

Weathering the Perfect Storm

How Retailers Can Navigate a Volatile Economy

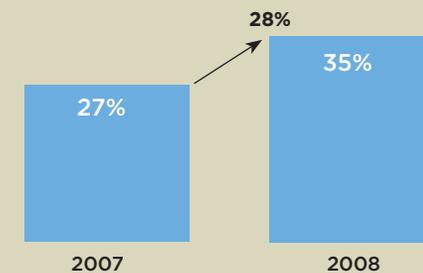
By Michael Dart, Principal and Strategy and Private Equity Practices Leader

While many retailers were braced for a slow-down in consumer spending, no one could have anticipated the unprecedented events of recent months: multiple bank failures, severe credit contraction, and astounding market volatility. All of this amid the housing bust, rising unemployment, and high food and energy costs has created a structural shift in consumer spending habits. Credit-based consumption is out while personal savings, debt reduction and value shopping are in. In short, consumers are spending less while changing where and how they buy goods and services.

Consider this: In its recently completed 2008 Retailer Brand Survey, Kurt Salmon Associates found that those who shopped for apparel only at value retailers increased 28% between 2007 and 2008, while those who shopped only at the more exclusive specialty and department store retailers declined 13%.¹

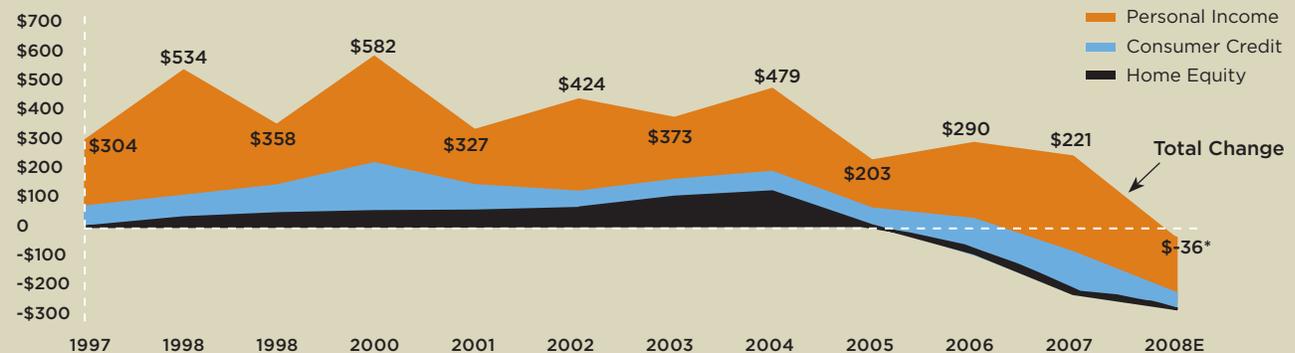
Consumers are trading down, and it is no wonder given the decline in availability of dollars for spending. From 1997 to 2007, the year-to-year increase in total consumer dollars available for spending from personal income, consumer credit and home equity averaged \$372 billion. In 2008, the change in total consumer dollars will turn negative, dropping to a period low of -\$36 billion. KSA estimates that this, along with recent inflationary pressure on non-discretionary items, will cause discretionary spending to fall between 3% and 6% in the next year.

PERCENTAGE OF RESPONDENTS WHO SHOP FOR APPAREL AT VALUE RETAILERS EXCLUSIVELY



¹ "Value retailers" defined as mass, discount, club, off-price, lower-end department stores or lowest banner of multi-tier specialty retailers (e.g., Old Navy, Ann Taylor Loft). Source: KSA's 2008 Retailer Brand Survey, n = 12,939

YEAR-OVER-YEAR CHANGE IN MONEY AVAILABLE FOR SPENDING (\$ Billions, Real 2007 Dollars)



*Includes tax rebate income of \$100 billion

How “best-in-class” retailers are responding to this environment

In this reduced-spending environment, retailers must find ways to become more competitive and adjust their organization to the new state of business. Based on KSA's work with leading retailers, the companies that will emerge successfully from this tumultuous period are those that adopt these five mandates:

- 1 Create a value orientation
- 2 Maintain brand integrity
- 3 Attack weak competitors locally
- 4 Manage costs aggressively
- 5 Manage liquidity

Create a value orientation

Although consumers are holding back on discretionary spending, quality items and strong name brands will still be attractive. The key is to drive real, or perceived, value offerings without destroying the stores' profit potential or brand positioning.

- > **Avoid enticing consumers to trade down.** Resist offering the same, or nearly the same, products at discount or lower price points (e.g., 30% off \$250 leather tote or \$150 canvas tote with leather trims). Doing so either erodes profitability and cheapens the brand proposition or encourages customers to trade down.
- > **Expand product range and price points.** Develop and implement a “barbell offer” strategy. Maintain pricing and assortment of flagship products, but add additional categories of items that are differentiated, yet relevant, and still represent a good value consistent with the brand (e.g., \$700 handbags on the one end and \$28 leather key fobs on the other). Alternatively, bundle products to create real, or perceived, value pricing (e.g., sample size sets, entry-level gift baskets).
- > **Maximize multi-channel outlets.** Use different channels to create different pricing strategies. Minimize discounts and promotions at full-price stores, but push them heavily through outlet stores, online stores or catalogs. The goal is to reach different customer segments through the different channels (e.g., best customers through full-price stores and value customers through outlets or online), and rotate items quicker without having to discount at the full-price stores (e.g., move stale products to outlets faster, instead of keeping and discounting them in stores).

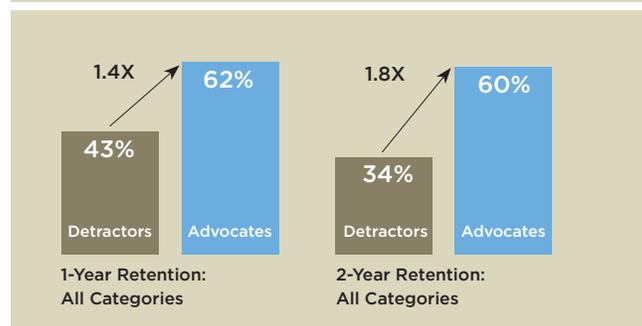
Maintain brand integrity

In this environment, it is easy to employ tactics inconsistent with the brand – such as competing on discounts or promotions, instead of creating a differentiated value proposition. These strategies undermine the retailer's brand equity and hurt the retailer in the long run. KSA's 2008 Retailer Brand Survey showed that retailers that compete on attributes consistent with their value proposition fare better in consumer advocacy than those that

compete on price or value attributes. Consumer advocates contribute to stores in two meaningful ways. First, a category shopper is more likely to return to a retailer for which she is already a proponent. Second, proponents help drive new traffic into the store through strong personal recommendations. KSA's 2008 Retailer Brand Survey showed that advocates are 1.4 times more likely to shop at the advocated retailer one year later and 1.8 times more likely than detractors to shop at the same retailer two years later.

² Net advocacy is a calculated measure based on proponents (those who would highly recommend a retailer) netted against detractors (those who actively do not recommend a retailer) and provides a better understanding of what drives same-store traffic and sales. Advocacy can be linked to top-line results and is especially insightful on performance vis a vis competitors. Change in advocacy is a key component of KSA's annual Retailer Brand Survey.

1-YEAR and 2-YEAR RETENTION (Number of Consumers Shopping the Same Retailer)



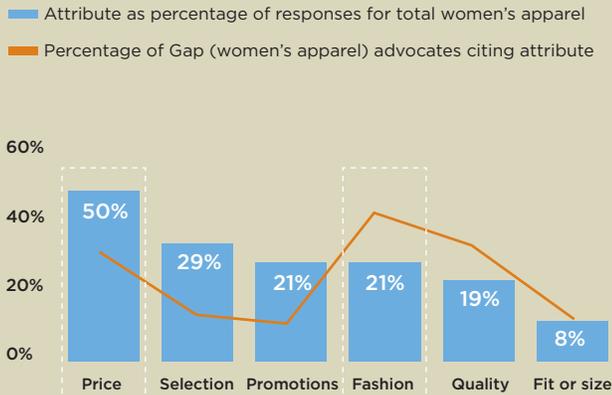
The retailers that truly outperformed were often below average on price attributes and above average on the key non-price attributes that support their proposition or brand relevance. Two illustrative performers are Gap in women's apparel and Cabela's in outdoor apparel (see chart on next page).

Brand relevance is critical to long-term success and is much more difficult to build than to destroy. The key to achieving brand relevance is the retailer's ability to deliver what its target market craves.

- > **Intelligent assortments.** Retailers must understand customers well enough to offer “just the right products for you” and not overwhelm with superfluous options. Customers trust that the retailer has done its homework on quality and selection. Eliminating unproductive SKUs is an obvious step toward this goal.
- > **Experiential environment.** Retailers should make the in-store experience more than a purchase transaction. Engage the senses with the environment (e.g., music, lighting and perfumed air at Abercrombie & Fitch), interactions or product showcases. Take advantage of “end caps,” promotional displays and regular resets to build excitement. Consumers should anticipate changes and a new store experience every time.

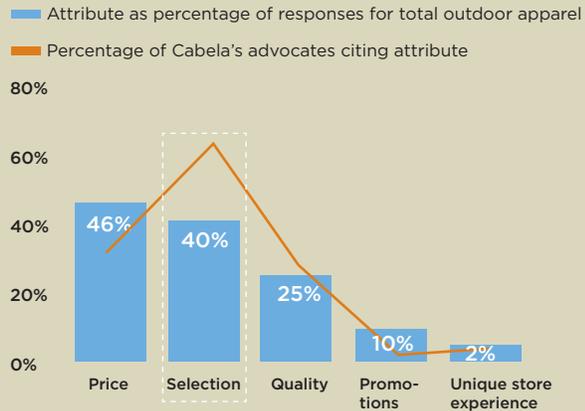
DRIVERS OF ADVOCACY

Gap (women's apparel)



Note: Percentages are based on advocates' responses

Cabela's



> **Brand affirmation:** Ideally, the brand is promoted by customers' peers and social groups. Word-of-mouth is even more critical now, given the fragmentation of mass media and proliferation of new brands. Implement "friends and family" specials and "refer-a-friend" programs.

Finally, even in bad times, shopping makes people feel good. It is the experience, not the goods, that delivers this phenomenon. Neuroscientists have shown that variety and anticipation of new things release dopamine, the hormone associated with feelings of pleasure and satisfaction. The goal then, when not competing on price or value, is to create excitement around the merchandise, store environment, or brand, giving people reason to come back again and again.

Attack weak competitors locally

In this evolving stage of the recession, performance gaps are already showing. Certain retailers are delivering superior same-store sales growth, despite flat or negative category growth (e.g., Aeropostale and GameStop). This presents an opportunity for retailers to take advantage of less sophisticated competitors at the local or regional level.

> **Retail performance analytics.** Trade area by trade area, it is critical for retailers to understand their competitive position in order to employ a localized strategy (e.g., proximity to competitors, local category drivers, impact of traffic pattern and demographics). Share-gain can be achieved by using these insights to develop localized pricing, merchandising, and promotional programs, and to focus on the stores best positioned to beat waning competitors.

> **Local talent.** Quite simply, hire the best local people from weakened competitors. Retailers with a strong balance sheet should have an easy time picking off high performers at this time.

In addition to creating a value orientation, maintaining brand integrity and attacking weak competitors – all of which will contribute to the long-term prospect of the business – there are also a number of execution tactics to keep top of mind and practice through this volatile period.

Manage costs aggressively

The pursuit of expense reduction or efficiency improvement is expected among the best retailers. When the top-line is pressured by macroeconomic factors, cost management should be even more zealously addressed in these two areas.

> **Volume-driven cost reductions.** Manage labor costs without weakening customer service by implementing a robust labor management system. In addition, schedule labor hours according to in-store traffic volume instead of potential cost reductions.

> **Process efficiency.** Relentlessly identify every activity executed by the in-store workforce and measure its value against the selling effort. If it contributes to the selling effort (e.g., merchandise setup), then improve overall efficiency by adopting the best demonstrated practice system wide. If it does not (e.g., price-tagging items), then eliminate the activity at the store level and move upstream to factories or headquarters.

Also, growth in the last five years has bloated various functional departments and processes. Marketing processes, for example, may involve significant approval

delays and inefficiencies in coordination and production. By reducing the time-to-market for collateral such as marketing circulars' (e.g., from six weeks to two weeks), retailers can take costs out of the process and become more responsive to competitive activities and other market opportunities.

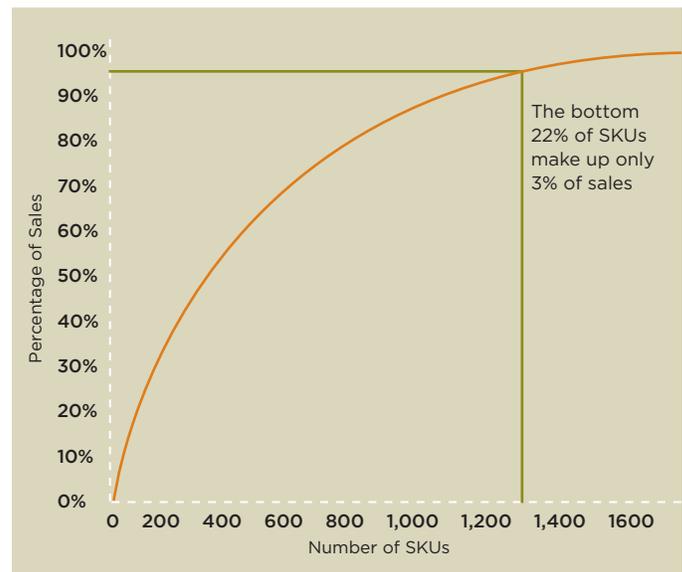
- > **Overhead cost reduction.** Expand span of control and implement a "hiring frost" across all management levels.

Manage liquidity

In uncertain times, new or different ideas that would not have been previously considered may turn out to be rich opportunities.

- > **Consider vendor-managed or consignment inventory.** Work with the right vendors to push ownership upstream. Selected vendors own and manage inventory through point-of-sale in exchange for more in-store presence. As a result, retailers benefit from increased liquidity and lower markdown risks.
- > **Renegotiate contracts.** Vendors facing lower demands (e.g., landlords, transportation, sourcing) are more likely at this time to renegotiate fees and costs or offer more flexible terms to help manage cash flow.
- > **Reduce inventory and optimize assortment.** Optimize assortment by identifying the best and worst performing SKUs and getting rid of the bottom performers. These SKUs contribute marginally to sales, but take up more than their fair share of the inventory carrying costs. In the following example of the handbag category for a department store, the bottom 22% of the SKUs contributed to only 3% of sales.

HANDBAG SKU PRODUCTIVITY FOR REGIONAL MULTI-LINE RETAILER



Cutting the bottom SKUs reduces product development resource needs and unproductive inventory investment, among other advantages. In addition, it frees up constrained retail space for more productive items.

- > **Rationalize store fleet.** Develop a clear understanding of store economics, competitive landscape, and geography of core customers to identify stores to close that will lead to increased cash flow. Knowing the drivers of store performance will prevent closing stores that are underperforming due to inconsistent internal execution, instead of location.

Prepare for better times

Consumer spending will eventually improve, though it may be years before it gets to the level fueled by the easy credit of the previous years. Buyers will be more selective, thinking harder about purchases and looking for products and experiences with the highest value to them. But even in volatile times, opportunities emerge to strengthen businesses and prepare for future growth.

No doubt the near term will pose substantial challenges for retailers. In 2008 alone, the expected number of retail store closures will account for \$10 billion in lost sales. In KSA's view, the retailers that will best manage through this period are those that effectively balance the five objectives.

Michael Dart, author of this article, is a principal at Kurt Salmon Associates and heads the Private Equity and Strategy Practices. For more information on this topic, contact him at 415.296.9200 or mdart@kurtsalmon.com.

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