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SHOP TILL YOU DROP

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You don't need a crystal ball to predict that 2011 dealflow in the retail and consumer goods industries will look a lot like that of 2010. The combination of announced deals, such as Gymboree Corp. and J.Crew Group Inc., and rumored deals in everything from children and teen apparel to discounters to even nutritional retailers is courtesy, in large part, to the return of consumer confidence.

But it is not back to business as usual for investors. A more careful examination of consumer-related industries reveals a fundamental shift in how and where consumers are spending their hard-earned dollars. The bottom line for investors? The diligence process going forward won't be complete without more scrutiny of these underlying drivers, the new demands they place on retailers and the markers that a merchant is capable of meeting those demands.

In our work we've been able to identify those markers. In 2007 we began a process of trying to understand why certain retailers were being so successful versus their competition. Our research led us to realize that there is a set of fundamental principles critical for the success of all retailers as they enter an era of true consumer power. This consumer power is fueled by the rapid increase in the supply of products and goods as well as selling capacity (retail square footage, websites, etc.), combined with the acceleration and adoption of new technologies that further enable the consumer to have quicker, easier and smarter access to buying what they want whenever they want. The result is a changed retail landscape in which having a great product, developing a so-called brand and having a great price are no longer differentiators, but just the price of entry.

So what are the principles we think are so important? There are three we see as being critical. The first is the capacity to create an addictive consumer experience that is rooted in the entire business model of the retailer. Here one should think of the ability of retailers to drive consumers to their store or website on a regular basis by generating enthusiasm for the brand above and beyond the product itself. Examples abound of brands that do this well, including Lululemon Athletica Inc., Zara, H&M Hennes & Mauritz AB, Trader Joe's, Gilt Groupe Inc. and Costco Wholesale Corp.

The second critical principle is the ability to pre-emptively distribute one's products ahead of the competition. In other words, retailers need to utilize all distribution platforms in a manner that is seamless and engaging for that particular distribution platform -- whether it is a website, a mobile application, a catalog, a pop-up store or a traditional brick-and-mortar store. Obviously, with the nexus of highest growth having shifted overseas, there is also an increased urgency for global distribution.

However, it is in the third principle that we see the impact on where the dollars are being invested and the diligence issues are being pursued. Our studies indicate that the other principles cannot be effectively executed without a superb operating model that underlies them. Over and over again we saw those companies that were thriving were building a business model that gave them increasing control over their entire value chain (from product design through sales and even consumption).

The leaders who were able to achieve this excelled in three areas. First, they were better at collaborating: with their customers, their vendors and cross-functionally. Second, they were better at decision-making. The companies that were thriving in the sector consistently shrank their organizational blockages and improved their product development cycle times, their processing of customer feedback, and their ability to open new distribution points (that is, pop-up stores, new formats, etc.) and to respond to external shocks (that is, commodities inflation) as quickly as possible. Finally, they had developed supply chains that rapidly and cost effectively moved products from multiple sourcing points into their distribution centers and stores. The initiatives in which they lead include cross-docking, hybrid distribution models and building in excess capacity to enable rapid-fire fulfillment.

The data supports the necessity of having a great operating model built around the criteria outlined here. In 2007 we randomly picked retailers from a variety of different segments: apparel, auto parts, consumer electronics, department stores, food retailers, sporting goods, etc. We then had a large number of executives and consultants familiar with these companies provide a ranking for each company on each of the three operating metrics. We then tallied the simple average of all of these scores and divided the companies into quartiles.

The results were startling. From 2002 to 2010 the top quartile accounted for 73% of all of the increase in market capitalization created. The bottom two quartiles created no economic value, and in the bottom quartile 25% of the sample had ceased to exist as independent operating entities. These results were independent of sector growth, consumer trends through the recession and competitive pressures. In other words, how well run a company is across the three metrics and how much it was able to use those strengths to gain or extend its control over the value chain were the key enablers in its ability to connect with the consumer, achieve pre-emptive distribution and ultimately provide economic returns to its stakeholders.

Our analysis has a number of implications as to where capital should be deployed and the diligence challenges facing investors. Obviously, a well-run specialty retailer with a strong consumer franchise should be able to attract top dollar. The trick is in making sure that the company has strong operating capabilities. For example, understanding how effective the product development and sourcing capabilities are relative to the competitive set will determine the confidence that investors can have that the retailer will be able to win through multiple fashion cycles, leadership changes, product missteps or inflationary pressure in core supplying countries. If the competitive set is the European or Asian "fast fashion" companies, there is an even greater need to understand where the target lies relative to them.

The next implication is that the more valuable wholesale brands are those with a credible company-owned distribution strategy that includes the ability to either develop company-owned stores or control the point of sale with its channel partners. The reality of the next phase of retail is that many wholesale brands will struggle to get shelf space against the increasing array of private and exclusive brands retailers that are now developing. This is equally true if you are selling health and nutrition products through GNC, apparel through Macy's or vitamins through CVS. The diligence issues here are many, but once again understanding how the operating strategy provides a distinct competitive advantage versus the growing and proliferating spread of retailer-owned private labels is critical.

The final issue is the question of managing growth. The reason so much market value has accrued to those with a strong operating model is that they are able to respond more quickly and effectively to new growth opportunities. It is clear that successful growth now requires the ability to manage multiple brands (with distinct customer benefits from the core on price, product or distribution). The saying "ubiquity is antiquity" has never been more true for most retail and consumer brands (an issue Gap Inc. and Starbucks Corp. are both wrestling with), and so the ability to manage increased complexity has never been greater. So how effective management development is, how the merchant groups are structured and how well the supply chain allows for both unique product flows and efficiency through shared costs are all critical. Without these capabilities, is it fair to believe that J.Crew can execute Crewcuts superbly, grow Madewell and penetrate international markets? Or, for that matter, that Gymboree can execute the expansion of its new value format Crazy 8, manage inflationary pressure and grow its online core business?

Our rules on retail dealmaking require that the diligence effort spent on the consumer, the brand and competitors is probably exceeded by the effort spent on making sure the operating model is designed and working well to enable success in an increasing complex and uncertain world.

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