Perspective

Simon Harper
Paul Leinwand
Marcelo Tau
Laura Harnett

booz&co.

The Path Back to Retail Growth
Rethinking Space Management

Contact Information

Chicago
Paul Leinwand
Partner
+1-312-578-4573
paul.leinwand@booz.com

Marcelo Tau
Principal
+1-312-578-4576
marcelo.tau@booz.com

London
Simon Harper
Partner
+44-20-7393-3434
simon.harper@booz.com

Laura Harnett
Senior Associate
+44-20-7393-3351
laura.harnett@booz.com

EXECUTIVE SUMMARY

The retail landscape is changing in ways that are placing significant pressure on retailers. The intersection of long-term trends—slow growth in mature markets, shifts in shopping habits, the development of new channels—and short-term challenges caused by the economic recession means that retailers must scrutinize every aspect of their operations and eliminate the inefficiencies they accumulated during recent times.

Retailers' strategies have been misaligned with both the long-term trends and the short-term challenges they face. This misalignment, coupled with retailers' unclear understanding of what was really driving consumer behavior and preferences, resulted in the proliferation of excess store capacity, nonperforming assortments, and suboptimal formats. Retailers are only now coming to realize that getting space management right is critical to safeguarding and driving profitability.

Responses to the dilemmas of space management tend to fall into two camps: one tactical, the other strategic. Tactical solutions usually concentrate on rationalizing assortments to improve margins. Strategic solutions, on the other hand, hinge on first answering more fundamental questions about what consumers really want—the retail proposition and how to create value—and then using space and assortment to carry out that vision.

Most retailers intuitively, and as a matter of course, understand the tactical considerations; few have adopted a more comprehensive and strategic approach to space management.

THE END OF A DECADE OF PROSPERITY AND EXPANSION

The last decade was a boom period for much of the retail industry. High household spending-to-saving ratios, readily available credit, and increases in disposable income helped to fuel impressive retail sales growth. With consumers willing and able to spend, the imperative for retailers was to keep expanding, either by opening more stores or by broadening their assortments and service offerings.

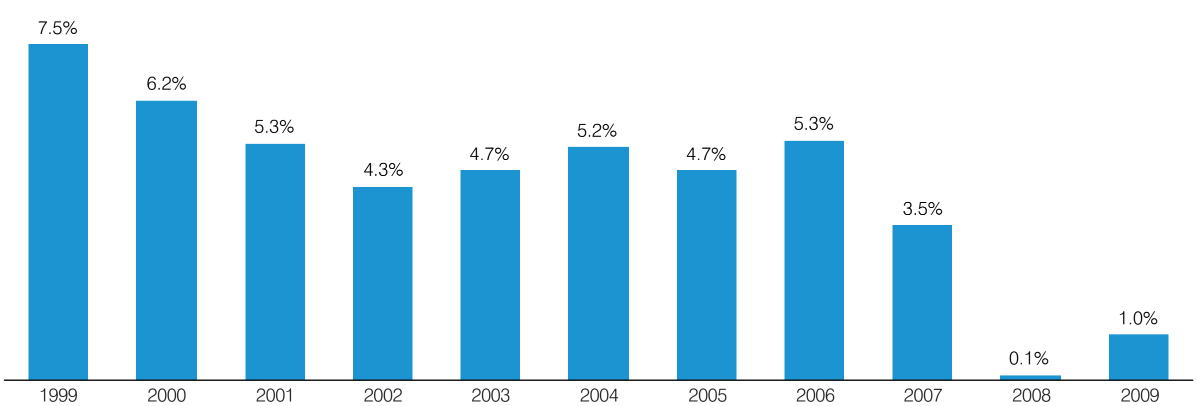
A recent Booz & Company study of approximately 90 major retailers showed that they had increased the number of their retail outlets by an average of 5.2 percent annually between 1998 and 2007; that growth was stopped only by the severe recession that started in 2008 and continued into 2009 (*see Exhibit 1*).

As they added new stores, many retailers deepened their product lines as well. According to the Food Marketing Institute, a typical food retailer's shelf in 2008 contained approximately 50,000 items, 50 percent more than in 1996. Retailers also embarked on a journey to deliver a wide array of "complementary" services ranging from personal shopping and concierge services to product alterations, delivery, and assembly.

However, retailers are now finding that they have too much store capacity and that part of the capacity is of the wrong type. This realization has led to a wave of store closings across the U.S., Europe, and elsewhere. Retail chains—from coffee shops (e.g., Starbucks) to specialty apparel (e.g., Ann Taylor and Gap)—have been closing stores and rationalizing space, shuttering tens of thousands of square feet of prime retail space for lack of profitability. Moreover, a surprisingly high number of stock keeping units (SKUs) have failed to deliver the returns that retailers had hoped for, and the additional services have not significantly increased traffic, conversion, or transaction size. In some cases, whole chains have gone under because their offerings no longer met consumer needs (e.g., Woolworths and Circuit City).

It is all too easy to attribute these hardships in the retail sector to the current economic crisis. In reality, the economic downturn has just accelerated some long-term trends and exposed the cracks in retailers' operating models. Going forward, the challenge for retailers is to find the right strategy to successfully manage retail space. That means finding the right footprint for today's still anemic retail environment and for the healthier environment that will come with full economic recovery, and aligning formats and offerings to new consumer behaviors.

Exhibit 1
Growth in Number of Stores (Based on a Sample of 90 Retailers)



Source: Booz & Company research & analysis

THE NEW REALITY IN RETAIL

The new model for retail success involves not simply space rationalization but an integrated approach to space management that will drive traffic, conversion rates, and profitability. Retailers will have to understand the changes in consumer behavior and preferences and align their space management strategies accordingly. Getting this right will require them to focus simultaneously on three imperatives:

- *Get the space and assortment right*. Retailers are optimizing and rationalizing their assortments based on improved analyses of profitability and the realization that variety may be overwhelming customers. Retailers know they need to do a better job of "curating" the assortment, assuming the roles of selector and chief buyer on behalf of consumers.

- *Leverage format strategies to manage space*. Retailers are reassessing their businesses and leveraging new formats (while winding down old ones) to efficiently segment and align their retail space to consumer needs and purchasing behavior and explore other opportunities for growth.

- *Integrate online and offline channels*. The growing importance of online shopping is changing notions of space management, introducing the concept of the "endless aisle" and encouraging retailers to treat the Internet as an integral part of their operations.

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GET THE SPACE AND ASSORTMENT RIGHT

Some retailers are already acknowledging that *more* is not always better and that consumers are expecting them to do a better job of selecting, merchandising, and simplifying their shopping experiences.

A recent Booz & Company study with a leading grocery retailer found that 25 percent of its stocked items accounted for nearly 100 percent of profits in the six categories examined, and that the slowest-moving 25 percent of items in those categories all lost money. By redesigning the assortment to identify the "smartest" mix of items that would effectively—and profitably—meet the needs of the store and the shopper, the retailer had an opportunity to grow category profitability by more than a third.

Separate Booz & Company research highlighted that shoppers' biggest frustrations were finding and selecting products quickly, a lack of differentiation among products, and the length of time they had to spend in stores.[1]

Many leading retailers are already changing their space strategies to use their available space more efficiently, drive profitability, and enhance the consumer experience. For example, Walgreens is cutting the number of items by 10 to 20 percent and making reductions of more than 50 percent in some non-core products such as super glues. Walmart is slashing assortments in categories such as toilet paper, mouthwash, and bar soap by 20 to 44 percent. Meanwhile, European grocers such as Morrisons are rationalizing assortments by reducing the overlaps between private-label and non-core brands.

Even more important than rationalizing assortments is selecting the right products. If retailers are now choosing only five items per category, they need to pick the right five. Therefore, retailers are also carrying out localization initiatives, selecting product lines to suit the specific tastes of consumers in a particular area.

Customization is a centerpiece of Walmart's "store of the community" strategy, which tailors products locally based on a segmentation model that includes six demographic groups. Retailers like Tesco and Ahold are allowing up to 10 percent of items to vary depending on the location. Macy's "My Macy's" initiative allows regional stores to tailor up to 15 percent of assortments to reflect local preferences.

Leading retailers are continually asking themselves what their customers are looking for, developing the capability to understand what is and is not working, and creating flexible models that can be adapted quickly to meet changing circumstances. They understand that the only permanent feature of their stores is the four walls.

LEVERAGE FORMAT STRATEGIES TO MANAGE SPACE

A critical challenge in managing retail space is reconciling the requirements of different consumer segments and understanding the trade-offs with respect to assortment, customer shopping experience, and space allocation, given that space is limited. Developing new formats is essential to overcoming this challenge.

Many retailers—for example, department stores and bricks-and-mortar booksellers that have significantly struggled in recent years—have difficulty accepting that their existing formats may not support their growth aspirations, and that categories once in high demand are no longer aligned with current behavior or price points. Retailers that fail to honestly acknowledge and assess the limitations in their existing formats may end up with irrelevant assortments, underperforming stores, and, ultimately, damage to their existing brands and concepts.

By developing new formats, leading retailers can align assortments to specific consumer behaviors and segments, optimizing space profitability and creating a better destination for customers.

A multi-format apparel and accessories retailer such as Inditex shows how this can be done. Its Massimo Dutti brand offers personalized

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service for affluent men and women. Its Bershka label targets the younger market, creating a store environment that resembles a social meeting place. And its core brand, Zara, targets mid-market customers in the 20-to-35 age group with "cheap and chic" offerings.

Similarly, Tesco has successfully followed a comprehensive format differentiation strategy based on shopping occasions. Its diversified formats include Superstore (traditional format for weekly shopping), Metro (small stores for highly populated urban areas), and Express (small convenience stores), each designed for specific purchasing occasions.

Several long-term consumer trends, accelerated by the downturn, are further forcing retailers to rethink their format strategies. Consumers are unbundling their shopping into multiple store trips, to both small and large formats, to find the best value. They are cherry-picking items and are less loyal to particular stores than in the past. The challenge for retailers is magnified because customers may behave differently depending on the shopping occasion. They may, for example, be price-sensitive while doing a monthly shopping, but motivated by quality and provenance in making weekly purchases of fresh items. Only by developing multiple formats can retailers successfully meet consumer needs and expectations.

Given current economic conditions, the overcapacity found in many markets, and the high cost of developing new space, retailers are understandably wary of launching or expanding new formats. However, retailers can and should reevaluate their existing spaces and concepts with an eye toward revitalizing or replacing those that are underperforming; developing new formats does not necessarily mean adding more overall store capacity.

To mitigate some of the risk, many retailers are leveraging the Internet to test new concepts before rolling them out in their bricks-and-mortar stores. H&M, for example, recently launched its Home Collection online, tailoring its offering to several European markets. It is now waiting to see how the venture fares before deciding whether to launch a new bricks-and-mortar store format. Similarly, J. Crew tested its Crewcuts kids' collection on the Internet before launching it in stores.

INTEGRATE ONLINE AND OFFLINE CHANNELS

While much of bricks-and-mortar retailing is in turmoil, online shopping has thrived. The shift to the Internet is not new, but it has accelerated in recent times. As a result, leading bricks-and-mortar chains are increasingly looking to the online channel as a fundamental element of their overall retail strategy.

The rise of the online channel has also changed the rules of space management. Space is no longer limited by the four walls of the physical store. In theory, the Internet is an "endless aisle" allowing retailers to extend their offerings without expanding physical space and while lowering their operating costs.

Yet retailers run the risk of adding new complexity to their operations and offerings as they explore new possibilities afforded by the online channel. It is still critical for retailers to make the right assortment choices, since customers can still get overwhelmed by too many options. Good website design and the latest online technologies (search being key among them) can help to reduce the appearance of clutter, but the core task of selection and "curation" remains.

Leading retailers have begun treating their offline and online strategies as a single set of decisions, rather than separate ones. Such holistic thinking is key to maximizing the opportunities of the new channel and efficiently managing space. Many retailers, including Gap, Walmart, and Tesco, already allow consumers to purchase items online but return them to bricks-and-mortar stores, or to order online and pick up at the counter. Other retailers—especially those offering luxury goods, such as Louis Vuitton, Prada, and Salvatore Ferragamo—are using online auction sites to sell off excess inventory rather than having in-store markdown sales. This is helping not only to maximize profitability by capturing the consumer's full willingness to pay, but also to improve the management of store space between seasons or collections by expediting the exit of products from stores.

Retailers have only begun to explore the potential of the online channel. Looking ahead, one could imagine retailers treating their stores as showroom space, offering only a limited range of products for sale but giving full access to the broader assortment via online terminals. J. Crew implemented part of this concept by offering petite and tall sizes not carried in stores through its in-store "red phones" and free home delivery. This could have the benefit of uncluttering floor space while exploiting one of the Internet's strengths, and reduce the complexity associated with moving inventory into and out of stores, organizing and merchandising goods in stores, and the like.

Integrating online and offline channels to manage space carries many possibilities, and it remains a relatively underdeveloped area. Successful retailers will be those who efficiently understand consumer expectations and purchase behaviors, and develop integrated space management strategies to deliver accordingly.

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CONCLUSION

The economic downturn came as a shock to the retail industry, overturning several assumptions about future growth. However, the recession simply accelerated some long-term trends, forcing retailers to improve execution in areas often neglected during times of plenty—one of the key issues being space management.

Going forward, the challenge for retailers will be to put aside some accepted truths of the past and embrace the possibilities of the future. That means moving from a solely tactical stance, centered on SKU rationalization, to a more strategic approach that encompasses leveraging consumer insight to define the right categories and product assortments; leveraging localization initiatives to promote differentiation and efficient selection; revisiting existing spaces and developing new formats to meet ever-changing consumer needs and increasingly fragmented consumer segments; and, last but not least, exploring the possibilities for integrating online and offline businesses, a potential game changer in space management.

Some innovative retailers have already set off down these paths. But for many others, much work and many tough decisions lie ahead before their space provides the appropriate return on investment.

Endnote

[1] Booz & Company Shopper Insights Consumer Category Survey, 2007.

About the Authors

Simon Harper is a Booz & Company partner based in London. He specializes in operational transformation of retail and consumer goods clients and leads the U.K. retail team.

Paul Leinwand is a Booz & Company partner based in Chicago. He works in the consumer, media, and digital practice and focuses on capability-driven strategy for consumer products companies.

Marcelo Tau is a Booz & Company principal based in Chicago. He specializes in operational transformation of retail clients, including store operations, supply chain management, and organization structure.

Laura Harnett is a Booz & Company senior associate based in London.

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