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What got you here won't get you there

Evolving the merchandising function in today's battle for share

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The technologies that are changing the retail world are there for everyone to see. There's no escaping the tactical transformations: Consumers increasingly use digital means to research, shop, and transact, while retailers use the same advances to connect, assort, and deliver. But is there more going on than just the march of technological progress?

Deloitte spent six months interviewing a broad collection of retail executives, industry analysts and leading industry thinkers. These people form a substantial cross-section of the industry and serve as a barometer on where the industry is heading. It was our goal to understand their views on the changing business landscape—and the implications those views will have on the operating model and the organization—in the hope of forming a collective view that goes deeper than the headlines.

While the opinions of those we interviewed certainly vary, with some retail executives thinking we are in the midst of a total disruption never before seen, others have more moderate interpretations. But taken as a whole, their inputs paint a clear picture of a substantial shift. Their candid observations form the basis of this paper. More than 1,200 discrete inputs later, here's what we learned:

Technology has rewritten what consumers demand, what retailers are capable of, and how retailers compete with one another. Assortment as a concept is no longer tightly bound to physical inventory. A customer relationship can be just as strong over a thousand miles as it used to be over a few city blocks.

If you're a merchant, you're always hearing about the "next big thing". But the transformation of the retail world that's happening right now is about far more than eking out another 2 percent.

Technology has rewritten what consumers demand, what retailers are capable of, and how retailers compete with one another. Assortment as a concept is no longer tightly bound to physical inventory. A customer relationship can be just as strong over a thousand miles as it used to be over a few city blocks.

> *"Traditionally, we used last year's sales data to drive the assortment decisions... We didn't use consumer information or insights."*
>
> - Industry Executive

And a business model that didn't exist a dozen years ago – the no-footprint, no-inventory, just-add-water retailer with an instant global reach and limitless assortment options – is here to threaten the traditional model. Technology has unleashed an onslaught of new competition with a different business model at the core. One industry executive referred to this onslaught as "a death by a thousand paper cuts."

Traditionally, scale has been the large retailer's bulwark against change, and acquisition was the lever that made it possible for large institutions to move in a way that mimicked the agility of smaller competitors.

But again technology is playing a role in reducing the barriers to entry, meaning size can no longer protect you as it once did. Just ask the many familiar brands that aren't here anymore. And the changes that are underway today are not like the ones those companies faced. This isn't a market evolution – it's a technology-driven disruption. One retailer told us, "If you think the answer is omnichannel, you're already too late." This change goes beyond channels altogether.

This is a transformation retailers need to adapt to on many fronts: capitalization, value-chain construct, infrastructure, marketing, talent, and finance, to name a few. As one retailer said, "I can see a future where marketing and merchandising must work much closer together aligned around customer groupings, then hand over to a bigger supply chain team – a pretty dramatic organizational change." As we heard in one interview, "It's all about competition – 'if I don't have to change, I won't.' However, that position is no longer viable."

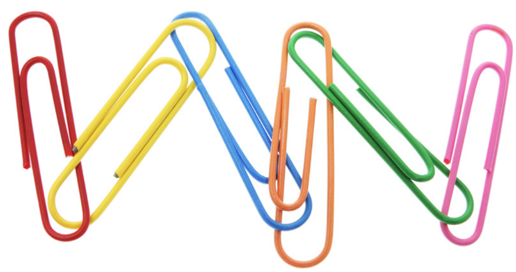
To be nimble without identity is to attempt to be all things to all people – which is to say, to stand for nothing. "Whatever you want, I can have it on your doorstep tomorrow" is a seductive path to follow because of how easy technology makes it simply to throw more SKUs into the virtual mix. But it's already well on its way to becoming a commoditized promise with price, ease, and speed as the 'race to the bottom' competitive dimensions.

On the other extreme, the meaning and good will that reside in your venerable brand aren't enough to see you through without a fresh approach to your fundamental value proposition – with merchandising and assortment in the crosshairs.

If your brand stands for something – and you carry out that promise in the new ways that digitally connected consumers demand – you can emerge from this disruption with a strong future. As one retail pro advised, "Understand what products really represent the brand."

Securing that outcome means breaking down the challenge, the response strategy, and the right early moves into distinct questions.

The business imperatives: Why change course?



By now, the technology advancements are familiar: complete consumer transparency on price, features, options, and availability. Virtual shopping that, in certain categories, begins to takes geography out of the competitive equation. The definition of a new profit model that decouples inventory and assortment and seeks new paths to revenue. And fulfillment at a pace that might once have counted as science fiction.

While many people think of these changes from the consumer's point of view, they have been just as transformative for retailers themselves. In particular, they have unleashed an onslaught of competitive pressure. Casting this as an online vs. bricks and mortar battle doesn't go far enough, because the lines between digital and physical are rapidly blurring and will be even more muddled as technology progresses. In a no- to limited-growth environment with an onslaught of new competitors, the real battle is for market share.

> *"We think we know our customer, but it has become clear that we don't. It is clear to me that we are a product-centric organization living in an increasingly customer-centric world."*
>
> *- A retailer*

1. **Reduced barriers to entry:**

   Bringing in more small, nimble players changes the nature of competition. The old, capital-intensive requirement to own all or most of the value chain is no more. Today, competitors can launch a competitive retail brand in a matter of hours with little more than a credit card in hand. And the retail value chain has been irreversibly affected.

   A new competitor can literally outsource any or all of the value chain, from acquiring assortment to sell and inventory ownership through customer call-center support, to email marketing, store hosting, and delivery, through to payment processing. Even the associate-as-employee model is being challenged with new models leveraging networks of people ready to sell, deliver or support. This dramatically changes the capital requirement necessary to play.

   One interviewee summed it up: "If small retailers no longer need the same level of capital to play, large ones no longer need physical at-scale presence to reach millions of customers." The net effect is a flood of competitors operating on surprisingly equal terms. In a market with stagnant growth, this intensifies the competition for market share and intensifies competitive behavior.

2. **Decoupling of assortment from inventory:**

   The Pareto curve of retail is flattened because forward-deployed inventory no longer drives sales the way it once did, supply and demand are increasingly separate, and demand that extends beyond geographic proximity unlocks long-tail opportunities.

   Thanks to the rise of this distribution model, retailers can have an assortment without the corresponding present physical inventory. This corresponds to the new assortment of expectations of consumers who have become more accustomed to purchasing and having products shipped to them. Because of advances in drop-ship capabilities, retailers can not only sell items they don't have on hand at stores – they can even sell items they don't own in physical inventory. This unleashes the potential to think differently about what a retailer sells and how.

> *"Before, we simply would have had missed sales and never have known it. Now that we have better visibility to demand, we at least know how bad we are at inventory management."*
>
> \- A retailer

That means demand aggregation is now a function of technology, not just geography. That affects economies of scale and adds viability to offerings that were once too "niche" to survive. It's left to the retailer to pull the consumer to shop with it instead of going somewhere else. As described by one executive, "This is a fundamental shift in the model."

"The retailer used to define what customers wanted, especially in fashion," one retailer said. "That is completely reversed now – this is subtle in a way, but completely revolutionary. The old way was supply driven; now we are demand driven."

Before they can apply that lesson, traditional retailers need to move away from the traditional relationship between assortment and inventory, and leave its limitations behind. Some retailers may say "We are already doing this," but the truth is for the vast majority of retailers that may be exploring this concept, they are largely only doing it in their on-line business unit, which still represents a small portion of the business.

"I imagine a world of just-in-time inventory, customization, and, perhaps 20 years out, 3D printing in certain categories, in a near-term single organization," one interview subject said, elaborating that there are three likely paths forward: a completely siloed approach, an approach based solely on store experience with no web team, or a middle ground in which a web-dedicated planner works with buyers for web-only items.

Very few retailers have figured out how to bring this sales model into the store where more than 90 percent of retail still happens today. "The big unlock will be when traditional retailers crack the code for their entire business."

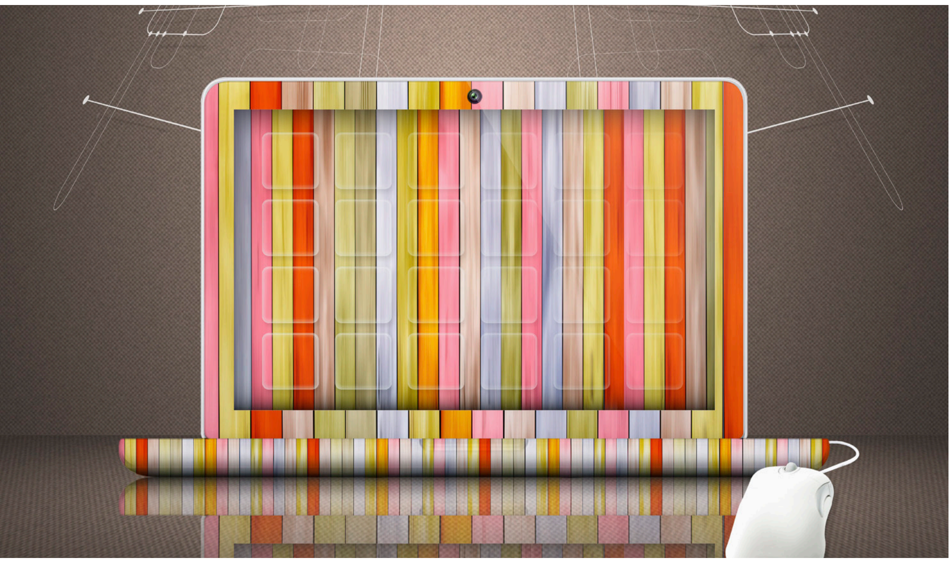
3. **Reduced cost to buy:**

   The traditional assumptions about what the consumer should invest in the buying process have been broken. Retail price is only one component of what it costs a consumer to research and acquire an item. Others include research time, travel time, gas, parking, effort, and frustration. Those costs add to the burden on traditional retailers – because they may "match the price" of an online retailer only to find they haven't come close to matching the consumer's cost to buy. The cost to the consumer of options has been dramatically decreased by technology, and the net result has been increased fragmentation of spend as consumer options come at a dramatically reduced overall cost.

   Many in the market argue that "the consumer has changed." But our interviews tell us that the consumer is still rational, and still evaluates the market for what they consider to be the most valuable offering. What has really changed is that competition has increased, and new entrants are offering the consumer many more options of increasing and differentiated value. The consumer is simply reacting to a new set of options.

   In this environment, "consumer-centric" can't be a motto or a gloss on old practices. It has to be a completely new way of operating.

The transformative strategies: What are the elements of the new operating model?



If retailers continue to operate with the traditional constraints that accompany a physical inventory mindset, they risk missing the opportunity of the new digital marketplace and leaving themselves at a fundamental disadvantage to the retailers who have broken those constraints – or never knew them to begin with.

Putting together a new retail merchandising operating model involves a major change across three components:

- Assortment – what I choose to sell?
- Placement – where I choose to "show" and "own" it?
- Fulfillment – how I choose to fulfill the demand?

Assortment: Must start with the customer, not channel or inventory.

Deloitte's *Navigating the New Digital Divide* research shows that in 2014, 49 percent of all in-store purchases had a digital influence, and that is projected to increase to 64 percent by the end of 2015. Using the customer lens means understanding the ways product categories differ and how that relates to customer desires. One interview summed up the opportunity well: "Retailers need to look beyond traditional product to adjacencies in products, services, content, and offerings." A retailer truly is able to set assortment and decide: "What should we sell? What does she want from us?" without limitations. This principle alone establishes a vastly different approach.

> *Deloitte's research shows that digital technologies influence 49 percent of in-store retail sales, a number likely to increase to 64 percent by end of 2015.*

The voice of the customer is not quiet.

More data exists than ever before to illuminate customers' preferences and the value they bring to the retailer. The customer is sharing and seeking information in new ways – and retailers need to learn to harness that information in building better assortments. In *Navigating the New Digital Divide*, 75 percent of consumers told Deloitte that product information found on social channels influenced their shopping behavior and enhanced brand loyalty. Winning retailers are infusing customer insight data and assortment analytics in an effort to create unique value propositions that align with their brands. They are also tailoring their approach by product category, as we know the digital influence varies by category.

There are a ton of variables," one retailer noted, "and currently it's hard to understand what the sales impact [of any one influence] truly is." Or, as another interview subject related from a different perspective, "I keep hearing, 'We didn't have a true view into the depth of demand.' This kills me! What have you been doing with all this demand planning?"

Product customization and assortment curation is becoming more important.

Successful retailers harness customer information to make thoughtful, data-driven assortment decisions instead of relying on intuition or past sales.

> *"We need to blow up the traditional role of the merchant, planner and allocator. Our issue is that the new model isn't completely clear, and many leaders don't yet recognize the need for radical change."*
>
> \- A retailer

This is giving rise to two key trends: customization and personalization, both of which create a conflict to this complex retail world we live in. The demands of the website to show more SKUs and broaden the assortment can conflict with the demands of stores trying to localize. All of which takes place in an omnichannel, "I can get it to you anytime, anywhere". Some retailers are looking beyond customer analytics and starting to rely on customers themselves, or the crowd, for opinions and suggestions on what products to carry.

In today's retail environment, customization can even extend beyond products. When they combine knowledge of what their customers want with flexibility in how they can respond, retailers can surround customers with an entire ecosystem of products, services, and partnerships that bring experience and loyalty to a new level.

Placement: Enterprise inventory is the new normal.

Inventory used to be tied to a specific channel and even a specific location. Many retailers are starting to enable enterprise inventory visibility, and the actual movement of inventory, across channels. And of course, inventory in today's new world need not be all owned. However, our interviews clearly showed that moving from enterprise visibility to enterprise management of inventory is a massive step, and one that few, if any, retailers have fully perfected. One retailer noted, "We were naïve in how much effort and trial and error making the leap would take."

The opportunity for retailers to optimize inventory can lead to increased sales, improved margins, decreased stockouts and decreased markdowns. Because inventory is one of the largest components on a retailer's balance-sheet, these improvements can create value. But perhaps even more important, they enable the retailer to fulfill anywhere, anytime the consumer needs. It is no surprise that the vast majority of omnichannel initiatives in the marketplace are primarily inventory sharing initiatives – because there is undeniable value. The bigger the retailer's inventory base, the bigger the opportunity. But as noted, the potential can be elusive.

Placement of product becomes a much more complex decision.

Thinking holistically means retailers have to determine what to hold in each store, what should be placed in the direct-to-consumer fulfillment locations, and what should be drop-shipped from vendors. The answer may vary by product, season, lifecycle, or location. The reality of this complexity is just starting to hit retailers, as many have just begun enabling various fulfillment options. As they go to anniversary them, armed with better information about actual demand, their organizations are asking: "Where should we place the product?" "What are we optimizing for?" "A year into it, our current business process and information do not support this level of complexity, but there is no going back!" Significant change is needed.

"Historically, the web channel was built discreetly because no one wanted to make the store operations more complex," one retailer noted. "No one wanted to spend millions of dollars on logistics, positioning, and how that store booked sales on a daily basis. Now the competitive landscape is clear. We have to figure out a way to make lemonade out of the lemons we have."

Inventory visibility and product data become vital.

This is an imperative, but a difficult one to fully grasp and even more difficult to master. One retailer told us, "We have no idea what stock is really on our shelves in our store at any given time." Store processes and technology may not have been designed to support this new requirement.

"Historically you had buying and planning," a retailer told us. "Now you need a new layer – one that takes into account virtual inventory."

Fulfillment: "Anywhere fulfillment" has become table stakes.

As part of the new merchandising model, the fulfillment model is changing fast. You can't extract the value of new assortment and inventory positions if you can't also find faster and more convenient ways to fulfill the orders. What used to be advanced in terms of buy online pick up in store, buy in store ship to home, and the myriad of permutations has become the new norm. And anyone who has attempted to fulfill from a store model knows this is no small undertaking.

> *"Given the increase in cross-channel sales, the concept of a channel as a business unit is rapidly evaporating."*
>
> \- An industry analyst

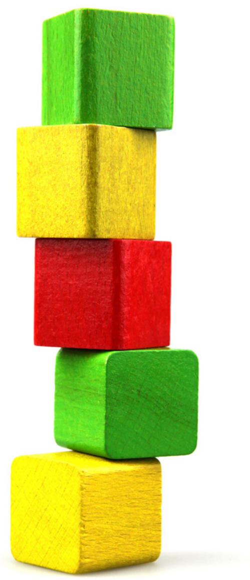
The new role of the store in fulfillment.

Each channel used to be responsible for its own fulfilment. Now retailers need to think of fulfillment more broadly. With smaller, more flexible players mushrooming, the larger companies need to exercise their advantages of scale and rethink the existing roles of stores. That means traditional retailers with a large physical footprint also have large fulfilment node networks – but they need to build this intelligence into their fulfilment systems for this to add value. One retailer told us, "We are attempting to build a fulfillment model that is a differentiator for us." The idea that store fulfillment is a critical component of the supply chain just may be a significant way to compete against online-only players.

Emerging expectations on delivery.

The race to solving the last mile to the customer has never been as intense. While flexible fulfillment options make it easier to satisfy customers by getting them their products, there is also the question of "speed" with new popular emerging options like same day delivery, recurring scheduled delivery, and even customer fitting via 3D printing all popping up in the marketplace. With so many "next big things" available to invest in, retailers need to be think about which supply chain capabilities are in line with their strategic objectives. Though it is clear that expectations are not the same across all products or customers. One retailer noted, "There will be a percentage of the population that will pay. But it really depends on the scenario."

How do I make it happen?



The challenge is that many do not know where to start, and there is a constant battle between performance in the here-and-now and the change that is required for the future. There is broad agreement among the merchandising pros we talked to on many of the things retailers need to do, but how they get there is where companies are struggling. At the highest level, the retailers we spoke to know there are several things that must change.

1. **Process overhaul:** The way you used to do things will not work
2. **Organizational structure:** Roles and structures must change…traditional boundaries must fall
3. **Approach to measurement:** Remove the traditional channel P&L and ROI approach
4. **Collaboration:** No longer an option for teams
5. **Leadership:** Alignment at the top is paramount

Many readers may look at this list and say: "Wow, this is massive." They won't be wrong. In order to move forward, retail decision-makers should ask themselves: *(1) What things are causing us the most pain – no assortment vision, two merchants, lack of fulfillment capabilities? (2) Where do we think we can create the greatest value and impact for our organization?*

Answering those questions will help to shape where to start. It may be with a focus on a specific capability area, or it may hinge on a certain category of the business. In any case, these five focus areas will likely be central to the effort. Our experience tells us that the answers are as different as the retailers in the market.

1. **Process overhaul:**

   The way you used to do things will not work. You need to fundamentally change the way you operate, which means more than just injecting new tools and technology into the established way of conducting business. Instead, embrace a new process of executing things, informed by new thinking and infused with leadership buy-in, to create a breeding ground for new capabilities and growth. How will you go to market? How will you make decisions on product? How will you plan your assortment, where will you place it, how will you fulfill it? Technology plays the role of enabler, but not the role of savior.

> *"We have to stop limiting ourselves based on how we operated last year."*
>
> \- A retailer

2. **Organizational structure:**

   Roles and structures must change and traditional boundaries must fall. Too many retailers are struggling to execute antiquated operating models. It simply no longer makes sense to organize around channels. The focus should be on sharing core capabilities to optimize touch points with customers – regardless of channel.

   – **The day of two-merchant organizations must end.** In most companies' operating models, channels still work as essentially separate entities. This does not work as well anymore. Smaller, niche companies are analyzing what the customer wants very intimately and are able to get it to them faster, cheaper, and better while giving them a splendid customer experience.

- **Re-evaluate traditional roles based on the capabilities they want to build.** The merchant as we know it must change. So must the roles we have known for years, such as "planner" and "allocator". Essentially all areas of the merchandising function at large must be re-evaluated. Merchants need to modify existing and potentially create new roles to support new capabilities such as fulfillment strategies, analytics, and others.

  "I don't think that we will have merchants, marketers and others anymore," one merchant told us. "There will be 'pods' of people. You need four people to move any decision forward, and you can't have collaboration without giving them the training to work that way. I don't think that large, mature companies even realize this need."

- **To deliver what customers want, retailers need to become nimble.** Customers, not goods, will be the focus of the modern retailer. Nimble organizations that can react quickly to create a better, seamless customer experience will likely drive customer lifetime value and win the future of retail. "What can you do to be aligned with lifestyle goals?" asks one retailer we interviewed. New organizational structures can give marketing, merchandising, technology, and analytics the freedom to design innovative solutions together. But organizations that need to build these capabilities shouldn't wait: "The people building this technology in the background are now being bought up," one retailer told us, "and there is more money being invested in it today."

3. **Approach to measurement:**

   Remove the traditional channel P&L and ROI approach. Retailers need to stop worrying about allocations that pit one channel against another. What is more important is how we are measuring brand-wide success and making business decisions. It no longer makes sense to incentivize people and drive decisions based solely on P&L channel performance, so the need to redesign reporting and incentive structures across channels is heightened. As we are making decisions on investments, retailers need to rethink the traditional ROI approach to have an omni lens, and include the digital influence on all channels. Remember how many in-store purchases are shaped by online experiences? That's one of many reasons for taking a fresh look at the KPIs that matter. Some of the past's signature metrics may not be important drivers any more. But redefining metrics can carry major implications for systems, talent, and rewards.

4. **Collaboration: No longer an option for teams.**

   The functional silos as we know them must come undone. The need for merchants to integrate with both their marketing and supply chain partners is paramount. Winning in retail today requires tighter planning and execution in these areas – from personalized emails through product placement and fulfillment. Some retailers are moving in this direction. As a start we see many using team integration or shared incentives in these areas.

> *"Every retailer I talk to says that the customer is ahead of them. Retailers are struggling with how much technology, where and what to invest in."*
>
> \- A retailer

5. **Leadership:**

   Alignment at the top is paramount. As in everything else, CEO sponsorship is vital to driving change. But many organizations have relegated these initiatives to the IT department, a myopic approach that perpetuates siloing. Customer-facing retailers have so much information that they're struggling to stay ahead of technology features and don't know how much, where, or what to invest in. That isn't a technology challenge – it's a leadership one that must start at the top to help ensure we break down those silos and move towards a common vision.

Conclusion

The end of an old business model and the rise of a new one is no longer just a hypothesis. Separate conversations with a large cohort of industry insiders, all of whom owe their livelihoods to how well they can anticipate the future of the business, bear it out. But knowing and doing are two different things, and change is never easy.

> *"We are spending a lot of time discussing the right strategy or the challenges it presents. Perhaps too much time. Now is the time to start moving."*
>
> \- A retailer

People should know that if they come to you for something, you can get it for them. Maybe on their doorstep. Maybe tomorrow. But they won't come to you in the first place unless you stand for something in their eyes. In short: Don't let the shiny new world of "I can" seduce you from a clear sense of "I should."

As a traditional retailer, you're accustomed to throwing your weight around. A thousand-pound steer has little to fear from a seven-pound piranha. The trouble starts if the piranha brings friends. They're small, but they're agile, hungry, and free to maneuver. This is what large retailers face today – a new assault from competitors at a completely different scale. You can get out of the water, or you can learn how to bite back.

"I think this is a radical transformation of organizational model" one of our interviewees said. Because of the pace of competition, this time retailers need to revolutionize, not increment. "Someone is going to figure it out. And it will be good news. The question is who will be around to celebrate the success?"

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