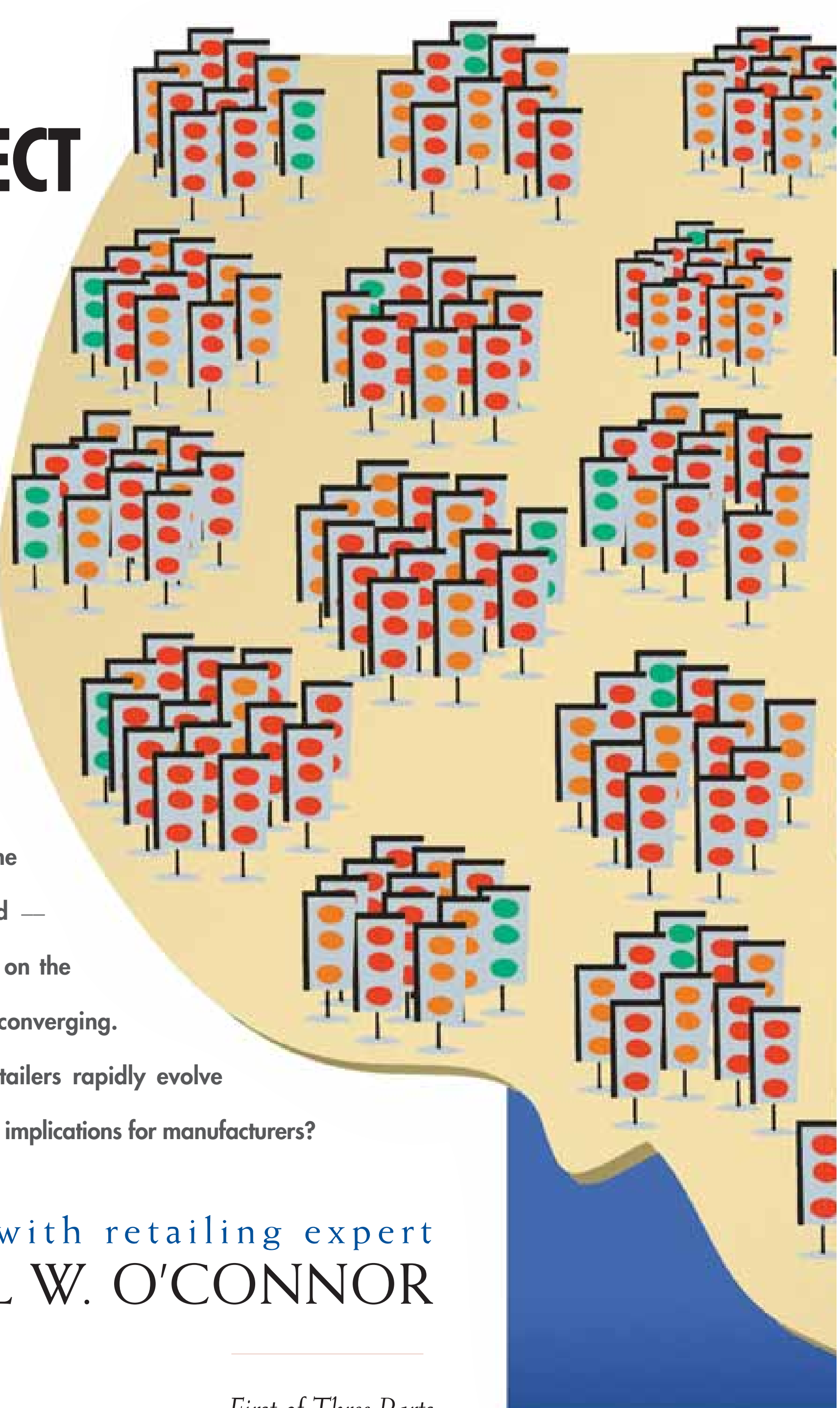
W 2007 HAT TO EXPECT

As Retailers Reach the LIMITS to Organic GROWTH



THE SQUEEZE IS ON

for big chain retailers, says Dan O'Connor. Market saturation — with over 200 of the 250 major US markets now overstored — concentration, substitution and a ceiling on the number of consumer shopping trips are converging. The result is fundamental change as retailers rapidly evolve into sophisticated marketers. What are the implications for manufacturers?

A conversation with retailing expert

DANIEL W. O'CONNOR

First of Three Parts


CREAM
UCE
CRACKERS
WHIPPED

For high-performing retailers, why it's A all about

PRODUCT AUTHORITY

For modern chain retailers, the competitive pressure cooker has never been more fraught with peril. Even those who have grown at a 10 percent or more CAGR for over a decade are now increasingly hitting the wall. Simply building more stores covers up the core issue — that more real estate is no longer the answer. That's why, says Dan O'Connor, retail leaders are now investing hugely in developing clear, unique "brandstands" intended to drive PRODUCT AUTHORITY. The goal: to become something specific and meaningful in the consumer's mind, and drive shoppers into THEIR stores.

In the GMA FORUM's three-part conversation with Dan, we explore why, and consider the implications for the CPG manufacturers who supply the big chains.

Dan O'Connor
President & CEO, *Retail Network Group* (RNG) and Founder/Co-Chairman, *Management Ventures, Inc.* (MVI).

GMA FORUM: Let's start with the backdrop to retailers' new emphasis on what you term *'product authority.'* Why are they thinking about a different aproach now?

Dan O'Connor: There are several macro-level trends going on in North America today, and in most developed parts of the world. These trends are immovable — no retailer is powerful enough to reverse them. They set the stage for fundamental change.

The Number One challenge — by far — that today's retailers face is that **the total number of shopping trips is relatively flat.** With the advent of superstores and other one-stop retailers, a decade ago shoppers began to consolidate trips. They used to go to the local supermarket, photo store, electronics store. Now, they go to Costco and other superstores for one-stop shopping. In effect, shoppers consolidated trips, reducing — or at least not increasing — the total number of shopping trips made.

Other factors such as traffic, congestion, household structures, play a role here, as well.

"Precision shopping" is increasing for basic "wants." The average shopper spends three to 40 minutes in the store (depending on the format), buys a focused list of items, investing an average of *two seconds* per product choice. Time is valuable and today's shoppers want to spend less of it doing routine replenishment.

Adding to the pressure is **channel or format substitution.** Shoppers now have alternatives to one-stop shopping in big boxes — a new "retail format rotation" is beginning to take place. One rapidly growing format that is substituting for a variety of big-box one-stop trips are "express" stores — small-box, "neighborhood-styled" markets with edited assortments. Some emphasize food (*e.g.*, Trader Joe's, Marks & Spencer's Simply Food), some food & nonfoods (Tesco Metro and Express). These evolving stores are generally positioned on two levels — either mid- to upscale, or downscale. The downscale stores are designed to hit opening price points (*e.g.*, Aldi and Lidl) The mid- to upscale are designed to skim off the premium shoppers —often with premium perishables, ready-to-eat meals — and very sharp price points are often achieved using the retailer's own brand — all within five minutes of the shopper's home.

A second rotation taking place is from store to non-store —online shopping is increasing year over year at 25 percent CAGR. It and catalog-related sales are now about five percent of all retail spending. But if you look at the 10- 20 of the largest web-oriented categories that are also in a supercenter or a club store (*e..g.*, apparel, footwear and accessories, sporting goods and consumer electronics), the volume of these categories is growing 25 percent on line and through catalogs.

GMA FORUM: Looking at Costco's jam-packed parking lot, it's hard to imagine all those people moving to the Web any time soon.

Dan O'Connor: I absolutely agree. First, remember that Costco is one of the clear share gainers in North America. I would argue that it's taking or consolidating other retailers' trips. Second, remember as a retailer, if I lose five percent of the store trips to the non-store options, I may not just lose the sale of one SKU — I may also lose the sale of four or five other things I'm merchandising in the box — the impulse buys the shopper makes while in the store for that SKU. Even if the shopper buys from my web site, we know it is much harder to cross-sell there as effectively as in the store. That's what causes this trip compression that is so complex for today's retailers

While it's true that these non-store sales are still relatively small, they are growing *five times faster* than the store-based sales! This sets up a basic paradox for store based retailers: How to both meet the growing demand for non-store retailing while leveraging their web/catalogs in general to drive shoppers into the store.

Does winning on the web mean losing in the store? Most chain retailers have not figured this out. While this is being worked on, the non-store traffic and sales migration contributes to fewer shoppers per store (on average).

Finally, retailers in North America open five to eight percent NEW square footage annually, adding about 5,200 stores. Assuming zero trip growth, the average trips per store is obviously challenged: *Just how DOES a store manager grow a store with five percent fewer trips each year?* Its clear then why the battle for shoppers and trips is the most important one.

GMA Forum: What are the other key macro trends?

Dan O'Connor: We also see **changing retail concentration patterns.** In retailers' terms, concentration simply means *more volume through fewer retailers.*

Over the past 20 years, the chain retailers we followed so closely at Management Ventures, Inc. grew their business between 100 and 150 basis points annually. For example, if all chains were 20 percent of the market in total, by the end of next year, as a group they would be expected to be at 21 or 21.5 percent. This went on for over a decade.

Today in the US, the market as a whole is growing at only about five percent annually, and the chains in the aggregate are growing only slightly faster than that.

What happened? The point is, the growth slowed. Beginning in 2003, **the large chains' share stopped exceeding the market.** There was a major slowdown that has not yet rebounded, and is not likely to. We believe one reason is that other retailers began to find effective new ways to compete, slowing down the chains' share growth.

For the large chains, that's a big change — and a big problem. In effect, what it means is that if the big chain wants to grow at eight to 10 percent annually — and it must, because its shareholder value gets better only if it can outpace the growth of the marketplace — it generally has to come from another chain. And that isn't as easy. Over two-thirds of the 290 active chains in North America today know enough to hold share when challenged by another chain. So the competitive intensity between chains increases with this changing concentration pattern.

Store saturation is compounding the problem. Today in North America, at least 80 percent of the DMA's (marketing areas) are adequately served by modern stores — a polite way of saying *they are saturated.* To be viable, any new store in these markets has to take share from existing stores, *or* be able to capture a very large percent of spending growth. So, we see flashing red and yellow lights around organic and even acquired growth in many markets, and conclude that retailers can no longer hope to grow at above-average rates through organic expansion — building new stores. Growth will only come to those who can ACTIVATE AND GROW THEIR *EXISTING* STORES… which are often over 90 percent of total stores. This is hard to do in saturated markets. Ask any retailer how to fix an out-of-stock and they know what to do — even if they often can't or don't do it. Ask then how to re-start a flat or declining store — systematically — and few will know what to do - not over hundreds or even tousands of stores. And yet 30-40 percent of their mature stores are often shrinking.

GMA Forum: So, retailers have hit a wall. What now?

Dan O'Connor: At least two things happen.

First, a "chosen few" will figure out that the market requires new strategies to win — and that it's not about better category management, shopper insights or shopper marketing alone. It's much more complex. It's about *how to get the entire "demand chain" developed and synchronized.* This is the focus of our research.

Secondly, for those who don't get it done fast enough, there may be private equity firms who realize that in the absence of growth, a retail chain looks a lot like a utility – it has huge cash flow, often under-leveraged real estate and the opportunity to optimize profitability and re-sell the company based on that cash flow. These investors have a totally different timeframe, cost of capital and point of view. Even Home Depot for example has drawn their attention recently — it has stopped growing, has great cash flow and has $60 billion worth of real estate, with a market cap of approximately $80 billion — and now the CEO has departed.

In short, when retailers are no longer a growth story, they become a financial engineering and optimization story.

GMA Forum: Were we a retailer CEO, that possibility would powerfully focus our mind.

Dan O'Connor: So it has. What's happening now is that retailers are getting incredibly focused on understanding and developing their demand chains.

Some early decisions involve the merchandise mix — for example, overall decisions about merchandise comparability versus everyday differentiation. In the 1980's, at least two-thirds of the

> *The brandstand taken to establish product authority fundamentally changes the way decisions are made by retailers, including the products and categories that determine the mix.*

merchandise carried by competitive supermarkets was comparable — sometimes "temporarily differentiated" by suppliers with promotion — but in general, the battle was about being in-stock on high-demand brands that were priced right. Conversely, today we see leaders like Target growing their food business with less and less comparability with their direct competitors — in other words, increasing "everyday differentiation." Trader Joe's, Marks & Spencer, Publix and Harris Teeter, too, have all significantly reduced comparability through re-staged corporate brands. This is a conscious, deliberate choice on the part of these chains that we see growing rapidly as a trend.

GMA Forum: So that's why, as the new GMA/FPA study finds *(page 62)*, **customization requests have soared recently — some manufacturers are now being asked for literally thousands of different items, services and packaging configurations.**

Dan O'Connor: That's right. The shelf and promotional space for vendor brands in the typical store is going to compress as retailer corporate brands grow and retailers learn how to compete with targeted and edited assortments. The pressure is on for suppliers to provide "everyday differentiation" — a brand, package or more permanent support, for example. Only a few large - scale suppliers will be able to win with "everyday comparable" products — those with very large brands that are top of mind for shoppers and are essential to the retailers' "Product Authority" equation. The balance will need to adjust rapidly. Category management, as most of us know it, won't get you there.

GMA Forum: So retailers have decided *they* need to become marketers, too — or instead of.

Dan O'Connor: Yes. It's no longer enough to have a real estate and supply chain focus. Now, retailers need a *demand-chain* focus. They need the ability to spark, to activate, a store. Remember, there are only two basic ways to drive comparable store sales ("comps") into existing buildings: *More traffic* and *higher average ticket.* Building traffic comes first, and it's hard. Each retailer must be precise about which households/shoppers they are going to target, and find a way to *activate* those. For example, if there are 20,000 households around a particular store, the retailer needs a good sense of who are the 1,500 that it will "spark" to grow that building.

GMA Forum: How many of the big chains realize this, and are acting on it?

Dan O'Connor: We are at the front end of this journey — even today's leaders see this as a multi-year journey. First, they need to set the strategy, then structure, systems, styles, etc. Change is not easy. And this new strategy tends to change decision rights — that is, where, when and who makes certain decisions, and how people are measured.

GMA Forum: But a few get it, you say.

Dan O'Connor: Over the last several months, I have tried to lay out, as if I were a retailer, the "demand chain roadmap" or "best practices" with an eye on short term store and shopper activation. It remains the hardest research I've ever done, because it involves both the rational and emotional aspects of shopper choice — and a lot of judgment calls. I started with selected "Super A" retailers — those with A-plus growth rates, return on invested capital (ROIC) and capabilities. All are major "share gainers." I visited their stores and spent a lot of time trying to figure out how they keep even their mature stores growing.

I learned that, in many of these leaders, only 10-15 percent of their stores over three years old have flat or declining sales. By contrast, in a more typical chain, 30 to 50 percent of stores three years and older are flat or declining. This is a HUGE difference in terms of asset productivity.

We concluded that the " Super A share-gainer" retailer's winning strategy boils down to a simple concept — a retailer's ability to establish genuine PRODUCT AUTHORITY in the shopper's mind.

This is an easy thing to say, and a very difficult thing to achieve. Through our research, we learned how to measure it — one way is to ask 100,000 households: *"Which are the first, second and third retailers you think of when you think of apparel, consumer electronics (or any category/merchandise class)?"* If one percent of those 100,000 households bring your chain's name up, you don't have *any* product authority. Shoppers don't know you for that business. But if 30 percent of households say: *"When I think of consumer electronics, I think of Best Buy"* — and they do — then you have very, VERY strong product authority and the ability to lead and communicate with that shopper.

The retail leaders we studied have such product authority in at least five major departments/sections of their stores. And they achieved it consciously. ■

In Parts Two and Three in upcoming issues, Dan O'Connor discusses the elements of product authority, how high-performance retailers are working to activate shoppers by getting each element of product authority right, and how this affects CPG manufacturers.