants because they become heavy and risky capital investments. Thus, an Act Vertical retailer is deeply involved in product design and development. But it isn't totally vertical in that it is vertical integration without ownership of manufacturing resources.

We also use the term Act Vertical to refer to vertical integration on the other end of the retail supply chain: with consumers. One way these retailers create unique products that, more often than not, have significant customer appeal is that they are far better connected to their target customers than their competitors. The most successful retailers employ more extensive research techniques, formal and informal, that enable them to better understand their customers' current and evolving needs.

But these retailers also do something else better than their competitors: They use their design capabilities and understanding of consumers to create experiences (today, primarily in their stores) that are carefully tuned to their target audience. They appear to pay as much attention to experience design as they do product design. That results in being superior at providing an experience that showcases the differences in their unique offerings, engages customers and enhances their lifestyles.

For some of the retailers, such as Aéropostale, Coach and Apple, Act Vertical is their dominant strategy: They design all or the vast majority of their products. For the others, Act Vertical is a key strategy in their success but not the only strategy. Along with selling many of their own products, they are major purveyors of national product brands. These retailers include Walgreens, PetSmart, and Target. They derived a good portion of their revenue from national product brands, i.e., products that weren't unique to their chains. Yet distinctive products and customer experiences were also critical to their success over the last decade. In fact, we believe the products and customer experiences that made them distinctive played an outsized role in their success. Their Act Vertical strategies sufficiently differentiated them from their competitors and gave customers a special reason to visit their stores, websites and catalogs.

How Retailers Are Faring

Mapping Out the Path of Act Vertical Retailers

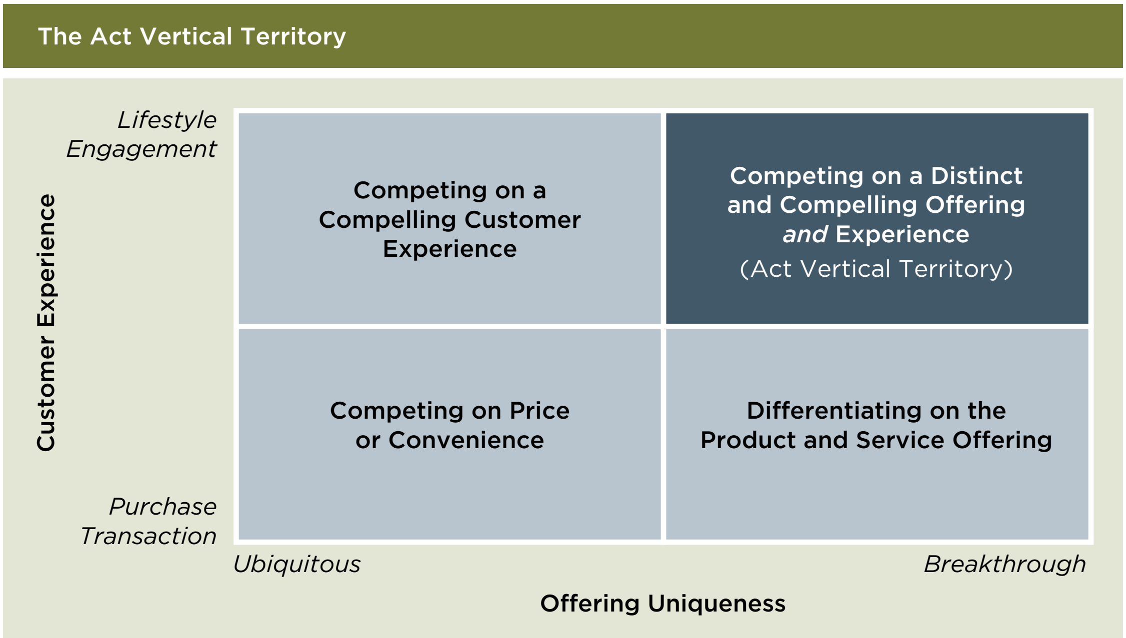
One way to understand how retailers succeed at Act Vertical strategies is to define the world of retailing in two dimensions: product and/or service offering uniqueness and customer experience (see Exhibit 3-7):

> **Offering uniqueness:** the extent to which a retailer's products and service offering, i.e., anything it sells, is both unique (they can't be found at other retailers) and compelling. The offering dimension can range from ubiquitous (the offerings can be found at many other retailers) to breakthrough. National product brands that can be found at many retailers are examples of ubiquitous offerings. The mass merchandisers and superstores are largely offering ubiquitous offerings. Even their private-label offerings tend to be low-cost knockoffs.

> **Customer experience:** the degree to which a retailer's interactions with customers—at the stores, on the Web, in the call centers, in the catalog, etc.—on one end of the spectrum reflect highly efficient purchase transactions with little guidance and customer attention or, on the other end, are highly engaging, what many customers might say has become "part of my lifestyle." Such customer engagement often comes in the form of entertainment, education, visual stimulation and social interactions. Apple's stores, Trader Joe's, Abercrombie and REI are good examples of these retailers.

How Retailers Are Faring

EXHIBIT 3-7: ACTING VERTICAL INCORPORATES BOTH OFFERING UNIQUENESS AND CUSTOMER EXPERIENCE



Retailers that use an Act Vertical approach often have a significant percentage of their products and customer experiences in the upper-right of this model. But even if a minority of their products and experiences are in the upper-right box, they can still cast a large halo over their brand. That is, most of their offerings and customer experiences might not be distinct, but enough of them are to make the retailer as a whole significantly different in the minds of customers. A very good example here is Target. The $63 billion (FY 2008 revenue) retailer has enough in-house or exclusively designed products with cachet that make it appear a much different discounter than Wal-Mart, Dollar General or superstores, and its store experience is slightly more upscale as well.

How Retailers Are Faring

How can retailers that excel at Act Vertical strategies outperform their competitors financially? By providing special offerings and special experiences, they appeal to customers on a far different basis than on low prices and high convenience. That is the primary way to win in the lower-left box of the matrix. (See Exhibit 3-8.) Successful retailers in the lower-left quadrant (Wal-Mart is the case in point here) sell largely ubiquitous products: national product brands that can be purchased from many retailers or knockoffs of those brands. They also offer a highly efficient customer purchase transaction experience (meaning, little customer handholding). From the customer's standpoint, that streamlined customer experience means one of high efficiency in getting in and out of the store quickly. It also means having the products they want in stock, a competitive advantage that Wal-Mart's vaunted replenishment systems have produced for years. But from the retailer's standpoint, streamlined means high efficiency in delivering its products. That requires (among numerous things) stripping out as much store labor as possible, which of course means a lower-touch and less-engaging customer experience.

Retailers in the lower-left quadrant can also compete on the basis of convenience. That is, they largely sell products other retailers sell but their locations make them much more accessible to consumers. Of course, this is the basis of competition for the convenience store sector. Nearly every product in convenience stores can be found at discounters for much lower prices. But convenience store customers are sacrificing price for time.

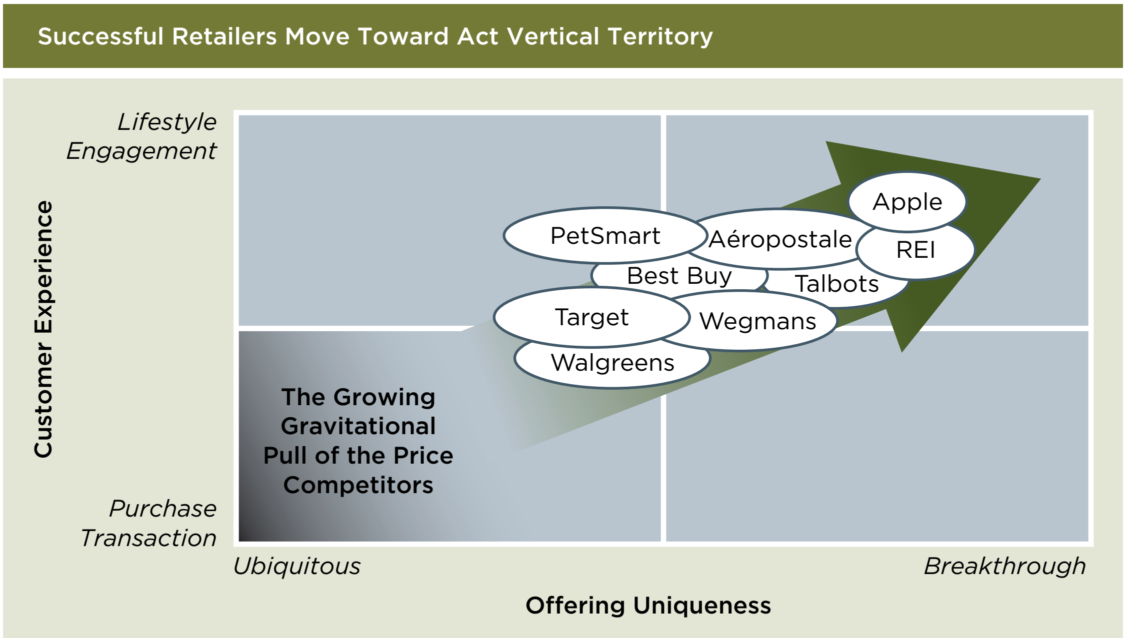
Retailers can also compete in the upper-left quadrant, selling products that other retailers sell (and, perhaps, creating better assortments), but differentiating themselves largely on a much more enriched and engaging customer experience. Many luxury department store chains operate on this basis: Saks Fifth Avenue, Barneys New York and Neiman Marcus, to name a few.

In our case studies, we found many retailers that embarked on Act Vertical strategies in order to escape the price competition, which they decided they couldn't win. (Note: They may have not referred to them as Act Vertical strategies, but nonetheless they employed them.) In effect, retailers such as PetSmart, Target, Best Buy, Trader Joe's, Walgreens and others moved more of their product and experience portfolio to the upper-right to escape the gravitational pull of the price discounters (Wal-Mart, Costco and other superstores). Without highly unique and compelling products (and services as well) and without differentiating the customer experience, their customers would rightfully have departed for lower-cost options.

How Retailers Are Faring

Retailers that compete in the lower-right quadrant have products and services that no other retailers stock but offer a customer experience that is more transactional than engaging in nature. Companies that come to mind here include Radio Shack, Spencer Gifts and Sharper Image.

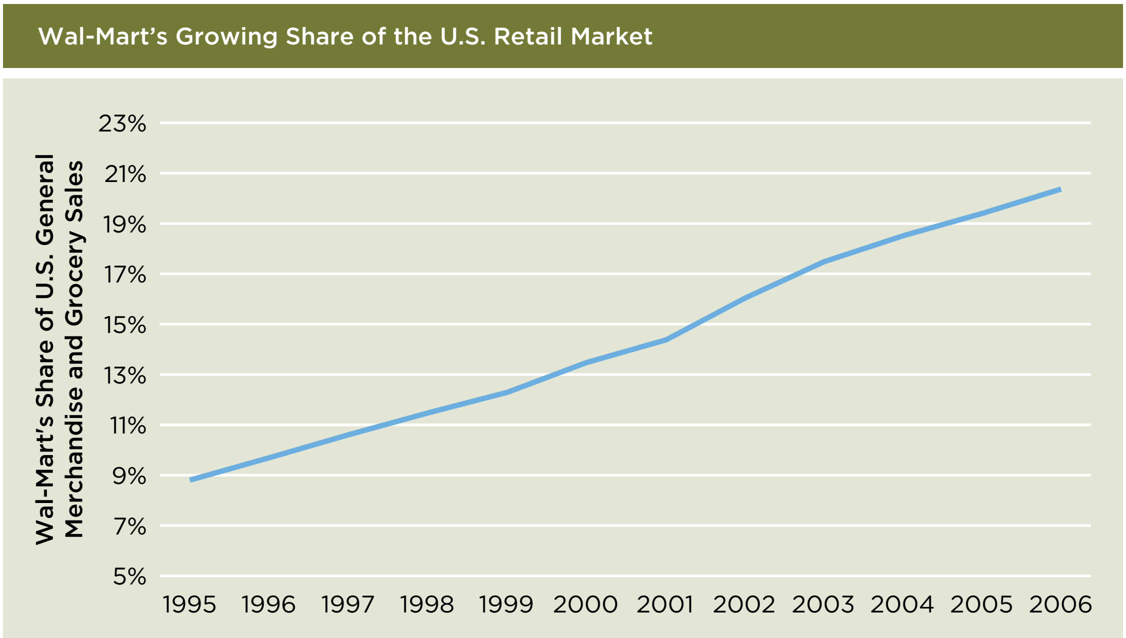
EXHIBIT 3-8: ACT VERTICAL RETAILERS ESCAPE THE BLACK HOLE OF PRICE



How Retailers Are Faring

One only has to look at Wal-Mart's rising share of general merchandise and grocery sales in the United States to see the power of the discounters. Between 1995 and 2006, Wal-Mart's percentage of all U.S. retail sales of general merchandise and groceries has more than doubled from about 9% to 20%. (See Exhibit 3-9.)

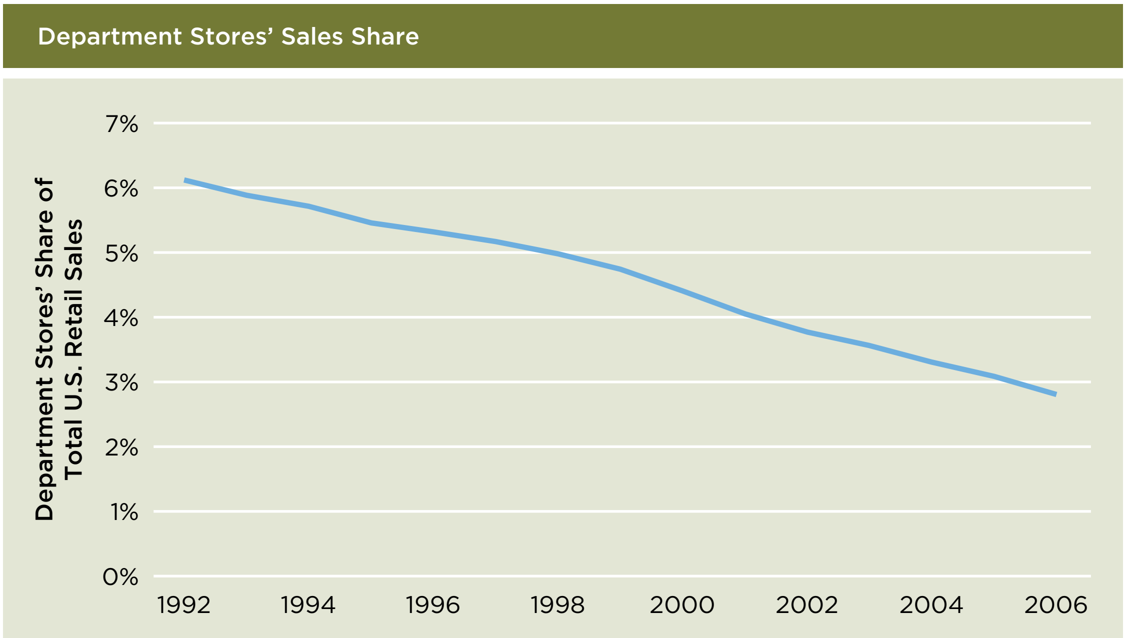
EXHIBIT 3-9: THE RISING POWER OF DISCOUNTERS



We did not structure this research to analyze any one retail segment such as department stores, convenience stores or apparel. Nonetheless, we believe the struggles of the department store sector can be better explained when looking at retail competition through this lens. Our data shows that the average U.S. department store is not highly distinctive on the product or experience dimension. Only 10% of the ones we surveyed generated more than 50% of their revenue from private-label or exclusive products. (In contrast, some 69% of the apparel retailers, a major department store category, yielded more than 50% of their revenue from unique products.) And only 30% of the department store companies provided high or very high degrees of information to help store customers determine what to purchase. That is a lower percentage than the apparel retailers (37%). Perhaps department store chains need to create a higher percentage of unique and compelling products or improve the customer experience (especially in the store)—or both.

This might help explain why the U.S. department store sector has watched its share of the total U.S. retail pie decline by more than half since 1992. (See Exhibit 3-10.)

EXHIBIT 3-10: U.S. DEPARTMENT STORES STRUGGLE TO COMPETE



Total U.S. retail sales excludes automotive, auto parts and restaurants (Source: U.S. Census Bureau)

It is clear that an Act Vertical model can propel a retailer to superior customer and financial performance. In the next section, we'll explore *how* the Act Vertical retailers that we studied were able to bring a steady stream of innovative and compelling offerings to market, as well as create an engaging customer experience.

Key Success Factors of Leading Act Vertical Retailers: Synchronizing Brand Strategy and Operations Strategy

It is clear to us that retailers which brought a steady stream of unique and compelling products to market over the last decade (whether their own brands or exclusive distribution of national product brands) as well as a distinctive customer experience have generally outperformed their competition. That is, the Act Vertical approach, as we refer to it, has been fundamental to their success.

But as important as establishing a link between retailing success and Act Vertical is shedding light on exactly *how* those retailers were able to bring distinctive and compelling offerings and customer experiences to market. What did these retailers do that other less-successful retailers did not do? What are the key success factors of Act Vertical strategies?

To explore this issue, we gathered extensive data from four primary sources:

> Constructing our survey in a way that let us compare and contrast the 26 retailers that we categorized as Act Vertical Leaders and Laggards. We saw significant differences in the effectiveness of many of their approaches to product development, store operations, sourcing, distribution, website and online marketing, marketing as a whole and other key aspects of retailing.

> Interviewing more than 30 executives at 10 retailers from a variety of retail sectors (from grocery and discount merchandisers to apparel retailers and pet stores). This group included both retailers that had and *had not* been successful at Act Vertical strategies.

> Conducting extensive secondary research on retailers and their Act Vertical strategies, including press interviews and publicly available financial statements (10-K, 10-Q, annual reports, press releases, investor presentations, etc.).

> Internal interviews of numerous KSA consultants with hundreds of years of collective experience in working with many of the world's leading retailers over the last 30 years on operations and brand strategy.

Our findings are wide-ranging but can be summarized thusly:

1. Retailers that want to excel at Act Vertical must think about vertical retailing in a whole new way.
An Act Vertical approach requires thinking about what categories of products would—and would not—distinguish a retailer, as well as how to differentiate those offerings. In addition, excelling at Act Vertical demands thinking about exclusive distribution of national brands and, as important, what *services* customers might pay for that would strengthen overall brand engagement. For example, PetSmart's turnaround over the last 10 years to a significant degree has been due to adding pet grooming, veterinary clinics, training and pet hotels. All of these are *services*—not products. Act Vertical also demands new mindsets for manufacturers that have entered the retail business

(like Nike, Coach, Apple and others have done for some time) or are considering going into retail. Act Vertical is not just about displaying their merchandise at high-profile locations or on the Web. It requires manufacturers to put as much care into designing the customer experience as it does into designing their products—from their marketing campaigns and websites to the store experience and their interactions with customers outside those sales channels.

2. Retailers with the most successful Act Vertical strategies make sure their retail-brand strategy is in synch with their operations strategy. By operations strategy, we mean how a retailer defines its offering and customer experience and how it then brings them to market. A number of the struggling retailers we studied did not have a clear idea of their target customers. In one case, a retailer had two sets of customers, neither of which wanted to be associated with the other in the use of its products. Other struggling retailers had clearly defined their target customers but had offerings that weren't compelling or provided customer experiences that eroded their brand identity. For example, one retailer relied heavily on coupons to stay price-competitive with the discount chains; however, its customers had to calculate the savings to see that the retailer was price-competitive. To create a successful Act Vertical strategy, a retailer must first clearly define its target customers and value proposition, ensuring its product and service offerings and experience reinforce those fundamentals.

3. Act Vertical will be a critical strategy for *all* retailers across all retail sectors—even those competing largely on the basis of price and convenience today. The reason: As the Internet increasingly gives consumers the tools for easily identifying the lowest-cost option, retailers that do not increase their number of distinctive products and enhance their customer experiences will lose share. All to say that the issue for retailers is not whether they need to employ an Act Vertical strategy for some percentage of their offering but on how much and which parts of it.

4. There are seven capabilities a retailer must ultimately master to thrive at Act Vertical. These capabilities encompass the way it conducts market and customer research, designs and develops new offerings, manages sourcing, controls inventory, creates brand experiences and executes its marketing campaigns.

The rest of this section goes into these overarching findings in depth and illustrates them through our case study, survey, secondary research and KSA's internal experts. We explain how:

> A successful Act Vertical strategy starts with a clearly defined retail-brand strategy: determining what customers to cater to (and not) and how to deliver value to those customers that is superior to that of other retailers.

Key Success Factors

- > Connecting the retailer's brand strategy to its operational strategy: defining the core set of products and services (the "offering") and determining the kind of experience that would help customers understand the unique differences in the retailer's offering, as well as its engagement with the customers' lifestyle.
- > Building the core capabilities required for superior execution of the operational strategy. We discuss seven core capabilities we found in our research and how retailers excelled at them.

EXHIBIT 4-1: RETAILERS EMPLOYING ACT VERTICAL STRATEGIES

A Look at Our Case Study Research

Retail Sector	Retailers
Specialty apparel, accessories	Aéropostale, Talbots, Coach, and "Specialty Apparel Retailer"*
Pet supply, services	PetSmart
Discount, mass merchandising	Target
Consumer electronics, computers	Best Buy, Apple Stores
Grocery	Trader Joe's
Convenience stores	Wawa
Drug stores	Walgreens

*Disguised retailer

Key Success Factors

Acting Vertical Begins with Retail-Brand Strategy

The retailers we studied with the most successful Act Vertical strategies had a much clearer definition of their target customers. That helped them better understand which customers to target and which *not* to target. It also helped them define an offering and customer experience that would fit the needs of that target group.

For example, teen fashion retailer Aéropostale explicitly focuses on the 14- to 17-year-olds who wear its clothes. However, the company also targets the parents of those teenagers because they make a significant portion of the purchases. As a result, Aéropostale carefully selects and designs products that please both teens and parents. And it has designed its store experience for both. (Contrast that with competitor Abercrombie & Fitch, which aims its edgier clothes and customer experience, both store and Web, at young adults and *not* their parents.)

In contrast, another apparel retailer that we studied had significant dissonance in its target customers. This retailer (which has had little revenue growth for 10 years) had once targeted both women's and men's clothing (at a time when specialty apparel chains were increasingly targeting one sex or the other). Even today, it targets one sex but also shoppers of all sizes (petites to plus, kids to missy)—multiple groups that would not want their clothing associated with the other. "I think we lost our way in understanding who our customer was," the firm's merchandising chief said. "There was no focus. ... We stood for nothing. We tried to be everything to everybody."

Another retailer that we studied whose brand strategy had become blurred was The Talbots Inc., the Hingham, Mass.–based women's apparel chain that sells classic fashion. The company operates nearly 600 Talbots stores in the United States, which generated 2007 revenue of $1.8 billion. After years of steady revenue and profit growth, the parent company (which also owns The J. Jill Group Inc., a women's apparel retailer based in nearby Quincy, Mass.) lost $189 million in 2007. To turn itself around, a new management team hired in 2007 began by conducting customer research which found that many customers saw Talbots' merchandise as dowdy. (The research found that even some 65-year-old and older customers thought the retailer's products were for women older than them.) The management team rigorously defined the target customers (upper-income women, 45+ years old) and the unique value the firm would deliver to them. Then Talbots repositioned its brand strategy, focusing on timeless, elegant classics. Chief Merchandising Officer Basha Cohen said, "We want to own the classics. We want to be known as *the* place to shop for classic apparel. But we don't want to be known for dowdy classics."

Key Success Factors

With a clearly defined (and not incongruous) set of target customers in hand, Act Vertical retailers better clarified the unique and compelling value they deliver to customers—from the products (and, in some cases, services) they sold them to the customer experience. The experience includes the store design, ambiance, service level, training and other non-product aspects of the purchase. It also includes how they interacted with customers throughout the lifecycle of purchasing and using the retailer's offerings. Here are the value propositions for several highly success Act Vertical retailers:

- Aéropostale: fast, affordable fashion that pleases young teens and their parents.
- PetSmart: catering to the pet and pet parent's total lifestyle needs.
- Coach: providing distinctive, accessible luxury products that are relevant, extremely well-made and of excellent value; this positioning (from Coach's company profile Web page) describes the firm's desired differentiation based on design (especially for the firm's original core business of handbags, business cases, luggage and other leather goods) and quality. (Coach continually emphasizes the quality of its craftsmanship.) But Coach has also made such luxury and design in its bags (and beyond, to perfumes, sunglasses and other products) one of affordable elegance (in contrast, say, to Gucci or Louis Vuitton).

The more successful Act Vertical retailers did a better job of translating the needs and lifestyles of their customers into product and service offerings that fit those needs. The Leaders also were superior at translating those customer needs into the right customer experiences. They were better at determining the inviolable core attributes of the brand. At Aéropostale those attributes are on trend (i.e., not leading but not trailing), great value (attractive clothing at very affordable prices) and good customer experience (a friendly shopping environment for teen and parent).

Such retailers appeared to do a better job of putting themselves in their customers' shoes. From the customers' vantage point, they were better at determining such issues as: "What does the brand do for me? How does it make me feel? What does it say about me?"

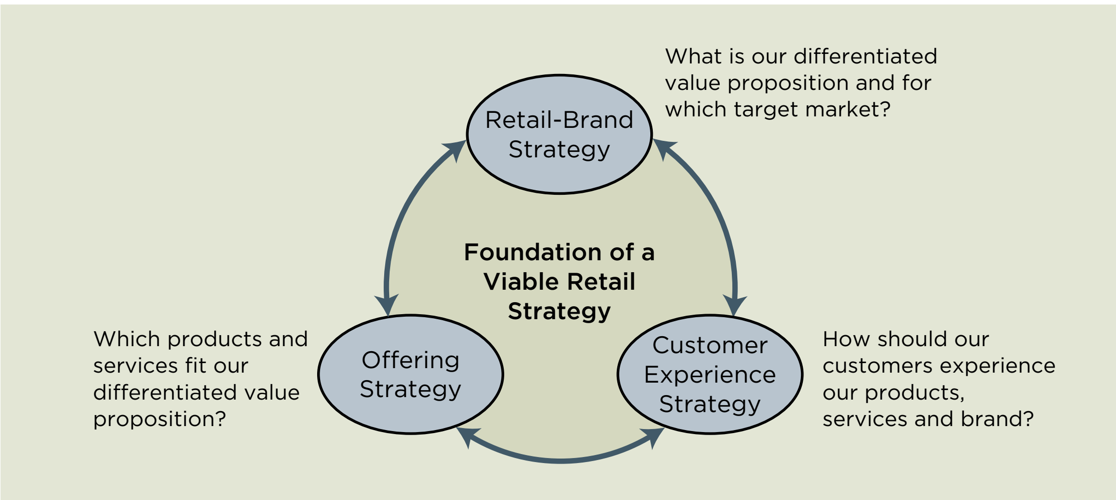
Key Success Factors

Connecting a Clear Retail-Brand Strategy to the Operational Strategy

In addition to clearly defining their target customers and reducing any possible dissonance between customer sets, the more-successful Act Vertical retailers were far more likely to have their brand strategies in synch with their operational strategies. That is, the products and services they brought to market—and the experience they created for customers to learn about, purchase and use the offerings—all achieved the brand promise. At the very least, they didn't erode—in small ways or large—that promise.

EXHIBIT 4-2: ACTING VERTICAL BEGINS WITH DEFINING THE RETAIL-BRAND STRATEGY

Components of a Viable Retail Strategy



Key Success Factors

Defining the Offering Dimension

The Act Vertical retailers that we studied did a better job of determining what parts of their offering should be unique (and which should not). Some of them have made significant investments to determine what products they should and should not offer under their own label. Walgreens, for example, spent significant sums on extensive consumer research to improve its private-label strategy. Some 20% of its general merchandise sales now come from private label vs. 12% in 2000.[8]

On the spectrum of uniqueness, any retailer's products and services can be classified in four primary ways (see Exhibit 4-3):

> **Ubiquitous:** These are national product brands sold by other retailers. This is the core offering of the discounters, warehouse stores, off-price retailers and the grocery segment. It is also the product strategy of most convenience stores.

> **Imitative:** knockoffs often sold under many retailers' private labels. Most grocery stores' private-label products are of this type, and so are many apparel retailers' products.

> **Enhanced:** a retailer's design of a product that features minor variations of existing products. It is with these types of products that a retailer gets heavily involved in product design (whether for its own label or exclusive distribution of a national label). The offering of apparel retailers that are on-trend (meaning, not trendsetters) fit in this category. Aéropostale's product line is a case in point. Target has differentiated itself from Wal-Mart and other discounters in large part by offering private-label products that are a little different (at least in design), so-called "cheap chic." Specialty grocer Trader Joe's carries numerous items that have been formulated especially for its shelves. Convenience store operator Wawa Inc. differentiates itself from competitors in two product categories: its own coffee and hoagies.

> **Breakthrough:** highly unique products and services that deliver whole new sets of value to customers. One of the best examples of this is Apple, which entered the retail business in 2001. Apple, of course, is renowned worldwide for its innovations in computers, music players and, more recently, cell phones. But breakthrough offerings can also be services. CVS and Walgreens were among drugstore chains that led the way this decade in opening health clinics in their stores. PetSmart added pet hotels in 2000 to go with its other services of grooming, pet training, etc. While pet hotels have been around a long time, they hadn't been in a pet store chain. The breakthrough was largely one of convenience. Outdoor gear retailer REI has been selling travel excursions to its customers since 1987. The company doesn't break out sales of the division but has said customers who go on the trips it sells increase their purchases significantly that year.[9] Trader Joe's not only carries enhanced products (foods that are a little different), it also carries foods that can't be found at other grocers.

Key Success Factors

EXHIBIT 4-3: ACT VERTICAL RETAILERS HAVE BREAKTHROUGH OFFERINGS

The Product and Service Uniqueness Dimension

Ubiquitous ⟷ *Unique*

Ubiquitous	Imitative	Enhanced	Breakthrough
Same brand and items sold by many retailers	Knockoff of a nationally branded product at a lower price	Minor variations of existing offering to make them different and better	Unique and compelling new offerings
Ex: National brands	Ex: Most retailers' store brands and private labels	Ex: Co-developed with national brand as exclusive or retail brand	Ex: Design-led retail brand; national brand co-designed with retailer as exclusive

Most retailers' offerings fit in the first three categories and some fit in all four. Research on private-label trends shows that in many retail sectors, the percentage of revenue from non-national product brands has been increasing (i.e., the last three of our offering categories). Much of that, no doubt, is revenue from knockoffs. Our research suggests retailers will need to increase their revenue from offerings of enhanced and breakthrough products and services. Those are the Act Vertical categories we'll explore further in this report.

Key Success Factors

Defining the Experience Dimension

Just as we dissected the offering dimension, we find it necessary to dissect the experience dimension. On this dimension, we find four flavors of customer experience on the spectrum from "transactional" to "lifestyle engagement":

> **Purchase transaction:** Making the purchase transaction efficient for the customer (ease of shopping, speedy) and efficient for the retailer (which helps reduce costs). That means reducing the amount of store help (and thus human guidance) and in some cases reducing the checkout personnel.

> **Convenience:** Here the focus is less on purchase transaction efficiency and more on making the offering accessible to customers. Convenience store operators are based almost entirely on this premise (although chains like Wawa are also trying to differentiate on a product uniqueness basis). Making offerings convenient, however, can also involve creating assortments that bring together a set of non-unique offerings that provide a one-stop shop for customers.

> **Shopping enrichment:** This is about creating a memorable shopping experience for customers, one that helps them better understand the uniqueness of the retailer's offerings and use them to enhance their lifestyle. On the experience dimension, this is where Act Vertical retailers begin to differentiate themselves. The successful Act Vertical retailers look to their stores, catalogs, websites and other direct marketing vehicles to help customers make the right choices, providing substantial amounts of information about those products and services. Apple's stores, for example, have "Genius Bars" at which customers can get free advice about Apple products.

> **Lifestyle engagement:** This is the ultimate way for Act Vertical retailers to compete on the customer experience dimension. Retailers that do so elevate their relationship with customers beyond the sales channels and become embedded in their lives. REI, for instance, regularly emails customers with announcements of local hikes and charitable events. Target is known for sponsoring numerous local charitable events across the country. (The company invests 5% of each store's sales back into that store's community.) We see these retailers today as the exception. Only 4% of our survey respondents said they were highly or very highly effective at engaging with customers outside their sales channels (in addition to being highly or very highly effective at introducing unique and compelling products that customers embraced).

EXHIBIT 4-4: RETAILERS MUST STRIVE TOWARD LIFESTYLE ENGAGEMENT

The Experience Dimension

Purchase Transaction ⟷ *Lifestyle Engagement*

Transactional	Convenience	Shopping Enrichment	Lifestyle Engagement
Making purchase transactions quick and efficient for customers; mostly self-service	Making it easy for customers to get access to the offering, e.g., locating stores in accessible areas, providing more items in one location, etc.	Making the full shopping experience pleasant and memorable before, during and after the purchase and across channels: stores, catalogs and Web	Elevating the customer relationship beyond sales channels and becoming embedded in and part of customers' lifestyles

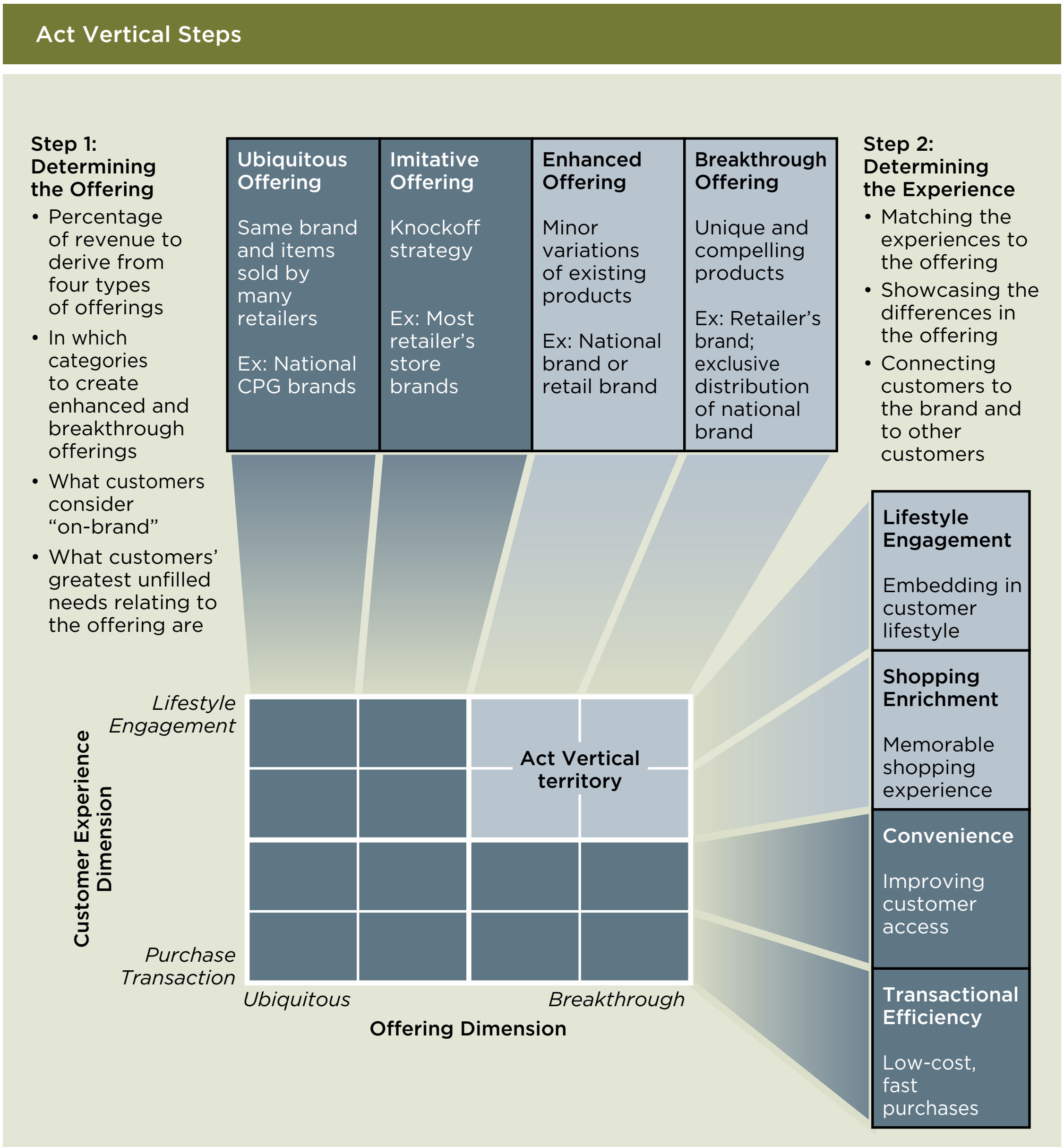
Key Success Factors

Connecting the Offering to the Experience

Act Vertical retailers need not just unique and compelling offerings—they need special customer experiences to go along with those products and services. (See Exhibit 4-5.) There is a symbiotic relationship between unique product and distinctive customer experience. Aéropostale carefully engineered not only on-trend but low-cost fashion into its product designs; it also engineered a store experience that has won over young teens and their parents. “We try to make it a fun, cool environment for the kid and comfortable for the mom,” Aéropostale’s Chief Operating Officer Tom Johnson said. In part, this requires continually training salespeople about how to interact with shoppers. Aéropostale has not cut back on sales training during tough economic times. “We never scrimp on our training and development programs,” Johnson said.

One reason Apple opened its retail stores in the first place was that it didn’t like the experience its customers had been getting at national computer and consumer electronics retailers. Apple spent significant time and money on developing the store experience. Like the company’s products, the Apple store experience is highly unique in the consumer electronics and computing retail space. The stores provide on-site customer training and support, as well as legions of highly knowledgeable and enthusiastic salespeople. Today, Apple’s outlets generate the highest sales per square foot in the retailing industry, according to one publication.[10]

EXHIBIT 4-5: CONNECTING THE UNIQUE OFFERING TO THE DISTINCTIVE CUSTOMER EXPERIENCE



The Seven Core Act Vertical Capabilities

As we stated in the previous section, the most successful Act Vertical retailers had their brand strategy and operations strategy in synch. They designed products and services that accentuated their brand differences. They also designed the experience their target customers would have with their brands.

But that wasn't all that characterized the Act Vertical retailers. After extensive analysis of the key factors behind their success, we found seven areas that we believe are critical to an Act Vertical strategy. Each capability requires new business processes, substantial amounts of new operational information and information technology, different reporting relationships, measures and rewards that encouraged unprecedented degrees of cross-functional collaboration and new cultural norms. The seven core capabilities are:

1. Market research that divines emerging customer needs, product and service opportunities, customer experiences and lifestyles

2. Product design and development that balances creativity and commercial appeal to maximize profit

3. Consumer testing that increases the return and reduces the risk of product innovation and customer experience innovation

4. Sourcing relationships that accelerate manufacturing but make key product decisions as late as possible (to better meet fast-changing customer needs)

5. Assortment, allocation and replenishment that rapidly shifts products to places of greatest demand and maximizes prices

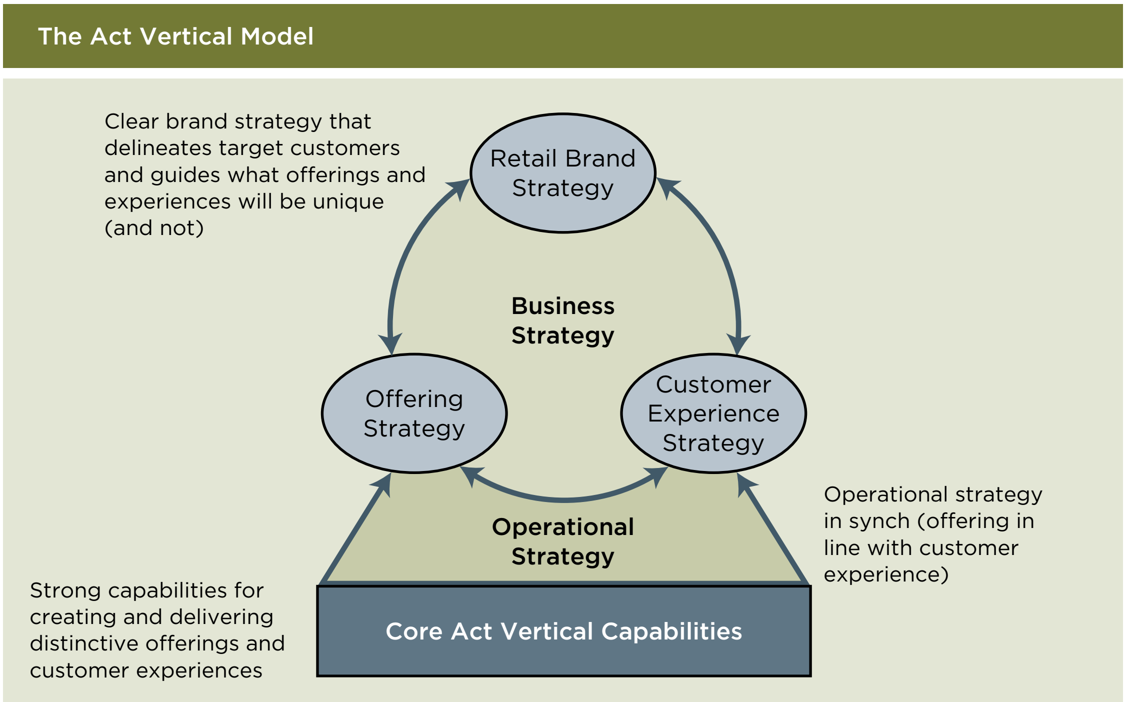
6. Design and execution of a consistently engaging brand experience across all channels

7. Marketing that communicates the brand promise across all channels and showcases how the offering and experience enhance customers' lifestyles

The Seven Core Capabilities

These seven capabilities are the foundation of an Act Vertical operational strategy. They enable a retailer to execute that strategy. (See Exhibit 5-1.) To be sure, not every retailer that had succeeded at Act Vertical had mastered each area—not even Coach, Aéropostale, Target, Apple, Trader Joe's or PetSmart, whose financial performances have been phenomenal. As a result, the discussion that follows is a rollup of sorts for our best-practices retailers: a guide for any retailer that wishes to compete on the basis of an Act Vertical strategy.

EXHIBIT 5-1: BRAND STRATEGY, OPERATIONAL STRATEGY AND ACT VERTICAL CAPABILITIES



The Seven Core Capabilities

In the following paragraphs, we review each capability, illustrate them with examples from our case study research and provide survey data that sheds additional light on how the so-called Act Vertical Leaders differed from the Laggards.

Market Research Yielding Uncommon Insights on Emerging Needs and Opportunities

Retailers that excel at Act Vertical strategies were superior at identifying unfilled or underserved customer needs. They had rigorous processes for studying societal and competitive trends that shaped consumer tastes in products and services, as well as shopping experiences.

The most successful Act Vertical retailers we studied not only relentlessly pursued new products that they could develop and call their own, they also unleashed their research and development activities on services for which they could charge, seeing them as crucial pieces to their "product lines." That's because some "products" that can greatly differentiate a retailer from its competition are not products at all. Rather, they are services that improve their customers' lifestyles and from which the retailer can generate a significant profit. Best Buy's service revenue is $2.4 billion, about 6% of total revenue. PetSmart escaped the gravitational pull of Wal-Mart and other price discounters by getting into the pet services business: pet training, pet hotels, grooming and so on. PetSmart's services business is nearly $500 million today and is en route to $1 billion by 2011. It isn't easy for the discounters to add such services to their stores. Services can also increase sales of a retailer's products—especially if the offerings help customers satisfy their larger emotional needs, lifestyle demands and aspirations. A number of retailers we found generated as much as 10% of their revenue from services. (See Exhibit 5-2.)

EXHIBIT 5-2: SERVICE WITH A SMILE (AND A FEE)

Size of Service Business at Several Retailers

Retailer	Total Revenue in Millions of U.S. Dollars	Services Revenue in Millions of U.S. Dollars	Percentage of Total Revenue	Type of Services
Amazon.com[1]	$14,800	$383	2.6%	IT, fulfillment, Web hosting
Best Buy[2]	$40,000	$2,400	6.0%	Installation, computer repair
Cabela's[1]	$2,300	$176	7.7%	Financial, travel, outfitter services
Home Depot[2]	$77,300	$3,500	4.5%	Installation, professional services
PetSmart[2]	$4,700	$459	9.8%	Grooming, vet clinics, training, pet hotels

[1]Metrics refer to FY 2007 [2]Metrics refer to FY 2008

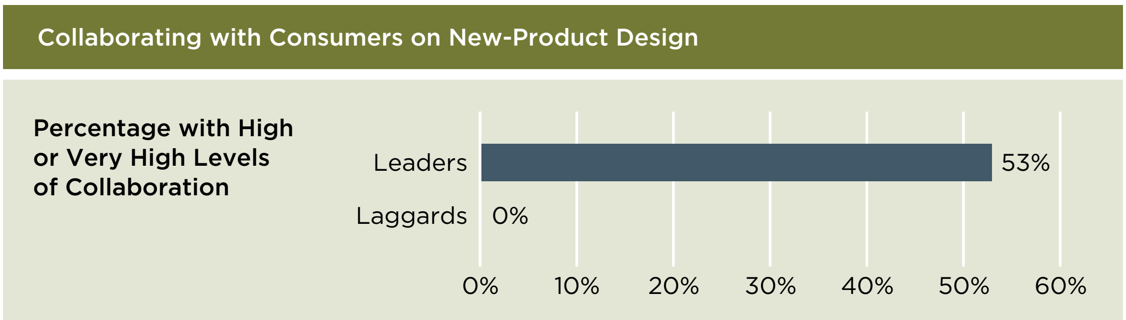
Aéropostale conducts significant consumer research to come up with insights about emerging trends. The company's revenue has grown more than fivefold since 2000 (from $272 million to $1.58 billion) and earnings per share have increased 32% annually since 2001. Its employees travel widely to see what teenagers are wearing at movies, sporting events, music videos and other venues.

Coach spends nearly $5 million annually on consumer research (including $2 million on consumer surveys). Twelve months before bringing a new product to market, the $3.2 billion company interviews hundreds of customers to get their reactions on seemingly every aspect of the product. In addition, it asks customers to rate new-product designs against existing offerings. Then six months before launching a new collection of products, the company tests them in a cross-section of stores. In all, Coach conducts nearly 70,000 in-depth customer interviews annually. Customers provide feedback on prototype products.

Best Buy, the largest U.S. consumer electronics retailer, used extensive customer and employee feedback in designing a private-label series of laptop computers made and branded by Hewlett-Packard and Toshiba (although they will be distributed exclusively through Best Buy). Best Buy has had exclusive distribution of some notebook computers for years. However, the latest models were designed from scratch with Best Buy's input. The line, Blue Label, was released in October 2008 and features laptops that are thinner, lighter and more elegant in design than many laptops. Best Buy said it wants to personalize computers' technology, design and style based on consumer input. "We were able to pinpoint consumers' specific desires and develop a unique product to best suit their needs," one vice president said. Best Buy plans to bring other products to market under its Blue Label banner.

Such collaboration with consumers in product design was one of the biggest differentiators between the Leaders and Laggards at Act Vertical retailers that took our survey. More than half (53%) of the respondents that we categorized as Leaders had high or very high levels of collaboration with consumers in designing new products. None of the Laggards were working with customers at that level of collaboration. (See Exhibit 5-3.)

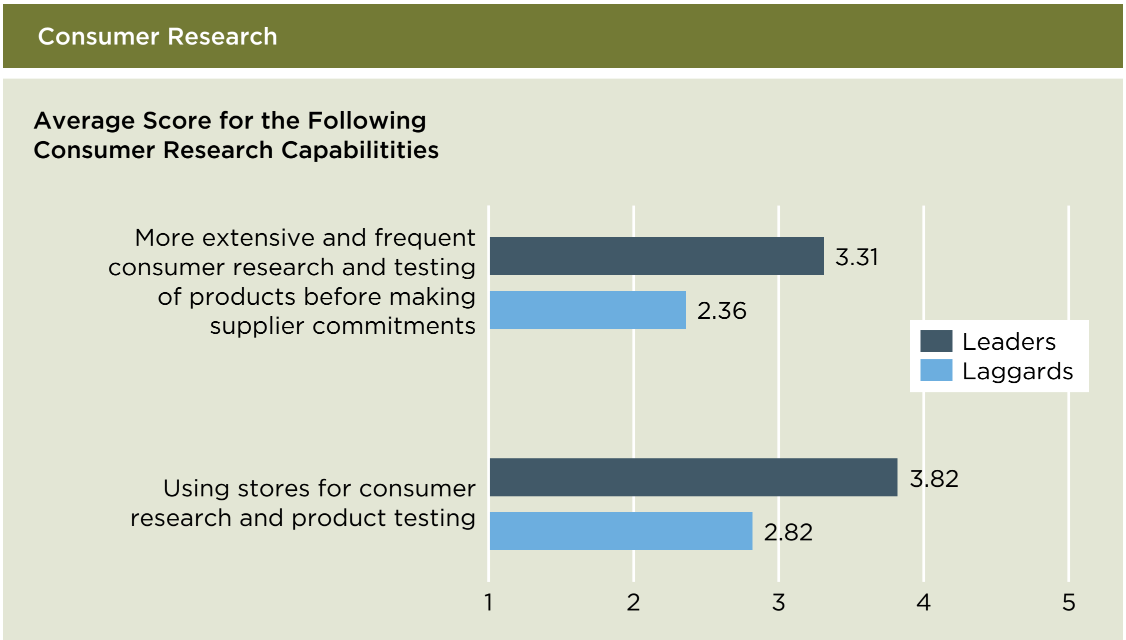
EXHIBIT 5-3: LEADERS SEE VALUE OF PARTNERING WITH CONSUMERS ON PRODUCT DESIGN



The Seven Core Capabilities

The leading Act Vertical retailers we surveyed were also much more effective at conducting extensive consumer research and product testing before making commitments to suppliers. And they were better at using stores for consumer research and product testing. (See Exhibit 5-4.)

EXHIBIT 5-4: LEADERS VS. LAGGARDS IN CONSUMER RESEARCH



Scale of 1 to 5, 1=Not at all effective, 3=Moderately effective, 5=Very highly effective

Beyond rigorous and continual market research, leading retailers were more likely to immerse top management in their stores and markets. This enables them to see firsthand what customers like (and don't like) about the offering and the customer experience. Coach CEO Lew Frankfort visits stores once or twice every week, anonymously greeting customers as "Lew." Trader Joe's CEO, Dan Bane, visits each of the company's 310 stores in the United States three to four times a year and spends two to three days a week working at the checkout lines.[11]

The Seven Core Capabilities

When Talbots' Chief Creative Officer Michael Smaldone and Chief Merchandising Officer Basha Cohen, arrived in 2007, one of the first things they did was to photograph Talbots' customers. "We spent a lot of time photographing and talking to customers to come up with a checklist of attributes," Cohen said. "That allowed us to better understand their lifestyle, not just the demographics."

The best Act Vertical retailers also were more likely to bring other customer intelligence into their planning meetings, not just POS data. For example, Talbots' top planners, merchants, marketers, designers, store operations and supply-chain managers meet weekly to review point-of-sale data with sales plans. But they also bring back the in-depth discussions they have with store customers—field visits they conduct far more frequently today.

Act Vertical not only requires continually interacting with customers in the stores, it also demands stepping back and taking measure of the larger trends that might affect consumer behavior in the upcoming season or year.

A critical point about new-product development: Act Vertical retailers don't just see opportunities for new products; they see opportunities for services that customers need to make better use of their products. PetSmart's services business has been growing an average 26% annually for the last nine years and is expected to become a $1 billion business by 2011. At Best Buy, services such as computer repair (Geek Squad), extended warrantees and installation have blossomed into a $2.4 billion business—some 5% of its $40 billion in annual revenue.

Once they reconceived customer needs as far broader than just about acquiring products, the Act Vertical retailers we studied saw some eye-opening opportunities.

Balancing Creativity and Commercial Appeal in Developing New Offerings

With trend data to ferret out customer needs that are just over the horizon and sales data and customer interactions to adjust today's offering, Act Vertical retailers make better use of customer insights. That's the first advantage they have in product and service innovation.

The second advantage comes from designing and developing new offerings. Act Vertical retailers are far better at balancing the creativity of the product designers with the commercial sensibilities of the merchants. It's a tenuous balance to strike. But getting it right is elemental to successfully bringing new offerings to market—products and services on which can ride millions of dollars in investments, research, prototypes, marketing campaigns, manufacturing commitments and supply-chain contracts.

The Seven Core Capabilities

The first element of such a balance that we saw was extensive product design collaboration among the design function, merchandising, product development, marketing and suppliers. Talbots moved its creative and technical design departments into the same location. But physically structuring for cross-functional collaboration must be accompanied by organizational structuring, i.e., the organization chart. In the more successful Act Vertical retailers we studied, design, product development, merchandising and marketing heads tended to be equals. (Coach's approach to doing this is to vest oversight of design, product development and marketing in one person: co-president Reed Krakoff. At Talbots, all responsibilities lie with different managers, but all of them reported to CEO Trudy Sullivan, who told us she doesn't tolerate "divas.")

Another hallmark of the Act Vertical retailers was strong coordination of product design, development, planning and other processes. Rather than sequential activities with their own calendars, they tended to be managed concurrently and coordinated by one calendar at the Act Vertical Leaders. At Talbots, managers in sourcing, distribution and catalog production adhere to this calendar—and so do their colleagues in design and planning. This ensures key decisions are aligned from concept to market.

For retailers selling largely enhanced offerings (variations on current products rather than wholesale breakthroughs), the balancing act between creativity and commercial potential appears to be tipped far more toward the latter. Aéropostale, the retailer that wants to be on-trend but not a trendsetter, refers to its new-product development process as one that is design-driven, merchant-modified. The company's designers come up with ideas, but its merchants refine them. Nine months before new products hit the market, the company assembles designers, merchants and other managers. They review the last season's results and pore over market research brought in by the design group: focus group data and observations from traveling to other stores, trade shows and other countries, as well as input from an outside design consultant. Once product decisions are made, merchandise planners determine the number of units to purchase in each category. In the end, the merchants' decision on what to pursue for an upcoming season wins. Aéropostale's organization structure ensures it. Its No. 2 executive, Mindy Meads, is president and chief merchandising officer. The senior vice president in charge of design reports to Meads.

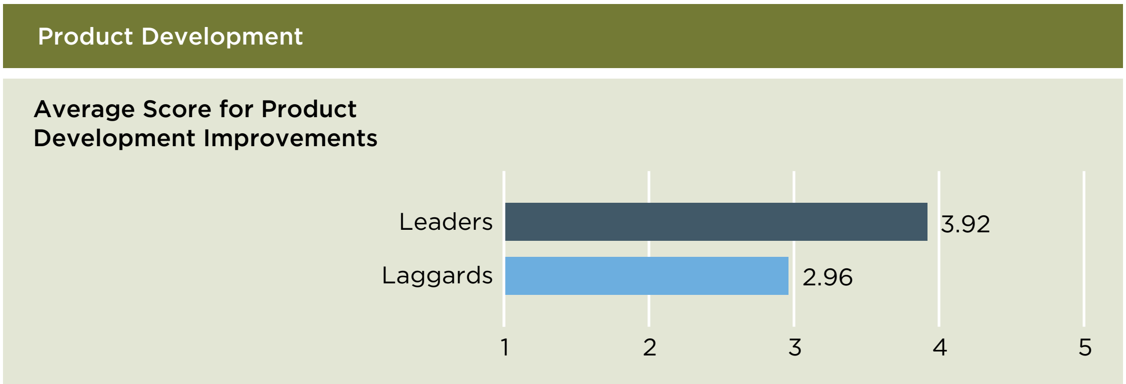
In retailers selling a greater number of breakthrough offerings—products and services meant to set trends rather than just respond to them—designers had a stronger role on the top management team. We refer to it as a design-led product development approach. Coach exemplifies it to the max. Co-President Reed Krakoff is the company's second-ranking executive, reporting to CEO Lew Frankfort. After joining the firm in 1996, Krakoff has led the firm's "creative renaissance," as its website refers to it.[12] (And quite a lucrative renaissance it has been. Since that year, Coach's sales have increased sixfold, from $513 million to $3.2 billion. Meanwhile, net income has grown nearly *40 times,* from $20 million to $783 million.) Today, Krakoff is responsible for nearly every aspect of the offering and customer experience: product design and development, marketing (including advertising, PR and more), store design and visual merchandising. An avid and accomplished photographer, he recently also assumed the job of photographing the company's global advertising and direct mail campaigns. Coach's CEO refers to managing the balance of creativity and commercial necessities as the "blend of logic and magic." The company balances its designers' inspirations with enormous quantitative scrutiny so that beautiful but impractical products do not languish on its shelves. (Note: 80% of Coach's sales are through its 548 stores, including 421 in North America; about 20% of sales are through other merchants.)

Talbots strikes the balance between design and commercial appeal by having design and merchandising heads report to the CEO. But perhaps even more important, a good balance is struck because of the personalities running those functions. They respect each other's talents immensely. "It's [Chief Designer] Michael's [Smaldone] job to push me," Cohen said. "My motivation always is, 'How do you push the envelope?' but also 'How do you remain true to your customer?' I always have to be the voice of reason on the financial side, and sometimes we disagree. But a truly great designer is one who understands the push and pull between art and commerce. He has both of those. We end up complementing each other."

Another hallmark of many Act Vertical Leaders is their focus on developing collections of related products and services, not just one-off items. When customers can be sold on multiple offerings to solve a need, it increases sales and profitability. But it requires designing offerings from a collection standpoint. Coach, for example, has gone far beyond selling bags and briefcases. In recent years, it has ventured into shoes, jewelry, watches, apparel, luggage, furniture, glasses and perfume. The ability to sell such groups of related items appears to be far easier when a retailer aims its customer experience at the lifestyle end of the spectrum, i.e., becoming known to its customers for a way of life, not just for a few memorable products.

Overall, the Act Vertical retailers were far better at improving product development. In fact, our survey showed a big gap between the 15 Leaders and the 11 Laggards on this count. (See Exhibit 5-5.)

EXHIBIT 5-5: ACT VERTICAL LEADERS ARE MORE EFFECTIVE AT PRODUCT DEVELOPMENT IMPROVEMENTS

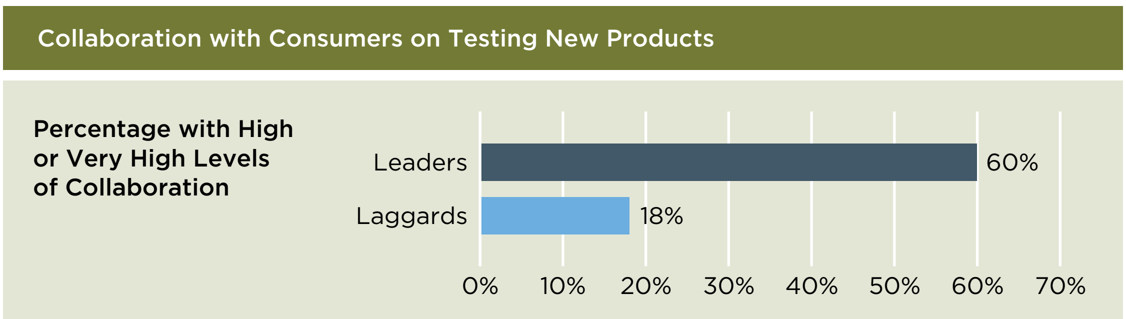


Scale of 1 to 5, 1=Not at all effective, 3=Moderately effective, 5=Very highly effective

Consumer Testing That Increases the Return on Product and Experience Innovation

Act Vertical retailers reduce the risk of product innovation, which can be significant. The Leaders that we surveyed were far more likely than the Laggards to have high or very high levels of collaboration with consumers in testing new products (see Exhibit 5-6). In addition, many of the Leaders test their experience innovations with customers as well, getting consumers to provide feedback on marketing campaigns, store designs, products, websites and other key aspects of the retail-brand experience.

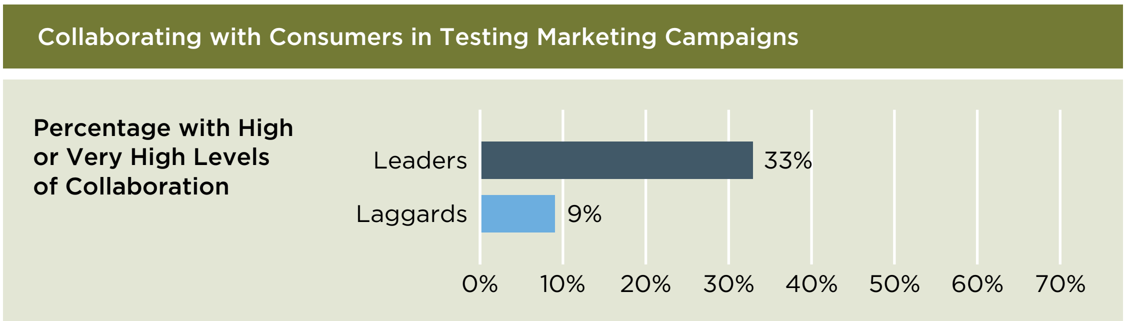
EXHIBIT 5-6: INVOLVING CONSUMERS IMPROVES NEW-PRODUCT TESTING PROCESS



The Act Vertical retailers not only were more likely to test their products before launch, but they also were more likely to test their marketing campaigns. To be sure, this practice is not widespread. Only one-third of the Act Vertical Leaders that we surveyed said they had high or very high levels of collaboration with consumers in testing marketing campaigns. (See Exhibit 5-7.) Yet that was a much higher percentage than the Laggards: only 9% of them said the same thing.

There are two primary reasons for retailers to test their products at this stage: to determine whether they have the right style or color, and how much to order. Catalog retailers for years have done such tests. Anthropologie Inc. conducts customer focus groups before finalizing a line. It also conducts limited tests on items at the end of a season to predict how well they will sell in the next season.

EXHIBIT 5-7: ACT VERTICAL RETAILERS INCLUDE CONSUMERS IN MARKETING



Sourcing Relationships That Speed Production Yet Delay Key Decisions

Every Act Vertical retailer we studied had sourcing under firm control despite not owning factories. Aéropostale owns none of the factories that make its products. Coach shut down its last plant in 2002; today its products are made in 40 plants in 15 countries owned by sourcing vendors. Trader Joe's manufactures none of its special foods and beverages, but it heavily influences their design.

Control over the offering starts with getting intimately involved in the design of offerings (and not outsourcing that along with production). Aéropostale designs all its apparel but outsources 69% of its production to five contract manufacturers. Trader Joe's has a number of people responsible for developing new Trader Joe's–labeled products. In addition to having buyers look far and wide for hard-to-find items (e.g., Morello cherries from Eastern Europe or Belgian chocolates), the grocery chain works with suppliers to develop many of its own items. For example, the company says its Two-Buck Chuck wine (a $2-a-bottle Charles Shaw wine) is the best-selling wine in the United States.[13]

Given that product design, development and manufacturing are done by different parties in different locations, accelerating the process requires using information technology to shift product specifications and blueprints rapidly around the world.

Technology facilitates such close collaboration between retailers and their sourcing partners. From our survey, the leading Act Vertical retailers enjoyed much higher levels of collaboration with suppliers in product design and development than did the Laggards. More than twice the number of Leaders (60%) said they had high or very high levels of collaborations than did the Laggards (27%). Such high levels of collaboration help retailers that are better at Act Vertical to speed their offerings to market. Speed to market was another major advantage that the Leaders had over the Laggards that we surveyed. (See Exhibits 5-8 and 5-9.)

EXHIBIT 5-8: ACT VERTICAL LEADERS COLLABORATE WITH SUPPLIERS

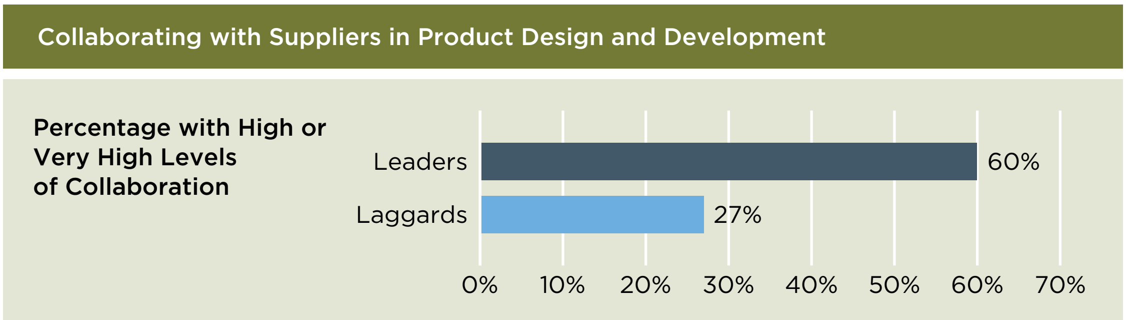
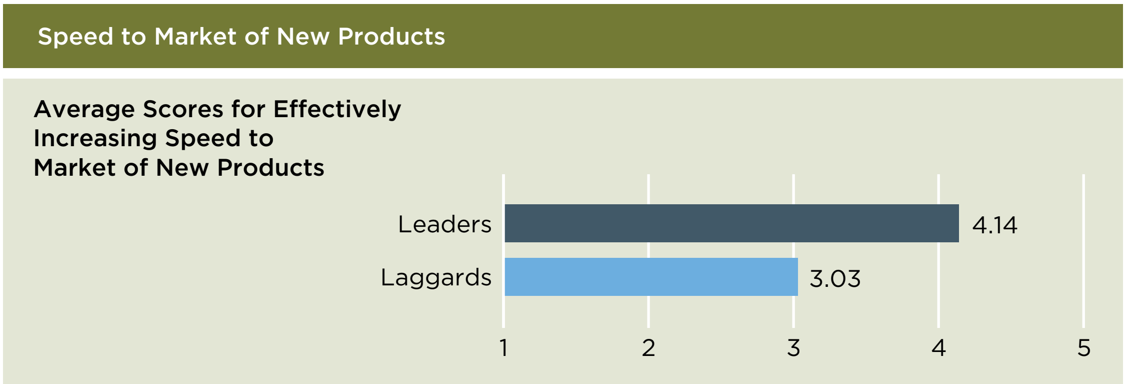


EXHIBIT 5-9: LEADERS VS. LAGGARDS AT EFFECTIVELY INCREASING SPEED TO MARKET OF NEW PRODUCTS



Scale of 1 to 5, 1=Not at all effective, 3=Moderately effective, 5=Very highly effective

Putting production into the hands of other entities reduces a retailer's risk of having stranded manufacturing assets: costly and unproductive overhead when a product line and its production processes become obsolete. It also gives the retailer the flexibility to shift where and how it sources products, which is critical given changing economies of countries and a retailer's product strategy.

Outsourcing manufacturing also helps retailers improve their speed to market with new products. A product strategy based on speed (e.g., a 10-week cycle time to market) requires a different production capability than does a product strategy with much longer lead times, such as those for more basic items.

But Act Vertical retailers must maintain control of their suppliers and their quality. Many have done so by cutting the number of sourcing suppliers and having more clout over the ones they use. Aéropostale, as mentioned previously, gets nearly two-thirds of its products from 5 suppliers. That's far fewer than it had in previous years. Aéropostale's Johnson said: "When I first got here, we exited suppliers that didn't really have a value proposition." The more business Aéropostale gives its core suppliers, the lower the markup they charge Aéropostale on each product. Still, the company continually seeks out new suppliers that can reduce costs (including distribution) even more. To ensure quality, many retailers work directly with their suppliers' suppliers. Coach, for example, works directly with leather suppliers to ensure quality and quantity.

To boost the speed of production, many retailers have located sourcing personnel overseas (although others have brought staff home from Asia and have delegated more authority to their sourcing partners). The key is to push decisions to managers closest to manufacturing. In some cases, that calls for having sourcing vendors or agents doing it. In other cases, the retailer must put its people at the source of production. Some Act Vertical retailers push product development activities onto sourcing vendors.

Given the ever-increasing consumer demand for trendiness, retailers that can make key product decisions on styles, colors, materials and other attributes as close as possible to the time they go to market can remove significant risk. Postponing such decisions enables apparel retailer Zara to go from concept to market in four weeks.[14]

Inventory Management That Shifts Products to Places of Highest Demand and Greatest Profitability

Creating hot products that can't be found at any other retailer is a formidable advantage. But if those products aren't made in the right amounts (or don't get to the right places in the right amounts), a retailer loses time and profitability. This is where great innovation processes must be supplemented with strong inventory management processes—assortment, allocation and replenishment. When those processes are robust, a retailer is able to quickly shift products to places of greatest demand and maximize prices.

From our research, the first component of such inventory management capabilities is excellent forecasting and fact-based replenishment decisions. Aéropostale's capabilities here are stellar. It can get hot items from its distribution centers to its 800+ U.S. and Canadian stores in one to three days. The second element behind such streamlined inventory management is assortment and supply-chain practices that enable rapid sell-through at high profitability. Increasingly, retailers are localizing their assortments even down to the store level. Rather than continuing to institute one-size-fits-all assortments chain-wide (save for climate-related variations in demand), a number of retailers are beginning to implement localization strategies. These retailers are installing assortment planning software packages that will let them tailor assortments by selling locations—store, catalog and Web. They have begun tailoring store assortments toward such customer segments. Talbots is instituting assortment planning software. One of its goals is to gear assortments toward sets whose items can increase cross-selling.

Besides matching their product supply to local demand, a number of Act Vertical retailers have created different supply chains to support different classes of products with very different replenishment characteristics. Best Buy, Target and others have one supply chain for products with predictable sales patterns, such as denim jeans, printer cartridges and baby strollers, and another for products whose demand is less predictable, such as seasonal and new products. They also have different supply chains to support different service-level agreements, e.g., high in-stock vs. low in-stock positions.

Increasingly, Act Vertical retailers are trying to improve the way they manage the lifecycle of unique—and often shorter-lived—products through product lifecycle management systems. These feature centralized calendars that coordinate the actions of planning, allocation and marketing. They also create entry and exit strategies and conduct post-mortem analysis to apply lessons to the next product initiative.

Designing and Executing Consistently Engaging Brand Experiences across All Channels

Maximizing the profitability of a retailer's unique products and services requires not only top-notch customer research, product design and development and sourcing and inventory management capabilities, but it also demands creating and executing a consistently compelling environment in which target customers can learn about, sample and purchase its products and services so that they can connect themselves more closely to the brand.

For sure, the store environment must be compelling, especially given a glut of U.S. retail space that may get worse for several years. But these days, so must the retailer's catalogs (if it has them) and website. The fact that many customers now start their shopping expeditions online forces retailers to pay far more attention to their websites. Those that showcase their special offerings in special ways are far more likely to have visitors clicking their computer mouse or heading into their stores. Retailers that let shoppers electronically communicate their purchasing desires to others (especially the ones paying for those purchases) will gain ground. Children today are already sending via cell phones pictures of store products they want to buy to parents and friends. For example, Abercrombie & Fitch's website allows viewers to post online wish lists for gift purchases and send emails with links to Web pages with the items they'd like.

All this requires special skills, processes and information to design and execute a consistently engaging and integrated retail-brand experience across all channels. Act Vertical retailers applied their design skills to the shopping experience, as well as their product and service offerings. They explicitly designed their stores to convey what was different about their brand. Some, like Apple, applied a whole different design sense to their stores. The president of Apple's store unit, Ron Johnson, has said that Apple transferred its computer design skills to retail, ignoring traditional store design dogma. "Why has it worked? I think it's all about Apple's grounding in design being applied to a different business from products—to a retail strategy," he told a design conference audience in 2004.[15]

Abercrombie & Fitch's loud and dark stores are magnets for teenagers and turnoffs for most parents. But that brand experience was intentional, and it has helped the $3.7 billion firm more than double revenue and profit in the last five years. Aéropostale's stores are inviting to both kids and parents. Cacique, an intimate apparel offshoot of plus-size women's apparel retailer Lane Bryant Inc., intentionally designed its 120 stores to make plus-size women feel as special about trying on intimates as the Victoria Secret Stores customer. Special fitting rooms use indirect lighting and mirrors that reduce shadows and a chest of drawers of bras is nearby so that the customer doesn't have to roam the sales floor looking for the next size. Cacique sales have increased 50% in the last five years.

Coach matches the luxury cachet of its products with modern, sophisticated and sleek stores with high-end fixtures and finish. They help communicate the firm's "affordable luxury" image. REI displays its connection to customers by teaching them how to climb rocks in their stores.

Perhaps the trendsetter in store design is computer-innovator Apple that, as we mentioned, applied a whole different design sense to their stores. With sales per square foot four times that of Best Buy (about $4,000 vs. $930), Apple's 250 stores have been a roaring success almost from their launch in 2001. Apple designed its stores to appeal to its customers' lifestyles—not around creating an efficient purchasing experience. "We think what's made our stores successful is the design decision to put the customer at the center—the life experience, not the buying experience," Apple's Johnson said.[16] The store is organized not just in product sections, but also by tasks (so-called "complete solutions"), i.e., the fundamental things Apple customers are trying to accomplish with those products: photos, movies and music. The Genius Bar also provides troubleshooting advice to store patrons for free. "We don't want the store to be about the product, but about a series of experiences that make it more than a store," Johnson has said.

But the design of the retailer's brand experience extends beyond the artifacts and look and feel of its stores, catalogs and website. It includes the way customers are treated by store personnel, interact with the brand and socialize with other customers. All the investments in store design can be squandered if the customers of an Act Vertical retailer aren't treated in a special way. Offering special products and services but ordinary (or worse) store experiences is anathema to the successful Act Vertical retailer. Competing in the lower-right quadrant of our retailing landscape has been a losing proposition for several retailers (including Sharper Image, which filed for bankruptcy in February 2008).

The Act Vertical retailers we studied paid great attention to their store sales associates. They accomplish this through rigorous hiring and training practices. They realize that a major piece of becoming more engaging with customers is hiring more-personable store personnel.

Act Vertical Leaders hire salespeople who are passionate about their products. Then these retailers make these people more knowledgeable about those products and their customers. Such retailers invested heavily in training programs to help new hires understand their customers, their customers' emotional needs and how to treat them.

Our survey showed a big difference between Act Vertical Leaders and Laggards in the amount of training they provided to store personnel (a nearly 1-point gap on a 5-point scale in degrees of store-labor training). They provided more in-store services. They also invest in tools for the stores and websites that enrich the customer experience and point out what's different about their offerings. Retailers like The Men's Wearhouse Inc., a $2 billion retailer whose profit has tripled in the last five years, pay special attention to applying product tags to shirts and other products that explain the benefits of its products. PetSmart has developed and placed a "Smart Nutrition Selector" on its website that helps customers determine what their dogs should eat. The online tool asks a number of questions: the age and weight of the dog, how active it is, whether it has allergies and so on. After answering the questions, a customer gets a recommendation on the right brand for their dog—brands that are not available in Wal-Mart or Target. The online calculator provides a big benefit for customers, good nutritional advice and, of course, a big benefit for PetSmart.

But it's one thing to enrich the shopping experience. It's another to enhance the customer's lifestyle outside the purchase. A number of Act Vertical retailers think about and design experiences that enhance their customers' lives. Casual Male Retail Group Inc., a $464 million retailer of tall and large men's apparel, has a blog that engages customers about their lifestyles. Apple holds private concerts at its stores that get its iPod music fanatics together. Wegmans allows customers to search its online recipe library, where they can also get nutritional information about prepared foods. They use their intimate knowledge of customers gained through market research and daily interactions and find ways to hook into their lifestyles. REI sends emails to customers about events in its stores (e.g., clinics on bicycle maintenance) and outside the stores (local hikes and charity events).

The Seven Core Capabilities

The best Act Vertical retailers don't limit their customers' experience to their stores, websites or mass-media advertising campaigns. They aggressively look for ways to engage with customers outside their sales channels. From our survey, 50% of the Leaders said they provided a highly or very highly engaging consumer experience outside the purchase transaction vs. 0% of the Laggards.

A retailer's hundreds or thousands of daily interactions with customers are its competitive weapon for product and service innovation, particularly retailers that sell complementary services to their customers, not just products. In this regard, retailers have a tremendous potential advantage over consumer manufacturers, most of which are shielded by retailers from their customers.

The Act Vertical retailers created a virtuous circle in which their innovative offerings and engaging customer experiences enabled them to create deeper bonds with customers. Their customers became passionate advocates of that retailer—people who also want to associate with other customers who share their passions, values and aspirations. (Case in point: Apple, whose 250 stores had about 150 million visits in FY 2008.[17]) Interacting with its tribe thousands of times every day then gives the retailer a superior ability (vs. national product brands) to continually create the next round of breakthrough and enhanced offerings.

Marketing That Communicates the Brand Promise and Showcases How the Offering and Experience Enhance Customers' Lifestyles

The ultimate success of Act Vertical retailers depends on whether their products and services are truly unique and compelling and on whether they provide value beyond what's provided by the brands consumers can get from other retailers. And, as we mentioned in the previous section, creating the right experience by which customers can learn about the offering, purchase it and interact with the brand in other ways is critical as well. But the more successful Act Vertical retailers also developed superior capabilities in getting the attention of customers and attracting them to their stores, websites and catalogs. This is about marketing, but marketing of a certain type. The marketing of the Act Vertical retailer must showcase what's better about its offering and the customer experience. It must also connect the retailer's brand with its customers' lifestyle needs, especially their life aspirations.

One marketing capability we found in the more-successful Act Vertical retailers was connecting their messages and the customer experience across sales channels. The ability to create cross-channel marketing that integrated messages on the Web, in the catalogs, and other marketing vehicles was a major differentiator between Act Vertical Leaders and Laggards (a 0.95-point gap). The key is to also make sure that whether customers are viewing the Web, catalog or store, they see the same visuals and product.

The messages of Act Vertical retailers consistently highlight the new and compelling offerings this month, week or day. Talbots, for instance, has shifted almost its entire marketing budget from mass advertising to its catalog. Each monthly catalog now introduces the company's latest collection, driving traffic to the stores and website. The catalog introduces "brand moments" every month, as the company refers to them.

Creating consistent marketing messages across all sales channels requires someone in charge of the messaging for those channels. At Talbots, this person is the chief marketing officer. At Coach, it's the co-president in charge of product design, development and marketing. While the marketing messages must create a consistent brand image, they become more effective when the Act Vertical retailer can personalize them for customers. Macy's uses such customer knowledge to direct much of its communications to its best customers.

But some of the Act Vertical retailers we studied didn't focus their marketing programs solely on campaigns to drive sales of specific products and services. Several of them—convenience store chain Wawa, REI, Target and Aéropostale—used marketing to make a higher-level connection with customers. They used marketing programs to connect themselves to their customers' aspirations and to enable their customers to mingle as a tribe.

Aéropostale, for example, knows that many of its young-teen consumers aspire to the college lifestyle. As a result, the firm connects its brand with the college experience through marketing campaigns and sales events on college campuses and by sponsoring college athletic conferences with co-branded apparel and scholarships. Aéropostale's marketing is laser-focused on ways to connect to its customers' lifestyle; the firm conducts very little mass media advertising.

Convenience store operator Wawa holds a "Hoagiefest" for lovers of one of its most popular and distinguishing items. The Pet Community area of PetSmart's website allows pet owners to trade pictures and tips. The site also has an online pet adoption search that enables pet lovers to find a pet in need of a nearby home. Marketing programs like these that connect an Act Vertical retailer to its customers' aspirations take the retailer's brand experience to a whole new level.

Key Barriers to Implementing a Successful Act Vertical Strategy and How to Address Them

The seven capabilities retailers need to thrive at Act Vertical are not easy to develop. The companies we studied did not build their capabilities overnight. In fact, some took several years. Furthermore, despite their stellar financial performance, not one retailer had mastered all seven capabilities. They all have a ways to go in improving their market research, product and service design and development, sourcing, marketing, brand experience, inventory management and consumer testing capabilities.

From our research and consulting work with retailers, we have found a number of barriers to adopting an Act Vertical model (see Exhibit 6-1). None is insurmountable. Our thoughts on how to overcome them are based on how they were addressed by the executives at the retailers we studied.

Key Barriers

EXHIBIT 6-1: CHALLENGES TO ACTING VERTICAL CAN BE OVERCOME

Act Vertical Challenges and Solutions

Challenges	Solutions
Driving unprecedented levels of collaboration and coordination across firm	CEO and top team must embrace, commit to and sponsor the change
Creating a culture that rewards cross-functional partnerships	Hiring team players and firing “divas,” especially in product design and development
Collaborating with customers in whole new ways to get new products and the customer experience right	Shifting research from episodic to continuous and focusing on the sales environment, not just the sales data
Embracing store-experience improvements as much as merchandise improvements	Regarding sales training as critical an investment as technology
Rewarding end-to-end operational execution over functional efficiency	Measuring everyone on the end result, not just on their role in achieving it
Gaining skills in managing total supply chain, from market research to the store	Demonstrating how the entire concept-to-market process really works
Valuing and maintaining strong sourcing and supply-chain relationships	Evaluating suppliers on the revenue and profit they help you generate
Getting past the ghosts of previous initiatives that appeared to be vertical	Truly understanding the distinct differences of an Act Vertical strategy

The first barrier is the functional silos resident in most retailers. Of course, such silos are a barrier to any corporate initiative that forces internally focused departments to closely coordinate their decisions and actions, shift activities from one department to another and revamp their reporting relationships. But an Act Vertical model requires unprecedented levels of collaboration in the demand-creation and supply sides of a retailer. A strong Act Vertical brand experience does not result when one function's success comes at the expense of another's. Product designers and developers need to pursue opportunities that market research has uncovered, not their own agendas. Merchandising, product development, store operations and catalog and website personnel must work hand in hand to reduce the risk that new ideas for products, services and customer experiences do not go over the heads of customers. Conversely, thinking about "what worked last year" cannot be allowed to trample the creative instincts of product design and development, marketing, store and other personnel.

To reduce the chances that entrenched functional managers defend their turf, an Act Vertical model must be championed *and* orchestrated by the CEO. CEOs who quickly delegate the responsibilities for shifting to an Act Vertical model to their direct reports—without gaining their full commitment and understanding of what lies ahead—will preside over an initiative that will fall apart before long.

The second major barrier is closely related to the first: shifting away from a culture that promotes functional excellence. The new culture must motivate managers across functions to subordinate their goals for the overarching Act Vertical goals. This is especially critical for creating an effective new-product and -service development process. Designers and merchandising managers must overcome any past vestiges of distrust or disrespect. Specifying and assigning responsibilities for each will help promote a strong working partnership. And creating joint measures and rewards will help cement the partnership. Metrics and rewards for end-to-end operational execution—for introducing highly profitable new offerings and their attendant customer experiences to market—must supplant ones that encourage functional optimization.

The next big barrier is one of old thinking on how to conduct customer research and on what to solicit feedback. Many retailers traditionally have focused their customer research on what products sold well and poorly in the past. To get an Act Vertical model going, this is important information—but only if it helps the retailer more deeply understand what attributes of their products are most important for customers and whether they are satisfied with them. Yet such research is of limited value in helping retailers identify whole new product and service opportunities, which customers often can't articulate. Thus, an Act Vertical model demands new ways of conducting customer research to get new products right—collaborating with shoppers in entirely new ways. But customer research can't stop with the products and services with which a retailer is experimenting. Because an Act Vertical approach also means creating new, distinctive customer experiences, retailers must find ways to collaborate with customers in designing such experiences. Collaborating with customers in the design of websites, stores, catalogs and other sales channels will be a whole new territory for many retailers.

Key Barriers

Changing entrenched attitudes that limit investments in the store experience will separate many successful Act Vertical retailers from the ones that struggle. A great number of retailers are merchandise-focused. "Get the product line right and everything else takes care of itself" is the thinking on the merchandise front. Other retailers lean toward investing in new stores to increase revenue and profit, rather than improving existing stores. Both mindsets lead to curtailing improvements in the store experience, especially in sales training. (One more destructive mindset: "Why train them so much when we lose them so easily?") They steer store managers to hiring minimum-wage staff instead of knowledgeable product enthusiasts. And they squeeze training when sales slump. The most successful Act Vertical retailers have a different mindset at the very top, with the two people who control the purse strings: the CEO and CFO. They recognize the importance of a distinctive store experience. They inherently believe in funding the *right* upfront and ongoing investments in people, design and furnishings that make the experience special.

A retailer's ability to make substantial profits from its unique products and services also depends on how well it can manage the product lifecycle—from the time an opportunity is identified in market research to the moment a new offering is available in the stores. Few retailing executives we've known—even those with long and illustrious retail careers—understand the entire supply chain. This is a consequence of years of functional and departmental optimization in the industry. Retailers traditionally have not valued managers with broad experience; they instead have embraced depth of narrow expertise. But without people who understand the downstream implications of changes to upstream work in the value chain, it will be difficult for retailers to optimize the concept-to-market process.

Another part of the supply chain requires whole new practices for acting vertical: managing sourcing vendors. Relationships that, in the past, were adversarial and at arm's length must shift to ones centered on trust and high collaboration. To rapidly manufacture and distribute innovative, high-quality products, retailers must treat manufacturers and distributors as partners, not supplicants.

The last key barrier to Act Vertical is entirely one of perception. It is the bitter aftertaste of disappointing past corporate initiatives that in hindsight appear to be of the Act Vertical variety. These might include private-label programs that didn't deliver; upgrades to stores, websites and catalogs that didn't pan out; ideation and product-innovation exercises; and exclusive distribution arrangements that didn't deliver. All of these are aspects of an Act Vertical initiative. None can be done piecemeal. Act Vertical requires synchronizing these and other initiatives around the offering and customer experience. It also demands that they're all in line with the retailer's overall brand strategy.

Profiles of Leading Act Vertical Retailers

In this section, we present seven short case studies on retailers across segments that instituted Act Vertical strategies: Aéropostale, Talbots, Apple, Target, Trader Joe's and Coach.

Aéropostale: Pleasing the Teens and their Parents by Staying On-Trend and On-Budget

AÉROPOSTALE AT A GLANCE

> **Sector:** Teen apparel (14- to 17-year-olds)
> **Year Founded:** 1987
> **Headquarters:** New York, N.Y.
> **Revenue:** $1.6 billion (2007)
> **Net Income:** $129 million (2007)
> **Stores:** 864 in the United States and Canada
> **CEO:** Julian Geiger
> **President:** Mindy Meads
> **COO:** Tom Johnson
> **Ownership:** Public (NYSE: ARO)

Launched by R.H. Macy & Co. in the early 1980s as a private-label line, Aéropostale Inc. has become a star in apparel retailing, reaching nearly $1.6 billion in sales in 2007 and competing against larger retailers like Abercrombie & Fitch, Hollister Inc. and American Eagle Outfitters Inc. for the hearts of American teenagers.

Aéropostale has carved out a healthy slice of this market through a highly successful Act Vertical strategy featuring a 100% Aéropostale-designed offering, insightful market research, a rapid product development function, highly responsive and efficient suppliers, a lean corporate center and a store experience that pleases teens and their parents.

The result for Aéropostale customers, boys and girls 14 to 17 years old, is on-trend clothes and accessories that are value-priced and designed to please both teenager and parent. "We're at the intersection of fashion and value," Tom Johnson, executive vice president and chief operating officer, said. "The most important thing for us is to deliver the right fashion, and current trends, at great value. ... We're not a fashion leader. We're not a fashion follower. We want to be on-fashion."

It's clearly been a winning formula. Aéropostale's revenue has grown eightfold since 1999; and on a compounded annual growth rate, earnings per share have increased 32% for the past six years. Even in the brutal year of 2008, the company achieved positive same-store sales in the month of September.

Aéropostale began life as a private-label brand sold at Macy's stores in the early 1980s. Macy's turned the product brand into a retail brand in 1987, when it opened the first mall-based Aéropostale store. By 1997, Macy's had expanded the concept to more than 100 locations. A year later, Macy's sold the business to its management team (backed by Bear Stearns), which took the firm public in 2002. Today, Aéropostale has more than 900 mall-based stores across the United States, Puerto Rico and Canada, as well as 14 Jimmy'z Ltd. stores.

The New York–based company is crystal clear about its target customer—the universal teen. It does, however, also consider Mom in the shopping equation. The offering and the customer experience are designed with that duality in mind. Most of the clothes sell for less than $50. "That compelling value really works well for the mom who is often participating in the purchase," Johnson said. Likewise, store personnel are very friendly and helpful.

On the supply side, Aéropostale gets low-cost, quality merchandise by concentrating more than two-thirds of its business with five vendors. "We have a core vendor base that we have been partners with for many, many years, and they have been loyal to us," Johnson explained. "In a world of free agency, retailers will jump around from vendor to vendor for the absolute lowest price. We take a more balanced approach. We stay committed to our vendors because we recognize that our long-term partnerships will give us a competitive advantage."

Aéropostale's lean way of operating carries over to the firm's West 34th Street headquarters. Its SG&A costs were less than 22% of sales last year. "We are a fairly lean operation compared to our peers and remaining cost-conscious is part of our culture," Johnson said.

The leanness stops at the firm's training and development programs, however. Store manager training is extensive. "It's very important that we train and develop our people and that we recognize them for great results," Johnson said. "For the many years that I've been here, we've done nothing but continue to improve our developmental programs both at the store and in our corporate offices." He believes keeping the pedal down on training is a major factor in the firm's 11 consecutive years of same-store sales increases.

The Aéropostale customer experience depends greatly on sales training and hiring the right talent. "We hire nice people, train and develop them and let them know our expectations," Johnson said. The company instructs them on everything from how to greet customers to how to end the customer transaction (with a smile). The company has upgraded the store experience in the last two years as well, with 200 of the 900 having been refurbished to a new and innovative architectural format. A seating area in the back pleases parents. Fitting room doors that fog up please their kids.

How does Aéropostale keep outperforming its competitors? As long as the product and experience engage customers, the firm's Act Vertical strategy will remain a winner. According to Johnson, "We want to deliver great fashion, incredible value, with a fun shopping experience. And, most importantly, we make sure that every customer leaves our Aéropostale store happy."

Talbots: An Act Vertical Strategy Rejuvenates a Once-Dowdy Apparel Chain

TALBOTS AT A GLANCE

> **Sector:** Women's apparel
> **Year Founded:** 1947
> **Headquarters:** Hingham, Mass.
> **Revenue:** $2.3 billion (2007)
> **Net Income:** $189 million loss (2007)
> **Stores:** 595 in the United States and Canada
> **CEO:** Trudy Sullivan
> **Ownership:** Public (NYSE: TLB)

Eight miles down the coast from Boston, the old Yankee town of Hingham, Mass., is an apropos place for the headquarters of The Talbots Inc. Founded in 1947 by Nancy and Rudolph Talbot, the company generated $18,000 in sales its first year by offering classic women's apparel. More than 60 years and two owners later, it hasn't veered away from its classic-style approach. Today, Talbots is a $2.3 billion publicly held company with two retail brands: its original Talbots stores (595 in North America) and J. Jill (a 2006 acquisition that was put on the block for divestiture at the end of 2008).

The last two years have been among Talbots' most tumultuous ones, the consequence of a merchandising strategy that had become stale earlier this decade and worsened more recently by a downturn in the market for upscale women's apparel. Talbots' annual profits peaked at $127 million in 2001 and have been on a steady decline, turning into a $188 million loss by 2007. It prompted the company to bring in a new CEO that year, Trudy Sullivan, formerly president of Liz Claiborne Inc.

In the late 1990s, Talbots was a highly successful retailer selling classic fashion to upper-income women 45 to 55 years old. But in 2000, competitors such as Chico's and Ann Taylor began taking share while Talbots clung to styles that many customers regarded as dowdy. In fact, by 2007 Talbots' research found some customers in their 60s who regarded Talbots merchandise as designed for women older than *they were*.

The organization had fallen into a creative rut because it had adopted a department store approach to merchandising. "It was almost a 'department-store-under-a-specialty-roof' mentality," Basha Cohen, chief merchandising officer, said. Following fashion trends, not trying to be on-trend, was the mindset. The result was a dearth of truly unique products that would compel customers to seek out Talbots rather than Ann Taylor, Nordstrom or another competitor. "There were no clear roles or definitions in top management," Sullivan said. "There has been a lot of group-think, a lot of consensus meetings. There had been no clear owner of the creative vision of the brand. There was a lot of what I call 'forensics.' You could have a great meeting to discuss what didn't happen," she laughed. "But there wasn't any looking forward or developing a point of view after rigorous consumer research."

Sullivan has been leading a transformation to what she calls a design-led organization from a merchant-led organization. To make the shift, she brought in an almost entirely new management team to run marketing, merchandising, supply chain, design (she created a new chief creative officer position reporting to her), public relations and other functions—executives who had worked in vertical retail models previously.

It's a turnaround that has accelerated a 10-year transition from a retailer that sold mostly national apparel brands to marketing its own merchandise. "Talbots was still vendor-based well into the 1990s," Sullivan said. In 2008, the firm for the first time in its history was 100% vertical in product: designing all its line. "Prior to this they were sending samples to vendors and getting them knocked off," Sullivan explained. "That meant they were two years behind the curve for a fashion brand. That is not where you want to be."

The turnaround began with a new brand strategy—not a wholesale change but rather a repositioning. Talbots decided to stay focused on classic women's apparel but be known for timeless classics. "We want to own the classics," Cohen said. "We want to be known as *the* place to shop for on-trend, current classics. We want to make customers feel like they are part of this century."

"Our goal is to become much more innovative, irresistible, inspiring and fun," Sullivan said. "We had been too safe and too serious for too long. Our customer is much younger and more vibrant. She wants our styles to be appropriate. We are a classic brand—but she wants it to be fun."

One of the biggest changes at Talbots has been in product design and development. Cohen and Michael Smaldone, the new chief creative officer, jointly determine the firm's product content. When they joined the firm, they began by observing customers and photographing them. They came up with a checklist of design attributes (e.g., the customer is "current," not "trendy"). Smaldone sets the product strategy; Cohen helps validate it with customers. One does not report to the other, as is the case in most retailers. They both report to Sullivan.

This means that the way Cohen and Smaldone interact is critical to Talbots. "It's his job to push me, and I am terrified staying stuck in the mud," Cohen said. "My motivation always is 'How do you push the envelope?' but also 'How do you remain true to your customer?'" She said that while they sometimes disagree, they truly respect each other and work well together. "Michael understands the need to balance the art and commerce, which is the sign of a truly great designer. We edit the line together."

Marketing has also undergone a sea change at Talbots. Out are mass marketing TV and print advertising campaigns. That money has been shifted to direct marketing: the Talbots website and catalogs, which are mailed to 50 million households. "We want to use the catalog as a main branding tool," Chief Marketing Officer Lori Wagner said. "We have a very loyal client base and a ridiculously small number of people generate a huge percentage of our business. Traditional advertising is not going to deliver the kind of traffic that we need."

In addition to overhauling its merchandise and marketing, Talbots has been refashioning its website. "We are moving to best in breed," Wagner said. Perhaps an even bigger change is better orchestrating all three of the company's sales channels (stores, Web and catalog). The channels had been treated largely as separate businesses in the past. Buyers for the catalog did not buy for the stores. Catalogs were not designed to reflect changes in store floor sets. All of that is changing. Merchandise showcased on the Web and catalogs can now also be purchased in the stores. That helps customers use one channel to buy and another channel to take delivery. "Our multichannel customers buy five times more than a single-channel customer," Sullivan said. "One of our biggest challenges is getting customers to shop across our multiple channels."

Profiles of Leading Act Vertical Retailers

Despite the grim fourth quarter of 2008 for nearly all U.S. apparel retailers, there were signs that Talbots' Act Vertical strategy was working. While customer traffic had dropped considerably in October during the nation's financial meltdown (same-store sales were off 14% in the company's third quarter ended Nov. 1), two core vital signs were positive: average dollars per customer transaction and customer conversion rates had risen. In addition, marketing was bringing many lapsed customers back to the stores. Further, for the first time since 2004, customer reaction to the company's new fall merchandise (as gauged by a study of consumers' planned purchases) increased 10 percentage points over the previous fall. In addition, inventories were lean, the result of major improvements in planning and allocation.

What has reduced inventories, even though sales are off? One major factor was Talbots' shift of purchasing responsibilities from merchandising to planning (i.e., purchasing units and sizes). "It was a huge department for the merchants here," said Jeannie Barsam, senior vice president of merchandise planning and allocation. Sales forecasts now come in weekly, not monthly. The company's planners for the first time track unit sales and gross margins. Weekly meetings that convene planning, marketing, stores, merchandising, catalog, Web and the business lines enable the firm to review sales forecasts and better understand what has been selling well and poorly. Talbots adjusts its promotion plans and assortments much faster than it did previously.

Despite the gains, big challenges are ahead. Shoppers for nearly all high-end apparel retailers were hard to find in late 2008. (Third-quarter same-store sales for Talbots rival Ann Taylor's 966 stores plummeted 24.8%, and the parent company, AnnTaylor Stores Corp., had a breakeven quarter before restructuring charges.) Talbots' divestiture of J. Jill will raise cash and enable management to concentrate on one retail brand.

Getting others below the Talbots' top management team to embrace and master the Act Vertical strategy is Sullivan's biggest issue. "Our challenge is the education process to the next line of management," Sullivan said. "Repetition is the mother of all learning. It's a huge teaching assignment. Everyone here believes in the Talbots brand. There is huge brand pride. And our customer is unbelievably loyal."

The changes are sizable—but necessary. "We're doing things in a very different way, and we have to build belief in the rank-and-file that this will work," Sullivan said. "Employees have been through six years of difficult times." She reminds people that this is a "three-year gig. It can't happen overnight in this environment. It's going to take longer to do. We have a plan. We're working the plan."

Profiles of Leading Act Vertical Retailers

Apple: Using World-Class Product Design Skills to Redefine the Retail Experience

APPLE AT A GLANCE

- > **Sector:** Consumer electronics, computers, cell phones
- > **Year Founded:** 2001
- > **Headquarters:** Cupertino, Calif.
- > **Revenue:** $6.3 billion (2008)
- > **Operating Income:** $1.3 billion (2008)
- > **Stores:** 247 worldwide (205 in the United States)
- > **President:** Ron Johnson
- > **Ownership:** Apple Inc. (NASDAQ-AAPL)

When it comes to retailing, computer pioneer Apple Inc. has earned big bragging rights, even if it has been a bricks-and-mortar merchant for only eight years. The company says it broke Gap's record for the fastest time to $1 billion annual sales, reaching that mark in just three years. That was in 2004. By last September, Apple's 247 stores were ringing up $1.7 billion in revenue a *quarter*. Sales per square foot in 2007 were a stunning $4,032—four times those of Best Buy and even 30% higher than Tiffany & Co.[18]

Apple's overwhelming success in retailing is the result of an Act Vertical strategy in high gear. (Given that the parent company outsources its manufacturing, Apple truly is an Act Vertical retailer.) The company transferred to retailing the design capability it used to dominate the online music business (today it's bigger than Wal-Mart's) and make rapid inroads in the mobile phone industry. In Apple's most recent fiscal year (ended Sept. 27, 2008), its retailing unit was a $6.3 billion business (nearly 20% of the company's $32 billion in total revenue) with a 20% operating margin. Half of Apple's 32,000 full-time equivalents work in the retail unit.

The person who has driven Apple's retail business from its inception is Ron Johnson, a former Target Stores vice president of merchandising. Johnson played a major role in Target's ascent and led the group that launched its vaunted Michael Graves line of fashionably designed products. In 2000, Johnson and Apple co-founder Steve Jobs scrapped the first Apple store design, which had been laid out by product category. That was not how consumers wanted to shop, they realized. They designed the store not around the shopping experience but rather to optimize what Johnson calls the "life experience,"[19] i.e., the total time a customer owns an Apple product.

It explains why Apple's first design decision was about where to locate the stores. When Apple began opening stores in 2001, it had a tiny share of the personal computer market, and so it was important to have stores where many non-customers could sample its products. That is why Apple has opened stores in high-traffic and expensive locations such as its underground shop in Midtown Manhattan's Fifth Avenue. "We wanted people to see our brand" rather than have to drive or walk a great distance, Johnson told a 2004 design conference.[20] Or as Jobs told *Fortune* magazine, the real estate strategy was to "ambush the customer." Customers using Windows-based PCs "weren't going to drive to a destination," he said. Despite the high rents, the locations made sense because customers "didn't have to gamble with 20 minutes of their time. They only had to gamble with 20 footsteps of their time."[21]

Apple considers 11 of its stores critical to creating broader brand awareness and generating corporate sales. They are bigger stores, have higher-traffic locations and have design elements that the others don't have. In fact, the company allocates their additional costs—$53 million a year—to corporate marketing expenses.[22]

Apple's unique store design helps customers better *use* Apple products, not just purchase them. That's why Apple's stores have sections called "solution zones" in which hardware, software and accessories are grouped together in such areas as music, movies, photos and children. The stores also have more-traditional product zones. They also feature "Genius Bars" where customers can belly up to a counter and get free troubleshooting advice from Apple technicians. Appointments can be scheduled online from Apple's website. The "Geniuses" are carefully hired (50 on average apply after Apple posts a job opening) and extensively trained—four weeks at headquarters and four in the store.[23] Store services also include training workshops and special programs for children. Customers can book appointments with personal shoppers who provide advice on purchases.

The company's Act Vertical strategy has been an incredible success to date. Compelling products, innovative store services that help customers use those products and a store location and design strategy that focuses on converting consumers to the Apple "lifestyle" have been a potent retailing formula.

Profiles of Leading Act Vertical Retailers

Target: How an Act Vertical Strategy Created a Divergent Path to Discount Retailing Riches

TARGET AT A GLANCE

- > **Year Founded:** 1962 (predecessor company Dayton's founded in 1902)
- > **Headquarters:** Minneapolis, Minn.
- > **Revenue:** $63.3 billion (2007)
- > **Net Income:** $2.8 billion (2007)
- > **Stores:** 1,648 in 48 states
- > **President & CEO:** Gregg Steinhafel
- > **Ownership:** Public (NYSE: TGT)

Over the last 20 years, the landscape of discount retailers has been littered with failures. The Caldor Corp., Bradlees Inc., Zayre Corp., Ames Department Stores Inc., Service Merchandise Company Inc. and many others have disappeared. Of course, the omnipotence of Wal-Mart Stores Inc. explains much of the carnage. While others have gone under, Wal-Mart's growth has been phenomenal, with annual revenue soaring 18-fold, from $21 billion to $379 billion since 1988. If that alone doesn't seem like a monumental feat, try this: In 1987 Kmart Corp. was *bigger* than Wal-Mart. Today, Kmart's revenue is $17 billion, less than it was 20 years ago.

While Wal-Mart has steamrolled discounters around the United States, one it hasn't flattened is Target Corp. The $62 billion retailer has thrived by using an Act Vertical strategy to compete on a different basis: creating more design-oriented products in many categories, offering a less-cluttered store experience and connecting with customers' emotions, not just their wallets. In doing so, Target has nearly tripled its annual revenue in the last 10 years, avoiding getting sucked into the black hole of price discounting dominated by Wal-Mart. Target's "cheap chic" approach to private-label products, which accounts for approximately 32% of total sales,[24] has enabled it to thrive over the last decade.

Target's brand strategy carved out a large segment of design-conscious—*and* cost-conscious—consumers looking for something more upscale than the average discount store experience. Design has been in its DNA since the launch of its discount stores in 1962. However, the company raised its design sensibilities up a notch in 1984 when Robert Ulrich became president of Target's stores division. Ulrich believed Target had to be clearly distinct from Wal-Mart and Kmart. He based that differentiation on upscale brands that were unique to Target, emphasizing design in fashion and creating a less-cluttered and more-sophisticated store experience. He brought over fashion watchers from the department store divisions of Dayton Hudson and launched a trend department in Target.

(Ulrich became CEO of Dayton Hudson in 1994. By 2000 the entire corporation was rebranded Target Corp. Ulrich retired in 2008.)

The design kick got another rocket booster in 1996, when Target created an alliance with world-renown architect and designer Michael Graves. Three years later, Target introduced some Graves-designed teapots and other kitchen items, as well as clothing designed by Mossimo Giannulli, a Southern California apparel entrepreneur, and cosmetics by Sonia Kashuk.

Extensive consumer trend research helps Target be more fashionable than the traditional discount retailer. One underpinning of that capability is a "creative cabinet"—a rotating group of a dozen people chosen by Chief Marketing Officer Michael Francis. They are his eyes and ears on trends around the world (e.g., the anime culture in Tokyo) that may later be baked into the company's products.[25] They also provide feedback on products and initiatives.

Design is so highly regarded at Target that the function reports not to marketing or merchandising but rather to CEO Gregg Steinhafel. The 300-person product design group is led by Michael Alexin, vice president of product design and development, who joined the firm in 2002 after stints at Eddie Bauer Inc., Nike Inc. and Levi Strauss & Co. He and his group work closely with Francis and his 1,400-person marketing unit. Although product design does not report to marketing, Target's corporate structure enables it to maintain one face to customers in and outside the store. Francis controls marketing, research, community relations and Target's website.[26] He also is in charge of strategy.

Target believes its design prowess has helped it establish an emotional connection with customers —the ability to get fashionable products they'd pay far more for elsewhere. Consumers' bond with Target's designs starts at the most basic level: with the Target bull's-eye logo. The company says 96% of Americans recognize Target's target—a higher percentage than can identify Nike's swoosh or Apple's apple.

But the company tugs on other heart strings of its customers, especially their social consciousness. Target's old parent company Dayton's had bylaws going back to 1946 that made sure 5% of pretax profits—$3 million a week today for Target—were invested in the communities whose residents shopped its stores. The company says its 5% figure is five times the national corporate average. Target also trumpets its diversity. Women hold 57% of all professional jobs in the company, 10 percentage points more than the average U.S. general merchandise retailer.

Target's long track record clearly shows how an Act Vertical strategy can enable a retailer to thrive in a segment occupied by the world's most powerful retailer. To be sure, in the second half of 2008, a time of slow sales, its design orientation was put to the test. Target tamped down the design part of its message and played up the price-value. It told analysts it matched prices on products Wal-Mart also sold in the same markets.[27] The company's challenge now is to convince its loyal customers that more fashionable products are of higher value and to raise the store experience to an even higher level.

Trader Joe's: How an Act Vertical Strategy Reinvented a Convenience Store Operator

TRADER JOE'S AT A GLANCE

- **Year Founded:** 1967 (although initially launched in 1958 by Joe Coulombe as a small chain of Southern California convenience stores called Pronto Markets)
- **Headquarters:** Monrovia, Calif.
- **Revenue:** $6.5 billion (2007 estimate)
- **Net Income:** Not available (privately held company)
- **Stores:** 310 in 25 states and the District of Columbia
- **CEO:** Dan Bane
- **Ownership:** Private (Coulombe sold the company in 1979 to a trust set up by German investor Theo Albrecht, an owner of the Aldi grocery chain)

About 40 years after it was introduced in Southern California, the laid-back, quirky format of Trader Joe's Co. stores is now a household name in many parts of the country. The financial performance of the privately held company—sales per square foot are said to be two to three times the grocery industry average—has made it the envy of the sector and attracted recent entries such as Tesco PLC's Fresh & Easy Neighborhood Markets chain. But what is less well-known is Trader Joe's Act Vertical reinvention in the 1960s, one it pursued to avoid going out of business as a convenience store operator. It provides numerous lessons on how to rejuvenate a retailer threatened by much-larger competitors that can easily beat it on price and convenience.

Profiles of Leading Act Vertical Retailers

The story begins in 1966, when Southern California convenience store operator Joe Coulombe realized he needed to dramatically differentiate his chain. Southland Corp. had expanded rapidly into the area with 7-Elevens, and Coulombe decided he couldn't take them head on. "The guy with the most money wins. He gets the best locations. It's very simple," he told his business school alumni magazine in 2006.[28] He decided he had to reinvent his stores to keep them alive.

A year later, in 1967, Coulombe had formulated his concept for a small grocery store targeting a very specific niche: overeducated but underpaid adults (e.g., musicians, writers, teachers and the like). He was influenced by a *Scientific American* article describing the emergence of a new generation of adults who had completed college. He also read about the Boeing 747's pending introduction, which would enable his target customers to travel abroad extensively and gain a bigger appetite for exotic foreign foods. He had seen how his mother-in-law prepared great meals on the modest income of a Stanford botany professor. So he began converting his Pronto Markets into Trader Joe's, with the first one in the Rose Bowl city of Pasadena. The stores' island vacation theme was one influenced by a Caribbean vacation.

By 1979, Coulombe sold Trader Joe's to German supermarket barons Karl and Theo Albrecht, owners of the Aldi chain. But the Monrovia, Calif.–based company has largely followed Coulombe's original formula in brand strategy (targeting highly educated but modest-income Americans), product offering (mostly private-label products that aren't easily found at mainstream grocers) and store experience (upbeat, helpful employees in the atmosphere of a quirky, island grocery store).

Today, Trader Joe's is run by Dan Bane, who joined the firm in 1998 as president of its western operations. At an estimated $6.5 billion in annual revenue, Trader Joe's is much larger than the firm Coulombe left 20 years ago. (The company reveals few financial details.) But according to one published report, between 1990 and 2001 alone, the store count grew fivefold and profits, 10-fold.[29] From 2003 to 2007, sales more than tripled, from $2 billion to $6.5 billion, according to industry estimates.

Coulombe believed the fundamental tenet of marketing was *choosing* one's target customers, not just being knowledgeable about them. Many Trader Joe's stores are located in college towns. In fact, one Trader Joe's store manager once told a reporter that the store's favorite customers were unemployed ex-college professors because they are "well-read, well-traveled, and appreciate a good value," the manager said.[30]

Profiles of Leading Act Vertical Retailers

How does Trader Joe's deliver on its promise of exciting, exotic grocery items and a distinctive shopping experience for the budget-conscious consumer? First, by focusing the majority of its narrow product line on private-label goods—about 70% to 80% of the 2,000 products it carries. Trader Joe's keeps prices low on many items by staying away from high-cost real estate (operating small stores in lower-cost, older strip centers), having a lean headquarters staff (there are no secretaries) and dealing directly with many suppliers. Stores are one-quarter the size of mainstream grocery stores.

Trader Joe's transfers the innovation it brings to food products to the shopping experience. Shopping in a Trader Joe's is akin to visiting a locally owned grocery store in a tropical location. Founder Coulombe wanted customers to feel like they were on vacation. Store employees wear Hawaiian shirts and refer to each other in nautical terms (store managers are "captains" and assistant managers are "first mates"). They are knowledgeable about Trader Joe's products and regaled for their courteousness. But the stores are also tailored somewhat to their locales. For example, many feature murals of local scenes.

The company carries the beach vacation theme to its marketing programs. It largely shuns advertising (other than local radio spots), opting for a direct-mail newsletter, its offbeat and humorous *Fearless Flyer.* The publication is replete with details on Trader Joe's unique products, often describing how they are produced as well as their appetizing attributes. For example, a recent issue waxed on about Trader Joe's Organic Sugar and how it was produced. ("Grown on sustainable sugar plantations, the sugar cane is cut by hand, then delivered to the mill where the juice is simply crushed from the cane. The evaporation process produces perfect sugar crystals, golden in color and rich in natural molasses flavor.")

In this way, Trader Joe's marketing showcases the unique attributes of its products. It doesn't have to rely alone on its product labels and store employees to sell the difference.

Profiles of Leading Act Vertical Retailers

Coach: The 20-Year Transformation of a Leather Goods Manufacturer into a Thriving Act Vertical Retailer

COACH AT A GLANCE

- > **Year Founded:** 1941
- > **Headquarters:** New York, N.Y.
- > **Revenue:** $3.2 billion (FY ended June 28, 2008)
- > **Net Income:** $783 million (FY 2008)
- > **Stores:** 579 in North America and Japan
- > **Chairman and CEO:** Lew Frankfort
- > **President and Executive Creative Director:** Reed Krakoff
- > **President and COO:** Jerry Stritzke
- > **President, North American Retail:** Mike Tucci
- > **Ownership:** Public (NYSE: COH)

Coach Inc. started life in 1941 in a Manhattan loft as a family-run maker of wallets and other small leather goods. The company soon expanded into women's handbags, luggage and other items, but it would be 40 years before it opened its first store. But in the last 10 years, the changes at Coach have been anything but gradual. The company has shifted from being a $0.5 billion manufacturer to a $3 billion Act Vertical retailing powerhouse, one whose gross margins exceed 70% and whose brand extends far beyond its iconic handbags.

Coach has the largest share of the premium handbag and accessories market in the U.S—22%, about twice that of LVMH's Louis Vuitton.[31] (Handbags account for 62% of Coach's sales and accessories 29%.) Coach has soared on the back of product innovation and extensive research that anticipates consumer needs and reactions to offerings and experience. It has been rounding out its accessories and other lifestyle products with alliances with manufacturers such as Jimlar (shoes), Marchon (eyewear), Movado (watches), and Estee Lauder (fragrance).

Since 1998, when it departed from its strategy of offering classic and conservative handbags and other leather goods, growth has exploded, with annual revenue increasing sixfold (from $522 million to $3.2 billion) and profits rising nearly 40-fold (from $21 million to $783 million). Today, Coach derives 80% of its revenue from its own sales channels: the Coach stores and factory stores (about 400 in North America and around 150 in Japan), and its website and catalogs. Sales through other retailers account for the other 20%.

Profiles of Leading Act Vertical Retailers

The transformation of Coach has had a number of twists and turns. Coach CEO Lew Frankfort, a one-time manager in New York Mayor Ed Koch's administration, has been with the company since 1979, when he was brought in by then-owners Miles and Lillian Cahn to head business development. Frankfort opened the company's first store in 1981, at Madison Avenue and 57th Street. By 1985, Coach had six company-owned stores that largely sold handbags, and revenue had reached $19 million. Then Frankfort arranged the sale of the company that year to consumer product maker Sara Lee Corp., and the Cahns retired to upstate New York.

Coach grew steadily under Sara Lee but hit a bump by the mid-1990s. In 1996, when Frankfort became CEO, trendier offerings from Gucci, Prada and Kate Spade were making Coach's offerings look stale. Revenue, which hit $540 million in 1995, began falling. Coach needed a design makeover. Frankfort told one magazine that "[Prada and Gucci] were changing women's relationships to their handbags. I realized that Coach had to be radically transformed to respond."[32]

The transformation began with a new design chief. Frankfort hired Reed Krakoff, who had helped propel Tommy Hilfiger Corp. His mandate was to create compelling handbags at much lower prices (around $300) than the ones at the high end, which can sell for more than $1,000. Krakoff injected more style into Coach's bags, using fabrics as well as leather, and remade the look of the company's stores and advertising campaigns.

Coach's design and product development overhaul has made its financial rebound truly stunning. Since Sara Lee spun off the company in 2000, yearly sales have soared from $549 million to $3.2 billion. Annual profits have shot up even more, from $38 million to $783 million.

What's behind Coach's success? It's an Act Vertical story that starts with a clear brand strategy. Coach sees its market as people who want distinctive, easily recognizable and "accessible luxury" products that are of high quality and great value. "Accessible" is a key term here: The company recognized the need of middle- and upper-class women who wanted affordable but luxurious handbags.

Coach is also a big proponent of meticulous and extensive customer research. It holds about 70,000 extensive customer interviews annually, getting feedback on everything from the features of a potential new line to the shopping experience (including how they are greeted at the door).[33] The company brings customers into simulated retail environments (including stores that are temporarily closed). As the firm described it in one SEC document, Coach's consumer research capabilities help the firm "assess consumer attitudes and trends and gauge the likelihood of a product's success in the marketplace prior to its introduction."[34] Or as Frankfort told one reporter: "We leave nothing to chance. By the time we release a product, we usually have a good idea how well it will do."[35] Such research cost the company nearly $5 million last year.

This customer data helps the company balance creativity with commercial appeal, a Coach capability that Frankfort often refers to as combining "logic and magic." Speeding up product development has helped the company bring more magic to market—monthly, in fact, rather than quarterly. Coach's research found that customers would visit stores more often if they displayed a greater number of new products. That led Krakoff's group to accelerate the cadence of new offerings to monthly. Customers now visit the stores monthly rather than every four months on average.[36]

Coach's marketing helps entice them to the stores. The company spent 1.8% of sales ($57 million) last year on marketing: direct marketing (website and catalogs), as well as national, regional and local advertising. Direct marketing has taken on greater importance at Coach. It views its website and catalogs as key marketing channels for driving store traffic and increasing brand awareness. Over the last year, the company revamped its website to allow online purchases of orders that could be picked up at its stores. It also increased email marketing, sending out 67 million emails to select customers in FY 2008, while mailing 2 million catalogs to select North American households.[37]

Designing and executing an engaging and consistent brand experience across all channels is within Krakoff's purview, and he has been given the responsibilities to make it happen. He runs product design and development, store design, visual merchandising, advertising and all marketing communications. (He had been chief marketing officer of Tommy Hilfiger before joining Coach.) More recently, Krakoff became the photographer for Coach's global advertising and direct mail campaigns. (He went back to his school, Parsons, to study photography in 2005.)

By having control of everything the customer sees, Krakoff has helped Coach create a consistently engaging experience, one that has helped vault the company to the top of the U.S. handbag market.

Study Background

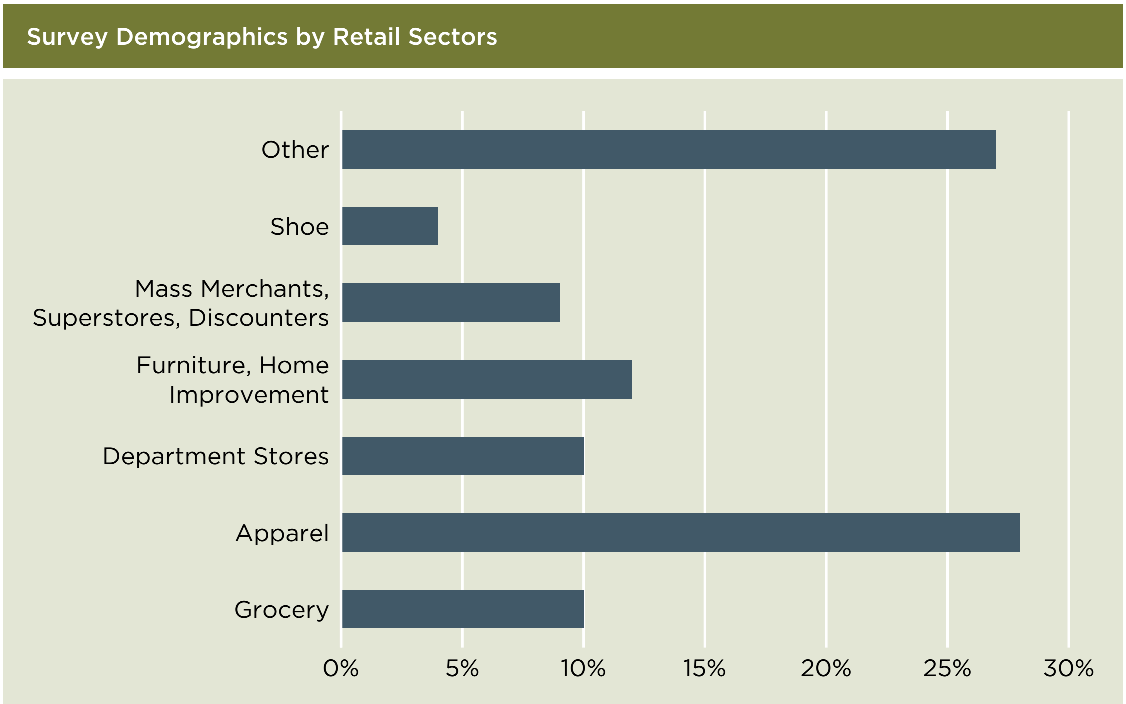
In March 2008, KSA launched research that used quantitative and qualitative methods to deeply explore vertical retailing and the characteristics of retailers that were most successful in designing and bringing their own products to market. On the quantitative side, we conducted an extensive 28-question survey with 101 retailers (all of which were more than $500 million in annual revenue). On the qualitative side, we conducted in-depth case studies on 10 retailers, eight of which came through on-site and phone interviews with a range of executives at each retailer. The other two case studies came from extensive literature searches and discussions with KSA subject-matter experts.

Survey Demographics

The survey part of our research was conducted from July through October 2008. We mailed and emailed invitations to participate in the survey to about 1,400 retailing executives in North America across retail segments. Some 101 retailers (all but one from different chains) responded, coming from a wide variety of sectors: grocery, mass merchandising, department stores, apparel, home improvement and others. About a third were apparel retailers (including shoe store chains), and another 20% were mass merchandisers, superstores, grocery and off-price retailers. (See Exhibit 8-1.)

Study Background

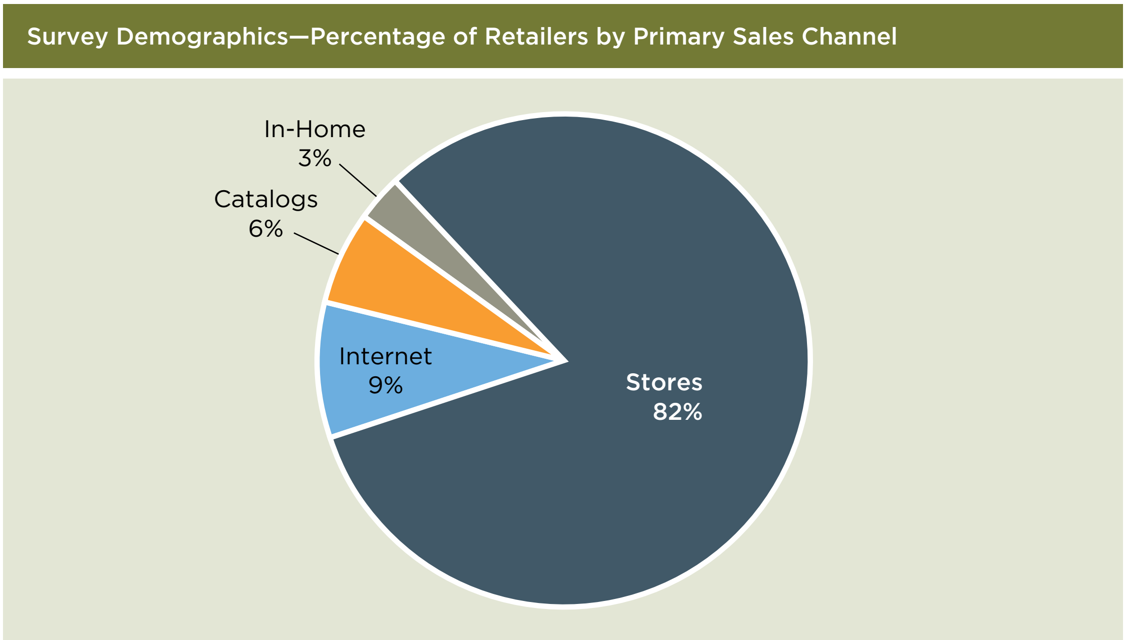
EXHIBIT 8-1: SURVEY INCLUDES A CROSS-SECTION OF THE RETAIL INDUSTRY



Study Background

The vast majority (82%) generated most of their revenue from stores. For 9% of the respondents, the Internet was their primary revenue channel, and for 6% catalogs were the primary channel. (See Exhibit 8-2.)

EXHIBIT 8-2: MOST RESPONDENTS GENERATE MAJORITY OF THEIR REVENUE FROM STORES

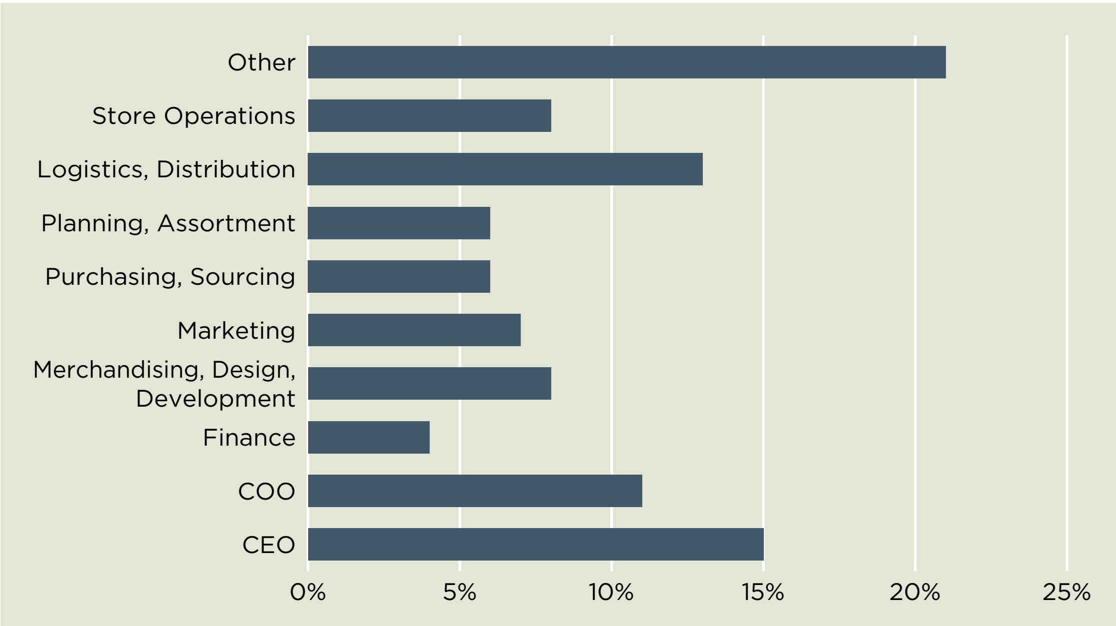


Study Background

We surveyed executives at the highest levels of these retailers. More than one-quarter (26%) were chief executives or chief operating officers. The other respondents provided a broad mix of executives in merchandising and product design and development, marketing, planning and assortment, store operations, sourcing and procurement, finance and logistics. (See Exhibit 8-3.)

EXHIBIT 8-3: MORE THAN ONE-QUARTER OF RESPONDENTS WERE CHIEF OFFICERS

Survey Demographics—Respondents by Role in Organization



Through an extensive questionnaire, we surveyed these executives about:

- The most important factors over the last 10 years in driving some retailers to sell products that were unique to their chains (private-label and exclusive distribution of national brands)
- The factors over the last 10 years that were most important in driving some retailers to improve the customer experience
- The amount of revenue they generated from their own products or from exclusive distribution of others' brands—both today and five years from now in (2013)

Study Background

- The type of customer experience they provided in terms of how much information they provided shoppers in their stores, catalogs, websites or other channels—today and by 2013
- The degree to which they engaged with customers outside their sales channels
- Their levels of collaboration internally and externally (with suppliers, distributors and customers)
- Key financial and operating performance measures, and how much they have increased or decreased over the last 10 years (1998 to 2007)
- The effectiveness of a number of strategies (54 in all) for improving performance: product-related, experience, launch of new retail brands, store-related, technology, operations improvement and performance metrics

Case Study Research

On the qualitative side, we conducted case studies on 10 retailers including Aéropostale, PetSmart, Talbots, and four apparel chains that requested anonymity. These interviews were conducted from June through September 2008. In seven companies, we interviewed multiple executives by phone or in person, including CEOs and presidents; heads of merchandising, design and product development; heads of marketing; heads of supply chain; and IT heads. We also conducted extensive secondary research to better understand the vertical models of Coach, Target, Trader Joe's, Walgreens, REI and several other retailers.

In our case studies, we sought to understand a number of issues. They fell into four categories:

- Why did these companies decide to create their own offerings, and how did they decide which offerings to make their own?
- How successful were those offerings in revenue and profitability, and in generating other revenue for the chain?
- What kind of customer experiences did these retailers create in their stores, websites, catalogs and any other sales channels? Like their product offerings, were these experiences unique as well, and if so, how?
- What were the key elements to creating successful offerings and experiences?

We also conducted two other streams of research: extensive interviews with subject-matter experts from KSA, as well as secondary research on various aspects of vertical retailing that have been studied by other organizations.

Appendix

In this section, we provide additional details on the survey results.

Ratings of Improvement Approaches

In Chapter 2, we discussed the most highly rated improvement techniques from a list of 54, ones that we said were in the first tier of effectiveness. In the following, we provide the techniques that finished in the second and third tier of effectiveness. The second tier comprised 28 improvement approaches that received average ratings of between 3.0 and 3.5. (See Exhibit 9-1.)

Appendix

EXHIBIT 9-1: RETAILERS EMPLOY A VARIETY OF TACTICS TO IMPROVE FINANCIAL PERFORMANCE

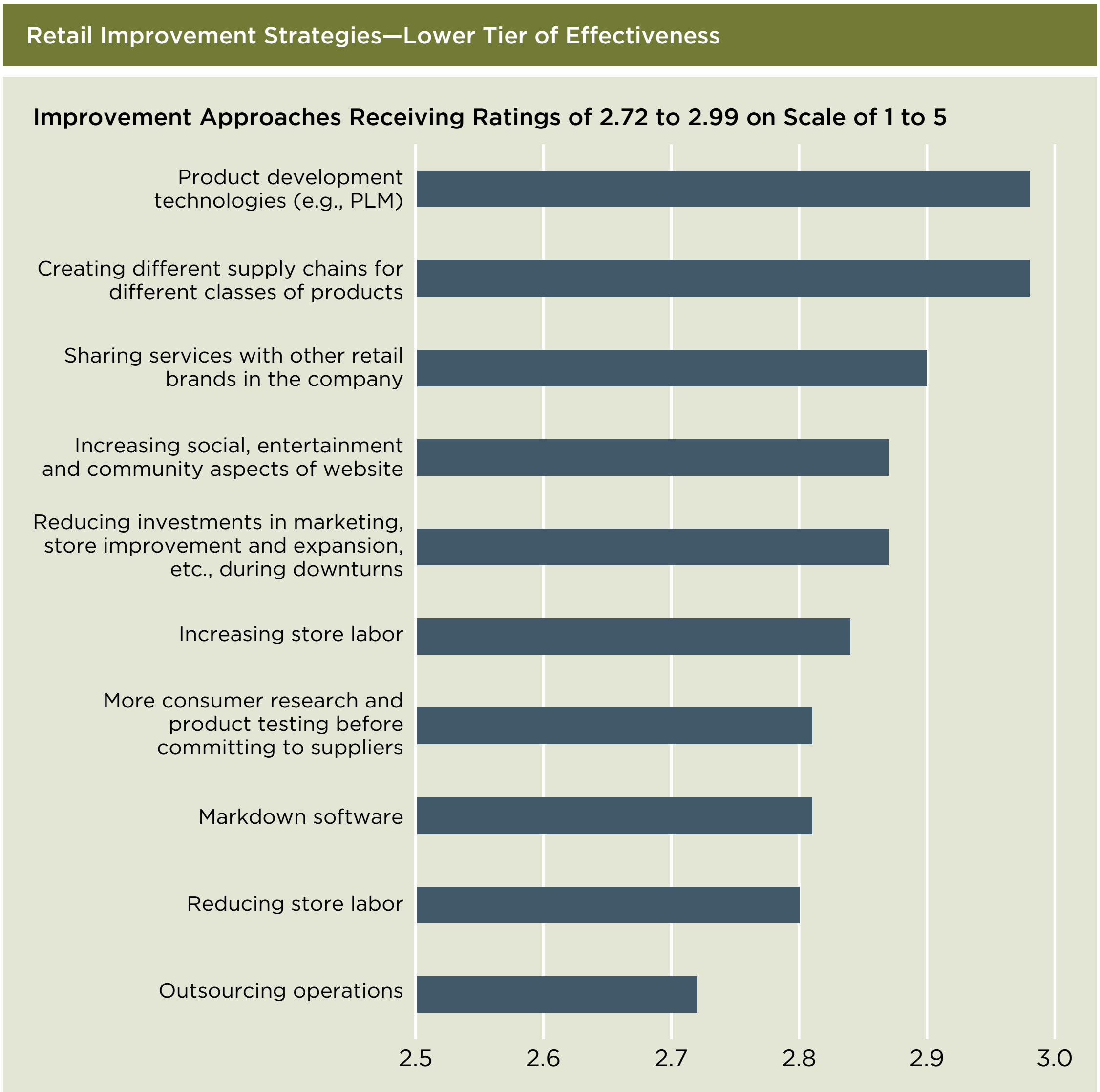
Retail Improvement Strategies—Middle Tier of Effectiveness

Improvement Approaches Receiving Ratings of 3.0 to 3.49 on Scale of 1 to 5

Appendix

Representing the bottom tier of effectiveness, 10 improvement initiatives received less than moderate effectiveness ratings by our survey respondents. (See Exhibit 9-2.)

EXHIBIT 9-2: RETAILERS FIND SOME TACTICS LESS EFFECTIVE AT IMPROVING PERFORMANCE



Appendix

Comparing the Financial and Operating Performance of Survey Leaders and Laggards

On a wide range of financial and operating measures, the 15% of our retailing sample that said they were highly or very highly effective at introducing unique products that consumers embraced and purchased *and* at providing high-touch store experiences significantly outperformed the 11% of the respondents that reported no or low effectiveness on providing unique or compelling products and high-touch store experiences. These metrics included annual revenue, operating margin, gross margin, same-store stores and inventory turns.

We calculated retailers' 10-year improvement (or decline) on these measures using an 11-point scale. Each point on the scale corresponded to a percentage range of increase or decrease (e.g., 0%-20% increase, 21%-40% increase, etc.). We used a range rather than ask survey respondents for their exact percentage increase or decrease on each measure, figuring they would be far less likely to give us such information, some of which they do not release publicly. We then averaged the responses on each measure, coming up with a score between 1 and 11. (Note: A lower score means a greater percentage increase and therefore better performance.)

Footnotes

1. According to the research firm Property & Portfolio Research Inc., as cited in *The Wall Street Journal*, Sept. 10, 2008, "Mall Glut to Clog Market for Years," by Kris Hudson and Ann Zimmerman.

2. Ibid: Property & Portfolio Research Inc. data.

3. *Women's Wear Daily* 2007 Report.

4. U.S. Bureau of Labor Statistics' Time Use Study, 2007.

5. National Retail Federation's Shop.org survey. Press release "Retailers Counting on Cyber Monday as Bright Spot of Challenging Holiday Season," Nov. 24, 2008. See www.shop.org.

6. Jupiter Research press release, "JupiterResearch Forecasts That Off-line Retail Sales Influenced by Online Research Will Reach One Trillion Dollars by 2011, Jan. 16, 2007.

7. "The 'Private-Brand Police," *CSP Daily News*, March 19, 2008.

8. NACS, the Association of Convenience and Petroleum Retailing, online magazine, March 18, 2008.

9. C. Tice, "Outfitter's travel unit goes to ends of earth to boost loyalty," *Puget Sound Business Journal*, July 9, 2004.

10. *Fortune* magazine article 2007 reference.

11. A. Sung, "Power 50 Profile Ranking," *Supermarket News*, July 17, 2008.

12. Coach's website details Reed Krakoff's contributions, and the critical role that design and innovation has played in the firm's ascent. For more details, go to http://www.coach.com/about/HistoryCreativeDirector.aspx.

13. Trader Joe's website and *Private Label Magazine*, November 2005 article on Trader Joe's.

14. "Fashion Conquistador," *Business Week*, Sept. 4, 2006.

15. "Apple Has a List of 100 Potential Store Sites," IFO Applestore, April 2004.

16. From an April 2004 article on the website IFO AppleStore (www.ifoapplestore.com/stores/risd_johnson.html).

17. Website IFO AppleStores. www.ifoapplestores.com.

18. According to a Sanford C. Bernstein report, quoted in *Fortune* magazine, March 8, 2007, J. Useem, "Apple: America's Best Retailer."

19. From the website ifoapplestore.com, April 2004. www.ifoapplestore.com/stores/risd_johnson.html.

20. Ibid.

Footnotes

21. J. Useem, *Fortune*, “Apple: America’s best retailer,” March 8, 2007.

22. Apple 10-K, FY 2008.

23. K. Hafner, “They’re Off to See the Wizards,” *The New York Times*, Jan. 27, 2005.

24. This number according to a Gerson Lehrman Group presentation, “Increasing Utilization and Strength of Private Label Brands,” July 31, 2007. The company said Target’s private-label sales were $19 billion out of $59.5 billion in 2006. It said Wal-Mart’s was 40% of 2006 sales.

25. J. Reingold, “Target’s inner circle,” *Fortune*, March 18, 2008.

26. Francis’ responsibilities were detailed in a Target press release issued Aug. 27, 2008, announcing his promotion to chief marketing officer.

27. So said Target’s executive vice president of merchandising, Kathee Tesija, at the company’s investors conference call on Aug. 19, 2008. From Thomas StreetEvents’ final transcript of the call, page 4.

28. K. Hoover, “He Brought Trader Joe’s to Main Street,” *Stanford Business*, February 2006. http://www.gsb.stanford.edu/news/bmag/sbsm0602/people.shtml. Trader Joe’s founder Joe Coulombe earned an MBA from Stanford in 1954.

29. “Trader Joe’s: The Trendy American Cousin,” *Business Week*, European edition, April 26, 2004.

30. “Trader Joe’s targets ‘educated’ buyer,” Associated Press, Aug. 30, 2003.

31. N. Haas, “Coach on the Edge,” *Condé Nast Portfolio*, April 2008.

32. Ibid.

33. Ibid.

34. From Coach’s 2007 10-K report.

35. N. Haas, “Coach on the Edge,” *Condé Nast Portfolio*, April 2008.

36. Ibid.

37. This is from Coach Inc.’s 10-K filing with the Securities and Exchange Commission, for the fiscal year ending June 28, 2008, p. 4.

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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