Competing in a Value-Driven World

North American Retail Practice

McKinsey&Company

Competing in a Value-Driven World

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A hand-to-hand battle for survival lies ahead for many U.S. retailers. It arises from a basic structural change now taking place in the industry, a change largely camouflaged by the recent economic downswing. McKinsey's Global Institute has recently concluded that U.S. retailers are among the world's most productive,[1] yet these retailers have been plagued by low consumer confidence and their senior management has looked to a rebounding economy for a bailout. However, a recharged economy is unlikely to help. Simply put, the retailing landscape itself has changed, with the fundamental and ongoing shift of consumer spend to value retailers.[2] Now, and in the future, success for U.S. retailers will mean learning how to compete in a value-driven world.

The Challenge: Consumer Shift to Value

Value retailers like Wal-Mart, Target and Costco were once largely known as the destination for the monthly stock-up trip. But today, they have penetrated the routine weekly shop. Our proprietary consumer research[3] shows that this consumer "shift to value" cuts across all ages, nearly all income groups and, to some degree, all consumer segments. A majority of consumers surveyed shop at a value retailer every week. As a result, whole categories have "gone to value," with value retailers nearly doubling their share of U.S. retailing over the last 10 years *(Exhibit 1)*.

What explains this dramatic shift? There are two interrelated factors:

First, consumers have fundamentally changed their reference points for both price and quality. Consumers have been trained to expect significantly lower prices at value retailers. Further, they no longer see the price premium demanded by traditional retailers as compelling across many different categories. As life styles have become more casual, many consumers have redefined quality from "good"

Exhibit 1

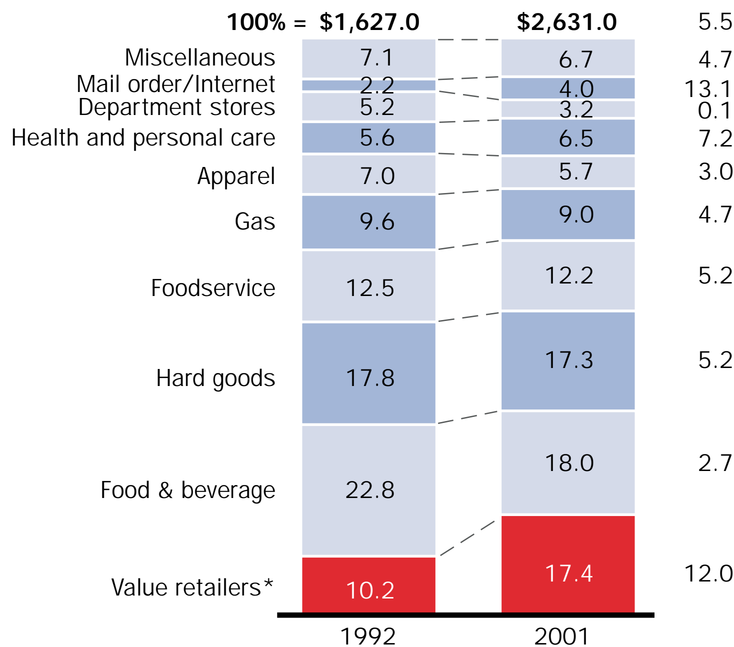
VALUE RETAILERS HAVE ALMOST DOUBLED SHARE IN PAST DECADE

U.S. retail sales 1992-2001

Percent share; $ Billions

CAGR

Percent



* Value retailers include mass merchandisers, warehouse, dollar, and big box stores

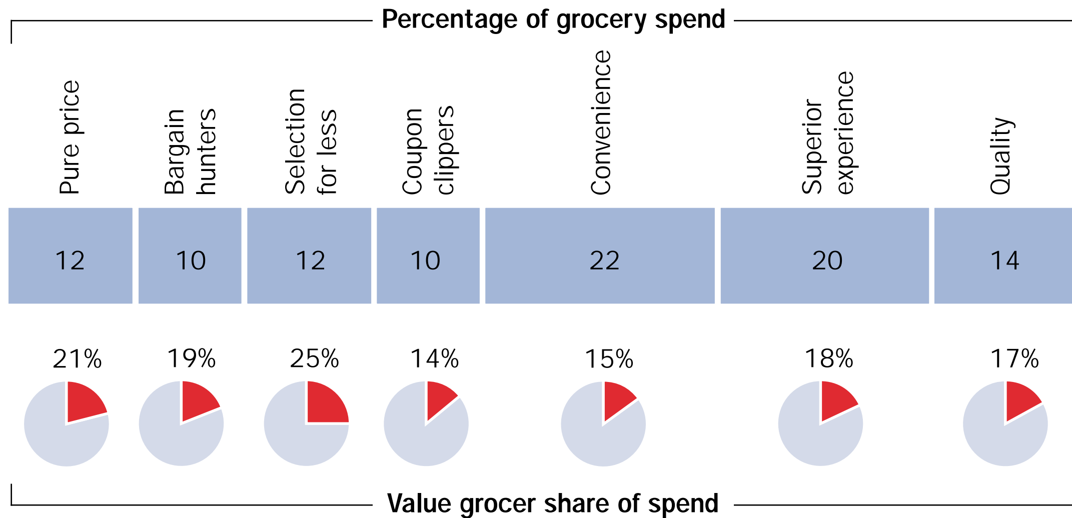
Source: Annual Benchmark for Retail Trade; U.S. Bureau of Census; Morgan Stanley, May 2002; McKinsey analysis

to "good enough" for certain items and occasions, such as the casual weekend wardrobe. And value retailers like Kohl's and Target have upped the ante by increasing access to popular brands at value prices and upgrading the quality of their private label offering. This closing of the perceived gap in quality has allowed value formats to capture disproportionate share of the weekly shop.

Second, value retailers have out-executed their competition and moved beyond price as the sole point of differentiation, often offering comparable assortment, convenience and in-store experience. For example, grocers have historically distinguished themselves by their perimeter fresh foods. However our proprietary consumer research in a market heavily penetrated by value players shows that consumers now view the value players as having "caught up" on "highest quality fresh foods" and "good store brands." Even segments focused on "quality" now willingly shop in value formats for a significant share of their weekly needs *(Exhibit 2).*

Exhibit 2

VALUE RETAILERS HAVE SIGNIFICANTLY PENETRATED ALL CONSUMER SEGMENTS



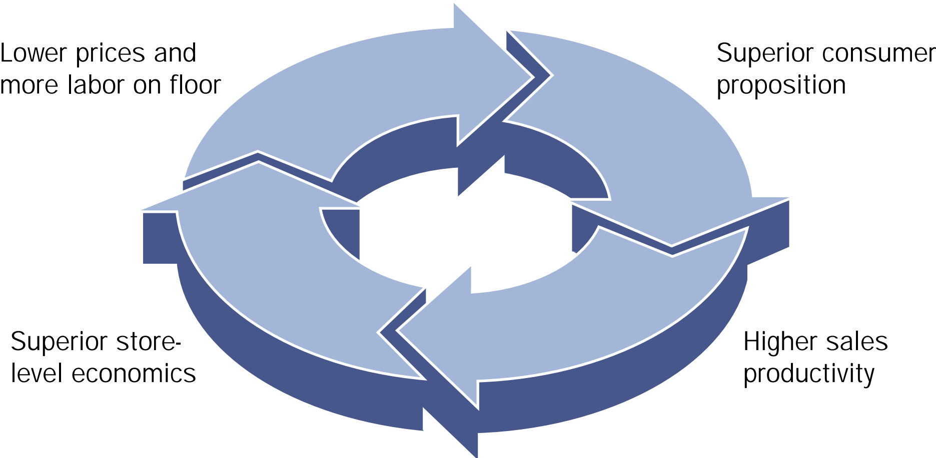
Source: McKinsey Retail Practice Consumer Research, November 2002

In addition, value formats continue to improve "shopability," providing more convenient store layouts and shopping experiences that make the task faster and easier.

Their strong consumer proposition has created a virtuous cycle for value formats *(Exhibit 3)*. The growth in both traffic and basket size has given them much higher sales productivity (i.e., sales per square foot). This higher sales productivity results in very attractive store-level economics, which, in turn, lets value players reinvest some of their surplus returns into even lower prices and, contrary to popular wisdom, more labor hours in the store. This, of course, results in improved in-stocks, better merchandise presentation, and thus an even more compelling shopping experience for consumers, leading to even higher sales productivity. Specifically, this cycle enables value retailers, when compared to more traditional competitors, to have lower gross margin percentages (lower prices), but higher gross margin per square foot. Likewise, these value retailers have significantly lower selling costs as a percent of sales (well beyond advantages conferred by lower wage rates), but more FTEs per square foot (more labor hours in the store). Over time, this virtuous cycle will place increasing pressure on traditional retailers who lack similar

Exhibit 3

SUPERIOR CONSUMER PROPOSITION FOR SUCCESSFUL VALUE PLAYERS DRIVES ECONOMIC ADVANTAGE



sales productivity levels, leading to diminishing service and presentation and/or an increasing gap in pricing, reinforcing value players' consumer advantage.

The strength of this virtuous cycle has significantly improved the economics of these formats. For example, our assessment of leading grocery formats suggests that value formats, like supercenters, have more than doubled their grocery returns on invested capital over the last 10 years, making them comparable to best-in-class retailers. For traditional players, this is creating an enormous competitive disadvantage. In fact, we believe that the retailers which fall significantly behind the leaders in their category on sales productivity will not be long-term successful players.

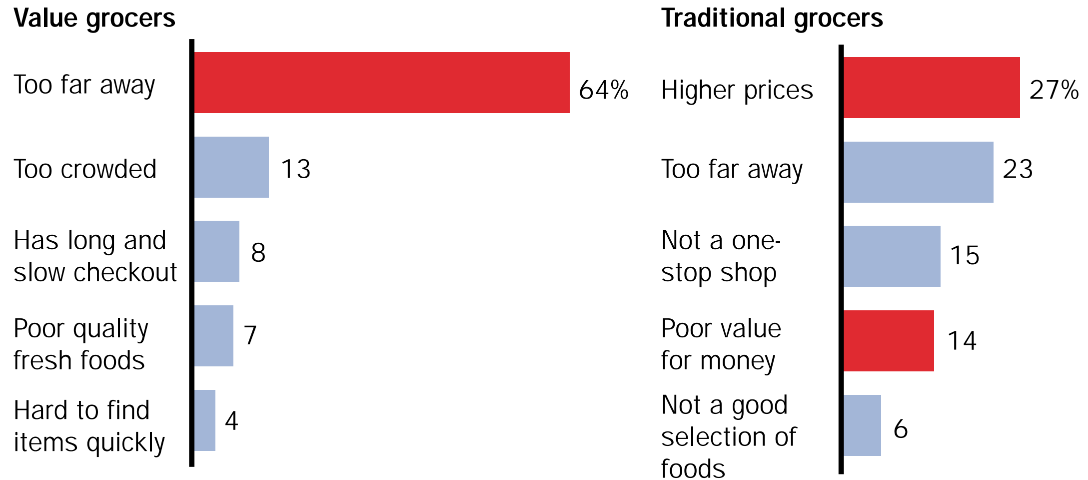
Looking forward, value retailers must meet aggressive Wall Street expectations for growth that are already embedded in their stock price and account for up to 70 percent of current stock values. As a result, value retailers will forge ahead with rapid network expansion plans, bringing more retailers and store locations under fire. Our consumer research indicates that the biggest barrier to increased usage of value grocery formats *(Exhibit 4)* is distance from a store, suggesting that value grocers face few barriers to increasing their penetration and continuing to capture share in many markets.

Exhibit 4

AS VALUE GROCERS CONTINUE TO EXPAND AND LOWER PRICES, CHALLENGES FOR TRADITIONAL GROCERS WILL INCREASE

Percent of respondents

Top reasons for *not* shopping regularly at



Source: McKinsey Retail Practice Consumer Research, November 2002

To date, the majority of regional and national retailers have not yet felt the full force of the value retailers. Less than a quarter of the stores owned by some of the largest national grocers currently face a Wal-Mart supercenter as a competitor. Target and dollar stores also continue to grow their geographic presence aggressively. Further, many value players are entering or dramatically expanding in new categories, such as TJMaxx in the soft home arena, as well as experimenting with new formats, like the convenience-oriented Neighborhood Markets, which target the traditional supermarket and drug stores. We therefore expect another wave of restructuring in the grocery, department store, and chain store industries, with a resulting net reduction in traditional retailer square footage.

Most vulnerable will be the smaller, undifferentiated regional chains that have consistently lost out to value formats when they arrived in the local market. These regional chains will likely be absorbed by larger chains or remain stranded, with limited growth outside their core geographies. Large national chains will also face challenges, as an aggressive rollout of value retailers will bring these sprawling networks under attack. Even so, retailers die slowly and sudden deaths will be few.

The New Priorities

These factors all point to an environment for traditional retailers that will only get more challenging. In the short term, retailers will need to pursue performance improvement programs and rationalize and refresh their store networks. But to survive and thrive over the medium to longer term, retailers will need to step back and fundamentally rethink their businesses around an agenda with five imperatives:

1. Decide what you're going to be "famous for"

Many traditional retailers have the near equivalent of commodity brand propositions. Given the threat from value retailers, they must reinvent their brand propositions with the aim of regaining both traffic and basket size. Specifically, retailers have to define a compelling brand proposition – across merchandise assortment, in-store experience, convenience and service – that stands apart from the competition. They need something they can be "famous for."

Walgreen's, for instance, has built a superior brand proposition around pharmacy authority and convenience. Walgreen's capital spending, organizational energy, and marketing dollars all focus on delivering convenience at every level, through real estate strategy, quick in-and-out convenience, layout, assortment and micro-merchandising.

In thinking about their options, retailers must consider an array of elements, including tangible benefits (e.g., format, assortment, price position, in-store experience, service and convenience) as well as intangible ones (e.g., emotional attributes).

In our experience, the best retailers learn and invest in delivering the benefits that most influence the target consumer's brand preference and loyalty. In the value-driven world, being competitive on price (with some allowance for the benefits at traditional stores, like convenience) will be a ticket to entry. Retailers cannot sustain large price differences without substantial distinctiveness elsewhere in the proposition.

Finally, winning retailers will identify the two or three most important triggers in the entire customer experience and consistently overdeliver on them to build

a strong emotional bond with their consumers. As an example, in apparel, the customer's experience in the fitting room consistently emerges as an important trigger. Leading apparel retailers must ensure that sales associates are available and properly trained to deliver a distinctive customer experience in the fitting room and so strengthen the emotional bond.

2. Achieve a "lean" cost structure

The trend towards price as a ticket to entry will fundamentally challenge the business model for most traditional retailers. These retailers face the task of doubling current operating margins – 6 percent of sales at one grocer we studied – so they can invest margin in price to approach value retailer pricing.

Yet these retailers also suffer structural disadvantages. Nearly 75 percent of the difference in cost between department stores and value formats stems from structural factors (e.g., store locations and sizes, union wage rates). Hence senior management at traditional retailers will need to mount a war on costs and rethink their basic operating models "to leave not a single penny on the table."

In our experience, lean manufacturing methodologies, as perfected in automotive companies like Toyota, can do much to eradicate waste from retail supply chains, stores and merchandising processes. Many of these techniques – such as simplifying work design, using pull rather than push to drive replenishment, removing bottlenecks in the supply chain, and eliminating all sources and types of waste (e.g., wasted effort, wasted time, wasted materials, wasted motion) – apply directly to the retail environment. Indeed, they can work powerful transformations when combined with concerted initiatives to upgrade management expertise.

By approaching the store as a factory – that is, a series of tasks repeated effectively and efficiently to serve customers well – our combined group of manufacturing experts and retail experts has been able to rethink many retail processes and approaches with quite significant results. Across multiple retail sectors, we have achieved 20 to 75 percent reductions in out-of-stocks, 10 to 30 percent decreases in inventory requirements, 20 to 30 percent reductions in store labor costs, and 5 to 10 percent increases in store sales as staff members refocus their time on customer-facing activities. In many cases, inefficient in-store processes are pushed upstream to vendors or outsourced. In other cases, entire

departments (e.g., the high-service perimeter departments in grocery) have been redesigned to better balance desired customer service levels with available labor dollars. The net result in some situations has been a 5 to 10 percentage point increase in return on capital. In the long term, these methodologies have a strong impact on the organization, since they result in an operating system that the front line owns and drives.

3. Get credit for value delivered

Traditional retailers cannot bridge the large price gap with value formats. In grocery alone, for instance, it is over 8 percent across the board in some markets. To compound matters, traditional retailers often also fail to get credit for the value they do offer. Going forward, it will be critical for almost all traditional formats to regain price impression through a fanatical dedication to being sharply priced on key value items (i.e., the items whose price consumers use to indicate overall store pricing levels). The challenge will lie in identifying these items and ensuring profitable execution. Often, this will require shifting promotion planning from a dialog between retailers and manufacturers to one that includes consumers as well. In addition, traditional retailers need to rethink their assortment strategies, including private label, to ensure favorable pricing at opening price points. Finally, traditional retailers need to significantly enhance in-store execution of pricing and promotions to get credit for value offered at the point of sale. In this area, winning value players offer several interesting lessons. Kohl's has shown us the effectiveness of a simple, clearly conveyed promotion strategy, with its lucid, consistent price signage and easy-to-follow price strategy and messaging. Every aspect of Kohl's communications is clear around promotional pricing. Similarly, Bed, Bath & Beyond offers a broad range of prices for its bedding and kitchen wares, but makes sure that its opening price points are competitive with value players, and that this "value" is effectively communicated in the store.

4. Out-execute the competition through simplification

Successful value retailers have won over consumers in part through their superior execution in store. These retailers profitably deliver superior and consistent in-stock levels, merchandise assortment, and service experiences by choreographing various supporting processes effectively and efficiently. Furthermore, successful value retailers have the ability to respond quickly to changes in their competitive environment in local markets. Not surprisingly, these retailers are able to translate their scale benefits into superior performance.

In comparison, traditional retailers have a challenging time driving consistently superior execution and capturing the benefits of national and local scale. Their core processes, like merchandising and promotions, are complex, since they involve thousands of weekly decisions across the organization. Yet, for many traditional retailers, both the processes and the roles and responsibilities of the many individuals involved are poorly defined. Further, traditional retailers, in many cases, lack actionable information and tools to support better decisions. Day-to-day decisions are therefore pushed lower down in the organization, to employees who are neither skilled nor equipped to make optimal decisions. As a consequence, organizations end up with too many management levels making sub-optimal decisions, with limited performance management. This makes traditional retailers less responsive to changes in the competitive environment and unable to translate national and local scale (where present) into superior performance.

To drive superior execution in this new world, traditional retailers must totally rethink their organization particularly in such key areas as buying, merchandising, pricing, promotions management, and performance management. They will need to reduce the number of management layers in their organizations, simplify core processes, redefine roles and responsibilities of key functions, explore outsourcing to transform the productivity of their support functions, and radically transform performance management. Naturally, information technology will be a critical enabler to radically improving information available to making better decisions and ensuring organizational and process changes stick. Those that have succeeded in this arena have moved beyond ineffective legacy systems to concentrate on high-value point solutions that make core retail processes like merchandising, pricing and promotions more effective and efficient.

Tesco and Wal-Mart are role models for traditional retailers in this regard. Their responsive organizations translate insight into customer behavior and business performance into coordinated actions across processes, functions, categories, and geographies to drive superior in-store execution.

5. Grow through new categories or formats

Finally, traditional retailers need to identify possible growth opportunities within their boxes and "out of the store," by aggressively using privileged knowledge of their customers' behavior and preferences, and continually

evaluating contiguous categories and competitors. Leading retailers, like Tesco in the U.K., have leveraged their customer relationships to branch into new arenas that include financial services, insurance, utilities and energy, travel, telephony and telecom services, and automobiles.

Further, retailers will increasingly have to move beyond their core formats to grow. Retailers will increasingly need to adopt a portfolio approach to their business. We therefore anticipate that many U.S. retailers will expand to multiple formats, like Tesco, which has four major footprints – small urban food stores, gasoline convenience stores, traditional grocery stores and hypermarkets – each focused on a different shopping occasion. This trend will also spur new concept development and acquisitions. In such cases, we expect retailers increasingly to take a "create, operate, and trade" attitude toward their portfolios, hastening the flow of acquisitions and divestitures.

* * *

Successfully navigating the current recession is a top priority for many CEOs at U.S. retailers. However, the value-driven world will be a minefield for leaders of these companies. To compete in this new world, retail CEOs must rigorously rethink each component part of their business. Survival for these retailers will require bold and decisive actions ahead. ■

Notes

[1] See "What's Right With The U.S. Economy," *McKinsey Quarterly* 2002, No. 1.

[2] Defined to include mass merchants, category killers and price-oriented propositions in other formats.

[3] Conducted by McKinsey in November 2002 to understand consumer attitudes and behaviors toward value and traditional grocers.

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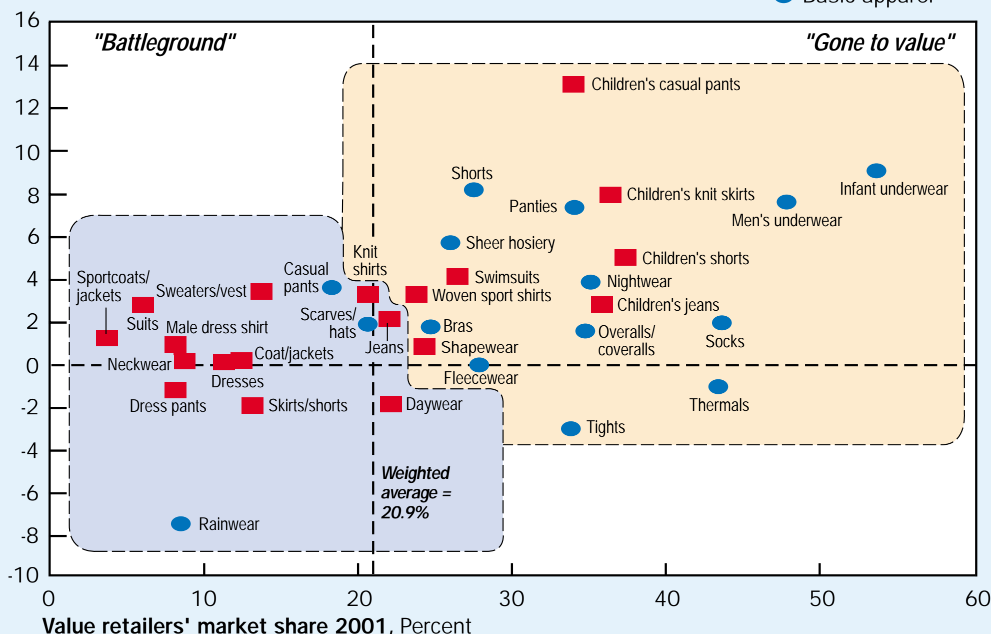
THE APPAREL VALUE CHALLENGE

Value players have relentlessly gained share in a number of apparel categories, resulting in several of these categories "going to value." Most notably, many basic categories like underwear, hosiery and fleece and children's wear have "gone to value." Several categories, like jeans and casual pants appear to be on the cusp of "going to value." Traditional retailers, however, continue to have a strong foothold in service-intensive and tailored categories, although several of these categories, like daywear and some outerwear categories, are also on the cusp of "going to value." The share increase for value players has been driven by many factors. For the basic categories and children's wear, consumers have determined that the value of retailers' offering is "good enough," given the price/value trade-offs and consumers' needs for the product. For other categories, like jeans, casual pants, and daywear, some value players, such as Kohl's, are gaining access to product manufactured by key national brands, like Liz Claiborne, Columbia, Dockers and Vanity Fair. In addition, increasingly casual life styles and workwear has fueled the growth of categories where value players are strong (e.g., casual pants) at the expense of categories where traditional players are strong (e.g., tailored clothing). These trends are evident across all ages and most income segments.

The "shift to value" has large implications for traditional apparel retailers. For many, management must understand that some of the categories are "lost," and reflect this understanding both in space allocation and in merchandise carried. As an example, some department stores are skewing the mix of their merchandise in these categories away from basics to fast-growth micro-categories (e.g., high-end designer jeans) and exclusive brands (e.g., Sigrid Olsen in department stores, private label). In the "battleground" categories, management at these retailers will need to redouble efforts to ensure assortment distinctiveness at competitive prices to defend and grow share. These retailers will find it challenging to achieve this distinctiveness with national brands alone, given the growing number of brands also available at value retailers, and the increasing speed with which value retailers reflect the latest fashion trends. We therefore expect traditional retailers to partner with their vendors to carry even more proprietary brands and merchandise, radically enhance the fashion sensibility and quality of their private label, and re-assort their stores to drive a better in-store experience for their customer and drive conversion.



THE GROCERY VALUE CHALLENGE

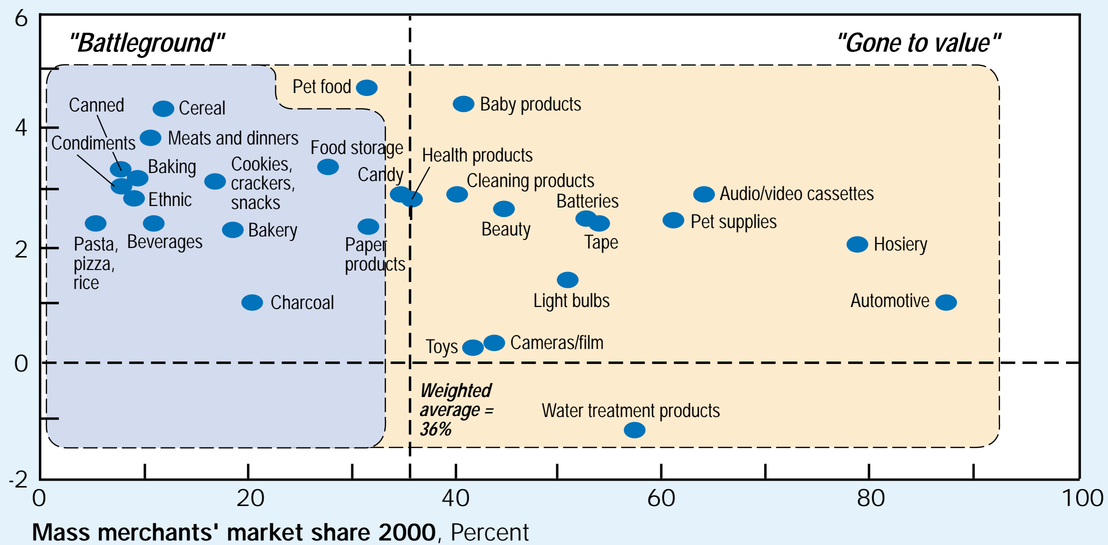
Value retailers have also relentlessly gained share in several grocery categories. Several key nonfood categories like pet food, baby products and light bulbs have "gone to value." Wal-Mart, for example, has created Old Roy, now the largest dry dog food brand in the world by volume. This trend is evident across all ages and income segments. Several "center of store" nonfood categories, like food storage and paper products, are on the cusp of "going to value." Traditional grocery retailers, however, continue to have a strong foothold in core food categories, and in particular in service-intensive categories, like perishables. The rapid improvement in customer perception of the quality of fresh categories at value retailers and the attractive value retailer pricing on "center of store" food categories, like cereal, result in these categories being in the battleground between value retailers and traditional retailers, with traditional retailers still dominating, but value players gaining share.

The "shift to value" has large implications for traditional grocery retailers. For some, management must come to terms with the fact that some of the categories are "lost" and reflect this both in space allocation and in merchandise carried. As an example, these retailers will need to identify which consumer shopping occasions they still retain for the "gone to value" grocery categories (e.g., fill-in occasion for some baby products). The assortment breadth and depth carried for these categories will need to be changed to reflect what traditional retailers own and wish to defend.

Traditional retailers will partner with their vendors to introduce distinctive products and packaging; a greater number of "control-label" brands are likely options at some grocers, particularly with third-tier brands. In addition, traditional grocers must reinvent the service departments to rebuild distinctiveness relative to the value retailers. Further, the space freed up through the reduced assortment in "gone to value" categories offers traditional grocery retailers a unique opportunity to add new categories by "cherry picking" other formats. A broader, superior private label offering and non-grocery revenue streams are necessary elements of making the overall economics work for the traditional retailers, given these category shifts. Finally, the decades-old promotional approach driven largely by manufacturers' needs must be replaced with an approach that better meets the needs of retailers. In order for the retailer to get more credit for the value they offer, the consumer will need to be at the center of the promotion dialog.

MANY GROCERY CATEGORIES HAVE "GONE TO VALUE"

Mass merchants' market share change 1998-2000, Percent



Mass merchants' market share 2000, Percent

Source: The NPD Group, Inc.; IRI; TIA; NACDS; McKinsey analysis

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