WHEN RETAILER BECOMES PRODUCT DEVELOPER

Lessons from Merchants That Know How to Innovate

By Peter Brown and Amy Klaris

To address the increasingly complex challenges of today's marketplace, retailers are reinvesting in core capabilities, including internal product development functions. In a recent Kurt Salmon Associates' survey of more than 100 large U.S. retailers, we found that 36% of retailers generate more than half their revenue from private-label and exclusive products. By 2013, we estimate that percentage will jump to more than 40%.

In this article, we explore the advantages, risks and best approach to building a world-class product development capability. Highlights include:

- Private-label and exclusive products create meaningful differentiation for consumers.
- Properly executed and managed, an in-house product development function drives sales and reduces costs. In our recent survey, we found that retailers with a strong product development capability had, on average, a 20% greater increase in annual revenue compared to retailers with a limited or no product development function.
- As such, retailers are increasingly building up their in-house product development capability. But creating a robust function isn't easy or without risk.
- The first step is to create a product-line architecture to determine which products should be developed internally.
- Subsequently, retailers must reinvent themselves as brand managers, reorganizing to create the focus needed to successfully build their new brands.

The benefits of a vertical model are inarguable: the ability to differentiate a retailer's offering to drive more sales and reduce costs to boost margins. We found that retailers that excel with vertical strategy realized a 20% greater increase in annual revenue compared to those who struggle with it.

Retailers in every segment—from grocery and consumer electronics to convenience stores—have been ramping up in-house product design and development functions. Their goal: to bring to market compelling new offerings bearing their labels or exclusive national brands with important product distinctions. These products give consumers a special reason to shop with them and not with other chains, especially the discounters that have gained enormous market share over the last 20 years.

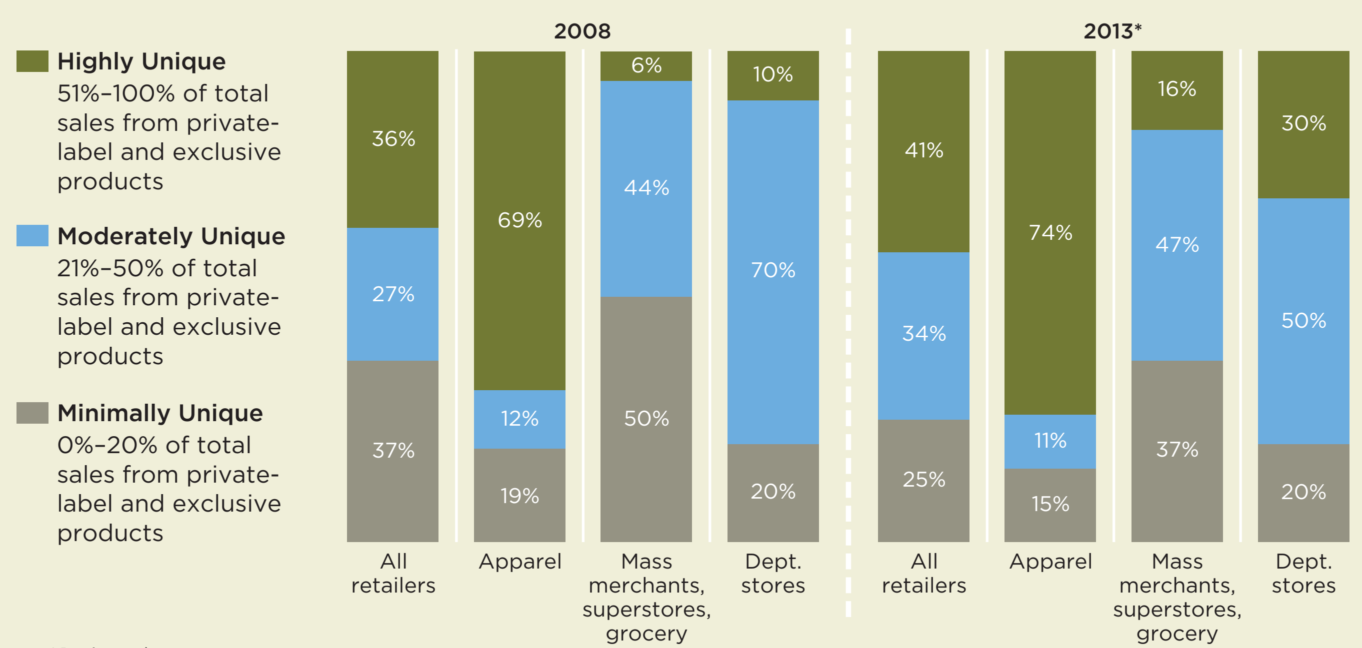
We have surveyed and studied more than 100 large U.S. retailers over the last year, and we found that retailers' ability to successfully develop their own products has become important across sectors. In our survey, more than a third (36%) of retailers generated more than half their revenue from private-label and exclusive products. By 2013, 41% expected to generate more than half their sales from their private stock. (See Exhibit 1.)

From our research and consulting work, we find that the benefits of a vertical model are inarguable: the ability to both differentiate a retailer's offering to drive more sales and reduce costs to boost margins. In our survey, when comparing retailers that excelled with a vertical strategy against those who struggled with it, we found that the former realized a 20% greater increase in annual revenue. Further, the cost savings for a retailer to develop its own products vs. buying branded products from the market can be significant. By doing its own product design, development, branding and sourcing, a retailer can greatly undercut the costs it pays to branded vendors that conduct these activities (and whose prices reflect that). (See Exhibit 2.) As a result, retailers that are successful at private-label offerings can generate highly profitable revenue.

But creating a product development function that churns out a steady stream of compelling new offerings is not easy.

EXHIBIT 1

Percentage of Revenue from Unique Products



*Projected

In our survey, fewer than half the retailers (44%) said they were highly effective over the last five years at getting consumers to embrace and purchase products that were unique to the chain. And struggling at product development creates new risks for retailers. From working with numerous retailers on product innovation over the last 30 years, we have found the risks of poor product development to be substantial for four reasons. First, product development and sourcing costs can become sizable. Second, product liability costs can be even greater. The third type of risk is inventory risk—of overbuying and getting stuck with unsold product that a retailer owns. And the fourth risk is to brand image: Becoming associated with poor factory working conditions can give a retailer a public relations black eye.

But these risks are manageable—if a retailer understands how to organize and operate a world-class product development and sourcing function.

Product Development: Elevating Private-Label Strategy

Becoming excellent at product development begins with a clear idea about the extent to which a retailer needs a differentiated offering, and what customer needs those offerings should fill. We refer to this as creating a product-line architecture—essentially, the decisions on what lines to create in order to provide a distinct offering. We have found it helpful to categorize a retailer's offerings, both products and fee-generating services, as one of four types:

- **Ubiquitous:** Same brands and items sold by other retailers.
- **Imitative:** Lower-cost versions of national product brands, which characterize most non-apparel retailers' private-label brands. These products compete on the basis of price.
- **Enhanced:** Products are better versions of national product brands in that they have certain features not available elsewhere. These products can be developed in-house or be exclusive national brands.
- **Breakthrough:** A retailer's own brands (or exclusives) provide unique and substantial new value in the form of new features, functions, etc. A good example of this is Apple's iPhone.

EXHIBIT 2

The Cost Benefits of Private-Label Offerings

Activity	Branded Vendor Cost (Passed on to Retailer)	Private Brand Savings (% of Product Cost)
Branding	5–10%	2–8%
Design and R&D	3–5%	2%
Develop & Source	4%	2%
Total Potential Savings		6–13%

EXHIBIT 3

The Spectrum of a Retailer's Offerings

Ubiquitous Offering	Imitative Offering	Enhanced Offering	Breakthrough Offering
Same brand and items sold by many retailers	Knockoff strategy	Minor variations of existing products	Unique and compelling products
Ex: National CPG brands	Ex: Most retailers' store brands	Ex: National brand or retail brand	Ex: Retailer's brand; exclusive distribution of national brand

Products that are low on technical content often don't need a strong national brand to attract customers. Those that sell in high volumes can generate big margins for retailers because of lower sourcing costs. This is what most private-brand strategies are about: creating lower-priced versions of national product brands.

Becoming a proficient innovator begins with determining how much of your product and service offering to apportion to each of those categories. This depends on the company's retail brand strategy—i.e., the fundamental decisions on how it will differentiate its offerings and customer experience, the two fundamentals of retailing.

The top management team must answer such questions as "Which products and services would make us distinct in the minds of our target customers—i.e., in what categories do we need 'enhanced' and 'breakthrough' offerings?" and "How many of them do we need (vs. ubiquitous products that we need to carry, but which other retailers carry as well, and imitative products, which compete primarily on the basis of lower price)?" In other words, in which categories should a retailer strive to be distinct and in which should they not? This is especially critical to retailers with broad assortments—merchants such as department stores, mass merchandisers, drug and grocery store chains—that must choose from hundreds or thousands of categories in which to be distinct.

Other aspects of your product-line architecture include determining what consumer segments to target, what needs to fill, the products' broad characteristics, relative positioning vs. other products on the market, opening price points, the margin roll of the product or category (e.g., loss leaders) and inventory roll (e.g., "once and done," replenishment or seasonal).

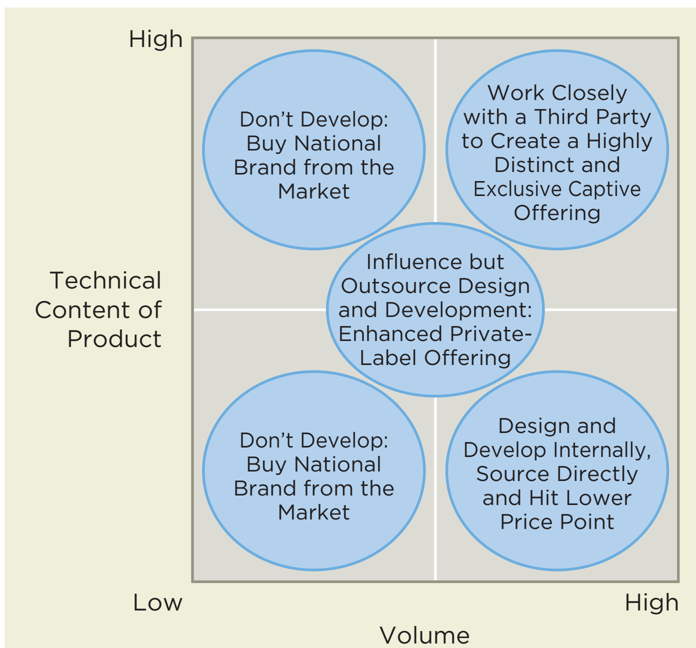
To be sure, certain products carry much more risk than others, especially highly complex products that require significant engineering talent and intricate manufacturing processes to get right. (See Exhibit 4.) While highly technical products can be big profit generators, they can also be a big profit drain if they don't sell well. On the other hand, having a low-tech product that is much like a national product brand and sells at lower prices in high volumes is a much lower risk strategy. This is the typical private-brand strategy of many retailers, particularly in the grocery and drug sectors.

Products that are low on technical content often don't need a strong national brand to attract customers. Those that sell in high volumes can generate big margins for retailers because of lower sourcing costs. This is what most private-brand strategies are about: creating lower-priced versions of national product brands. In fact, many retailers' first step in private branding is increasing the amount of product they source directly. Products that are low in technical content and high in volume are very attractive to retailers for developing their own offerings.

But more technically complex products present challenges for retailers to design, develop and source. For those that are highly technical in content and sell at high volumes, a retailer should let someone else design and develop them—although, of course, with the retailer's input. This is what Best Buy is doing with Hewlett-Packard and Toshiba on its Blue Label exclusive line of enhanced notebook computers.

EXHIBIT 4

Product Development and Sourcing



The most successful consumer products companies are stellar in the art and science of managing their brands. They intimately understand the needs and aspirations of their target consumer. The second key success factor is having a dedicated product development function—within or outside of merchandising.

In 2008, Best Buy partnered with HP and Toshiba on an exclusive line of premium notebooks. The designs of these computers were based on extensive Best Buy customer data showing the need for such product enhancements as longer-life batteries and thinner and lighter models. It is also what Sears has done for many years with outside designers, developers and manufacturers of the products that carry its Craftsman tool and Kenmore appliance brand names. Sears doesn't do the technical designs, but it does get involved in defining product attributes and advantages over national brands. Such highly respected proprietary lines have helped save Sears from extinction.

After determining which products should carry its label or be exclusive, the next element in innovation is creating a product development function that can turn out innovative offerings repeatedly. Because many retailers are not hotbeds of product innovation, determining who the function reports to, how it's staffed, how it's measured and rewarded and how it operates is paramount. We'll shed light on some of those issues, based on our experiences with leading retailers.

Organizing Product Development

Given that apparel retailers are farther ahead than most other retail sectors in developing their own products, there is much to be learned from this sector. And make no mistake, the key success factors in developing hot-selling clothes, handbags and shoes are no different from those in launching new-product successes in consumer electronics, appliances, food, tools and other non-apparel goods. Chains such as Aeropostale, Coach, Zara and H&M have found several factors critical to product development.

The first is brand management. The most successful consumer products companies are stellar in the art and science of managing their brands. They intimately understand the needs and aspirations of their target consumer. They are adept at determining their products' positioning (opening price point, features, functions, benefits, tradeoffs, etc.), and they are masters at creating robust demand through compelling marketing campaigns and attractive product packaging.

Retailers that are serious about product innovation establish a separate function run by a "brand owner"—an executive whose job it is to determine what products and product attributes are "on brand" and which are "off brand" (meaning, not to be pursued). Retailers with some of the most successful private-label apparel offerings—e.g., Target, Kohl's and Macy's—have a group developing private brands that is separate from merchandising. Importantly, they collaborate strongly to ensure minimal competition between the company's private and exclusive brands and its national brands.

The second key success factor is having a dedicated product development function—within or outside of merchandising. When product development is a part-time job of dozens of people in a large merchandising function that focuses on buying products from the market, the retailer's brand clarity can be placed at great risk. The authority to use the retailer's brand becomes highly fragmented. Dozens of merchandising employees can interpret in vastly different ways what the retailer's own products stand for, what customer needs they must meet, what benefits they must provide and how to differentiate them. The result can be little consistency in features and benefits across products, and thus a highly confusing brand image.

The most successful product innovators in retailing also have an effective operating plan. Realizing the significant risks of developing their own offerings, they actively lower those risks by knowing exactly what they must do every week to monitor product quality, sources of production, the status of new designs and packaging and consumer feedback—from both POS data and testing. Consumer research must be an ongoing process, not just a focus group done at the outset to test a new product concept or new attributes of an existing product. Such feedback must be communicated quickly to product design, development and sourcing personnel so they can rapidly adjust what they do.

Exhibit 5 shows the evolution of most retailers' product development function and some of the key skills, responsibilities and reporting relationships they must gain. From buying copies of national product brands and slapping their store label on it, retailers evolve to establishing their own brands.

Most retailers whose private-label offerings are lower-cost alternatives to national product brands do not possess such capabilities. If they want to raise their game in product innovation, they need to raise their capabilities. Exhibit 5 shows the evolution of most retailers' product development function and some of the key skills, responsibilities and reporting relationships they must gain. From buying copies of national product brands and slapping their store label on it, retailers evolve to establishing their own brands. They then look to cut the costs of sourcing high-volume, low-tech products by sourcing directly with manufacturers. In the next phase of the evolution, the merchants design concepts to fill voids in the product line but outsource design and development. The final step in the evolution is about significantly differentiating the offering, which requires the retailer to take on product design and development.

Sourcing: Creating Relationships That Ensure Quality, Safety and Good PR

Unlike fashion retailing star Zara, most retailers that ramp up product development are unlikely to build their own production facilities. The cost and complexities of setting up and running plants are too great for most. (Even Coach no longer owns factories these days; neither does Apple.) Yet when the retailer's brand goes on the product, it puts its reputation squarely on the line. Defective offerings,

EXHIBIT 5

The Evolution of Retailer's Product Development Function

	Low-Cost Private Label	Creator of Enhanced Offerings	Creator of Breakthrough Offerings
Design	Focus on packaging and price points; outsource product design	Focus on product differentiation and packaging; both in-sourced	Totally in-sourced or designed collaboratively with key partners
Development	Outsource product development	In-source some product development	Totally in-sourced
Reporting Structure	Private brands reports to chief merchandising officer	Reports to chief merchandising officer	Works closely with merchandising but on equal footing (reports to CEO/COO)
Sourcing Relationships	Several, based on ability to meet cost and quality targets	Fewer, based on ability to deliver consistent quality and product development flexibility	Very few, based on ability to develop and deliver innovation and quality
Key Success Factors	Meeting rigid cost targets; packaging	Incisive consumer research to determine what key product attributes to enhance; in-store and mass media marketing to highlight product differences; store salespeople who can sell the differences	Extensive consumer research and market watching to ID trends and needs; in-store and mass media marketing that can sell whole new product concepts; highly trained store salespeople who can educate consumers on a new offering

unsafe products and unhealthy plant conditions can become liability and PR nightmares, and they become an issue when the retailer can't control what goes on inside the four walls of a factory. As a result, a retailer must be very careful about the sourcing vendors it selects. It must structure deals that promote good working relationships for both sides, not ones that encourage corners to be cut. Our study found that 60% of the most successful Act Vertical® retailers had high levels of collaboration with suppliers in product design and development vs. only 27% of the least successful retailers. For many chains, that requires reducing their supplier base. For example, Aeropostale funnels two-thirds of its production to just five suppliers—many fewer than in the past.

Since a retailer takes on a product's liability in a private-label offering, it needs a sound methodology for certifying vendors. Fortunately, there are many independent certification services which do that today. But while ensuring sound manufacturing practices may require an intermediary, finding a manufacturer no longer does. A decade ago, most retailers needed a middleman to help them wade through the mysteries of offshore manufacturers (especially in China). However, Asian manufacturers have grown in sophistication, and advancements in information technology (design/development software, videoconferencing, etc.) have made it far easier to collaborate with them in product development. Skipping the middleman has two big benefits: not having to give up margin and reducing the chance of a vendor misinterpreting a new-product idea.

Many offshore vendors not only run highly efficient plants, they have built elaborate distribution and logistics capabilities as well as product design and engineering functions. And the Internet has dramatically lowered the cost of collaboration with retailers. Everything is possible now, from cheap phone calls and videoconferencing to product designs that can be transmitted from the United States or Europe in seconds to the computer screens of product developers and plant engineers in Asia.

Still, retailers that outsource production must get better at forecasting demand for their products. Most sourcing vendors don't have the replenishment capabilities of major consumer products companies. Retailers must also get more rigorous about setting margin targets and costs for private-label products. Many don't have an adequate understanding of the costs of components and manufacturing, thus they have difficulty knowing a good sourcing deal from a bad one.

A retailer that wants to differentiate itself in part on proprietary offerings must be highly competent in product development and sourcing management. Those that have done so are giving customers a big reason to shop with them rather than on price with the discounters down the street.

About the Authors

Peter Brown, senior partner and vice president, and Amy Klaris, partner, are the authors of this article. For more information, contact them at peter.brown@kurtsalmon.com or amy.klaris@kurtsalmon.com.

Kurt Salmon Associates

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.

Contact

Kurt Salmon Associates
650 Fifth Avenue
New York, New York 10019
212.319.9450