Global Retail Expansion: A Recipe for Creating Shareholder Value?

Measuring the potential shareholder benefits of global expansion and understanding the drivers of value creation

May 2013

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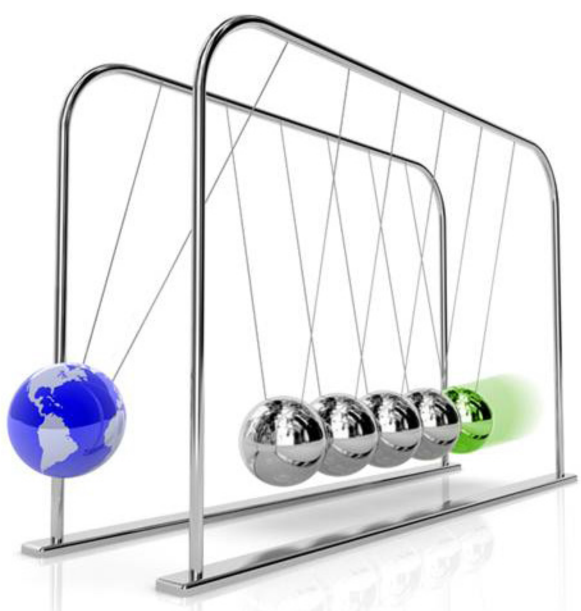
Introduction

Given the mature state and slow growth of the North American retail environment, global expansion has become one of the hottest growth strategies explored by leading retailers. Gaining access to new customers and untapped markets offers an alluring opportunity to drive new sales growth. In order to expand into new countries, companies use a variety of strategies, such as brand acquisition, strategic partnerships, wholly-owned expansion, or eCommerce-enabled shipping. Before developing their global strategy, however, retailers should understand their unique value proposition, operational capabilities, and organizational structure.

International expansion is hardly a slam dunk – but with a carefully thought out strategy, it can be a recipe for value creation



Global expansion requires a well-thought-out strategy and roadmap for execution; selection of the correct markets where the retailer's merchandise and brand can most closely resonate with customer needs; determination of effective entry method given the stage of expansion; and development of an operating and governance model that can support global operations. In determining whether to expand internationally a few questions arise:

- While expansion can create opportunities to grow sales, does it also generate shareholder value?
- What are the drivers of shareholder value creation (or destruction)?
- What factors should be carefully considered before embarking on global expansion?

To answer these questions, Deloitte analyzed 87 North American-based specialty retailers over a 10-year timeframe. The companies evaluated present a mix of domestic and international exposure, and fall within a variety of retail segments including apparel, home improvement, automotive, computer and electronics, home furnishing, and specialty stores. Deloitte analyzed the retailers across several different financial metrics including enterprise value, total shareholder return, earnings, and EBITDA margin, expecting to find that retailers with a global footprint generally outperformed those that remained domestic. Instead, the analysis yielded surprising results that could carry significant implications for retailers considering international expansion.

Findings

The analysis indicated that over a ten year period, North American specialty retailers who remained focused exclusively on creating enterprise value growth in the domestic market delivered values that grew about 50% faster (3.9% ten-year CAGR for domestic-focused retailers versus 2.6% CAGR for international retailers) and total shareholder returns that were 20% higher than retailers with an international presence (see Exhibits A and B). At the same time, while EBITDA % of Revenue fell across both groups, retailers with an international presence experienced a smaller decline (see Exhibit C). These findings were surprising, but when examined more closely, can be explained by three potential hypotheses.

Exhibit A: Int'l vs. Domestic Enterprise Value Comparison

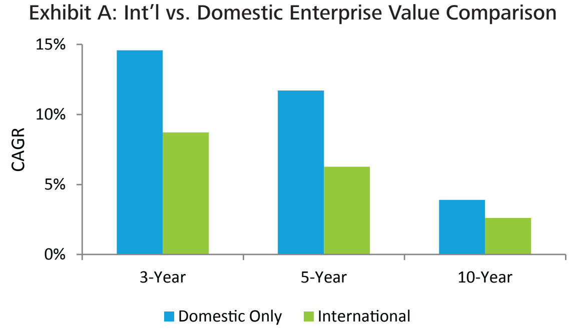


Exhibit B: Int'l vs. Domestic TSR Comparison

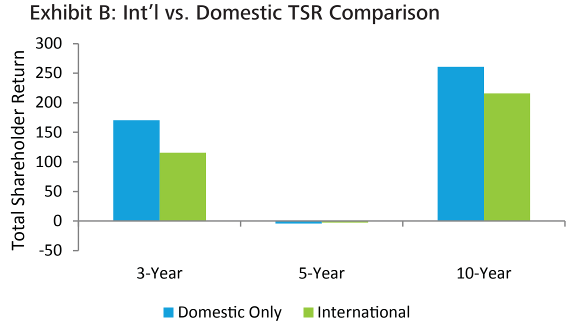
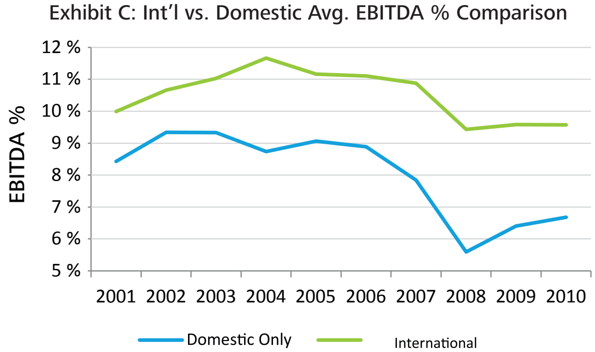


Exhibit C: Int'l vs. Domestic Avg. EBITDA % Comparison



1.'Lifting and shifting' domestic operations without understanding and adapting to local market trends and consumer tastes

In addition to defining an operating model that enables retailers to address local market needs, retailers should incorportate the core values and culture of the organization. Maintaining a consistent corporate culture can be extremely tough when there is more than one office in the U.S., let alone with additional offices overseas. Collaborating to implement key communication, governance structures, and reward mechanisms provides consistency among the overseas and domestic operations, and facilitates exportation of the organization's core principles.

Another potential challenge is the retailer's ability to not only understand international consumer preferences, but also effectively translate their brand and value proposition to new markets. Frequently, retailers believe their brand will resonate in all markets in the same fashion and thus fail to adapt to unique needs and preferences. For example, when one luxury retailer entered Europe, they chose to sell the same handbags that were so wildly successful in the U.S. However, the company did not recognize that U.S. female shoppers typically prefer bags that are larger and carry more items than their European counterparts. In Europe, females walk more frequently and thus desire smaller handbags to wear on their shoulder. Despite the planning involved, the retailer strategized around off-base underlying assumptions. In another example, a fast-fashion retailer found that in China, the retailer could not sell men's green hats or summer dresses with playful daisies, as the phrase "wearing a green hat" refers to a cuckold and white flowers are associated with death in China.[1]

These examples highlight the importance of understanding the market and defining the operating model that addresses each market's unique challenges that are critical to global expansion. Retailers should recognize local market preferences and evaluate how to adjust messaging

1 *With Vivian Chen, H&M* is Adapting Western Fast-Fashion for China, Advertising Age, July 22, 2012

or product offering to appeal to that customer base, without compromising the integrity of the brand. Retailers should also determine whether to customize their products and design for local markets, not customize them at all, or find a compromise between the two. All three scenarios have allowed many retailers to meet their goals in the past, so it is important for retailers to understand which strategy makes the most sense for their brand, value proposition, operating model, and strategic goals.

2. Investors place a higher cost of capital on international retailers due to increased risk

Conventional wisdom suggests that companies operating in multiple markets are able to diversify their market risk. Investors' actions, however, indicate that they believe the extra complexity and resources it takes to run a global business might outweigh the benefits of diversification. The fact that international retailers outperformed domestic retailers in EBITDA (see exhibit C), yet underperformed in total shareholder value or enterprise value growth, demonstrates that investors are placing a higher discount rate on global retailers' returns. However, the story is not bleak for all that expand – some international retailers in the sample did see consistent increases in total shareholder return over the ten years, likely because they were able to reduce the risks involved with expansion while significantly improving their top and bottom line financial results. These retailers spanned across all segments, indicating that their performance drove the shareholder value increase and not a particular segment's performance. It makes sense that investors may also favor domestic retailers due to their potential for high growth rates in a familiar market. Domestic-only retailers are typically smaller and in a less mature stage. As retailers consider global expansion opportunities, they need to understand how their business models will translate to the global market, how much additional risk they will be taking on in order to expand, and what they can do to increase the return on their significant investment required for expansion.

3. Emphasis on efforts abroad causes the retailer to lose focus on their core business in the domestic market

One reason investors may place a higher risk premium on retailers who expand abroad could be due to a tendency for retailers to lose sight of their core business as they start venturing abroad. One of the key challenges that organizations may face as they embark on international expansion is how to organize their teams to support global growth while not distracting from the core business operations that made the company successful in the first place. The delicate balance between the two requires a targeted operating model with a clear roadmap to achieving that model which considers the various phases through which the retailer will grow. Even well-developed plans can run into setbacks as competitors become more aggressive and sense opportunities to capture market share. Recently, a U.K. based multinational grocery chain announced plans to exit the U.S. market after accumulating five years of losses. The retailer had spent 20 years considering a move into the U.S. market and sent their 'A-team' from the U.K., which left their 'B-team' to run U.K. operations. Since then, the brand's image in the U.K. has taken a substantial battering, a result of an investment in British stores being put on the back burner.[2] While building out an operating model and detailed roadmap requires valuable time that may delay expansion, it provides the opportunity to consider their core business in tandem with an international business. Early identification and establishment of an appropriate operating model may save retailers significant cost and wasted time verses if they had otherwise not planned to this degree.

While the domestic operations may be compromised by focusing on international expansion, the evolving tastes of the core customer in the domestic market may also be overlooked. As trends and styles continue to evolve, retailers should evolve their offerings to keep pace with changing demand. Recently, a luxury jewelry retailer

2 *Fresh But Not So Easy,* The Guardian, December 8, 2012

reported lower than expected quarterly earnings, in large part due to a nearly 10% dip in sales at their prominent U.S. flagship store. The company has aggressively expanded into Europe and Asia-Pacific, so while some may assume those international stores have cannibalized the tourist sales in the U.S., the retailer said the drop in sales was entirely due to lower spending by locals.[3] While the economy plays a part, analysts fear that the weakness has also been a result of poor execution and product assortment by the retailer in the U.S. – a loss of focus on their domestic customer.[4]

Retailers interested in expanding internationally should be prepared to dedicate intense focus and substantial resources. Retailers should not lose sight of their domestic operations, competitors, and customers, and should maintain focus on the organization's ability to consistently address domestic requirements in parallel with the growth opportunities overseas.

3 *Tiffany Expects Pressure on Profit to ease,* Reuters, August 27, 2012

4 *Tiffany Struggles But Its Outlook Isn't That Grim,* Seeking Alpha, August 29, 2012

Learning from the Early Movers

Learning how some retailers have increased shareholder value is just as important as understanding why others have not because when international expansion is executed in a strategic and methodical manner, it can offer substantial benefits. Being cognizant of the various reasons why retailers that expanded abroad experienced on average a smaller gain in total shareholder value can enable retailers that are considering international expansion to avoid those same pitfalls and create positive value for their shareholders. Retailers should consider the following when looking at expansion opportunities.

Target Complementary Markets

To reduce risk, retailers should consider market opportunities where common infrastructure can be leveraged and consumer tastes and cultural tendencies (e.g., language) are relatively similar. A leading fashion retailer recently opened a bridal boutique in Japan, where several red dresses were added to the collection to address local preferences; there are subsequent plans to open a Shanghai and Hong Kong boutique if the retailer considers the strategy in Japan a success, as these markets share similar tendencies in consumer tastes within the bridal segment.[5] Similarly, retailers could consider entry into Hong Kong and Singapore where Western styles are more accepted before expanding into nearby markets such as mainland China in order to learn about the local markets.

Targeting complementary markets can provide important lessons to retailers that can help them shape their strategies for expanding into more unfamiliar markets. By solving some of the operational, organizational, and legal issues from expanding into more familiar markets, retailers can reduce the number of unknowns as they embark on more complex expansion efforts.

Understand the Competitive Landscape

Retailers can also mitigate risk by differentiating themselves from the local competition. In Australia, two local competitors traditionally controlled the grocery market and competed to own market share primarily through price. The landscape is becoming more competitive and dynamic, however, as large international supermarket chains enter the scene. A large American wholesale club attempted to be the third major supermarket giant in the market, differentiating themselves by operating on a membership strategy and selling in bulk.[6] Often, companies will underestimate the local competitors when evaluating the attractiveness of a market. Considering potential responses by competitors and developing mitigation strategies in advance can enable expanding retailers to stay ahead of the competition and increase their chances for enhancing shareholder value. Identifying markets where the local competitors offer a different experience could create an opportunity for retailers to enter with a unique value proposition that local competitors may not be able to match. The critical question to understand is whether customers will react favorably or unfavorably to the new value proposition. Understanding the local customer preferences is essential to understanding how to position relative to local retailers.

Develop a Roadmap for Implementing a Global Operating Model

As the global economy has changed, many retailers have failed to adapt their operating models to the global retail market that exists today. Transitioning from a U.S.-centric operating model to a global operating model can require an organization to consider the trade-offs between a centrally driven model and local responsiveness. Various factors can influence this decision, such as brand equity, variance in customer tastes, desired flexibility, and price pressure from competitors. Expanding globally creates more 'moving targets' where decision-making, operational flexibility, risk communication, and maintaining brand

5 *Vera Wang Unveils Japan Bridal Boutique*, Women's Wear Daily July 10, 2012

6 *Costco Attempts to be 3rd Major Supermarket Giant in Australia,* International Business Times, July 19, 2012

integrity can be challenging. A well thought through operating model supports the retailer by establishing and maintaining a strategic direction that they feel may be most important for their organization. Note, however, an operating model may vary depending on the stage of expansion. Retailers should understand how the operating model should evolve as they grow and develop a roadmap accordingly. Having a plan that considers the next few stages of growth may help the evolution be consistent and cumulative, while positioning each phase of their expansion efforts to be impactful.

Determine a Leading Method of Market Entry

The entry method is also an important consideration when entering a new market. Retailers should balance between speed and control when determining the preferred approach for their business model. Each of the three primary market-entry methods – franchising, joint venture, and owned expansion – present trade-offs between speed and control. Selection of one of those methods will be influenced by multiple factors, including level of investment, time to payback, brand control, customer expectations, and internal capabilities, among others. No one strategy works for all retailers or all markets.

Recently, a Spanish apparel retailer described its flexible expansion model, opening small 1,000 sq. ft. stores in airports, large 15,000 sq. ft. stores in Paris, London, and Barcelona, and partnering with a department store retailer to provide their products in cities where the retailer could not afford to be otherwise. The retailer considers each market uniquely, adjusting their product to meet the needs of the market without losing the brand's identity, particularly in China, a country of many unique markets.[7]

Retailers need to weigh the tradeoffs between different entry methods and decide which method or combination of methods makes the most sense for their brand. For further guidance on market entry methods, refer to *Retail Global Expansion: Determining Your Method of Market Entry* which delves into speed and control trade-off through the concept of *The Control Continuum.*

Understand the Economic and Regulatory Environments of Potential Markets

As retailers look at potential markets, they should consider the impact of economic and regulatory factors such as foreign exchange rates, taxes, new regulations, and the political environment. While in the past few years, China has been able to sustain high luxury sales amidst a generally stable economy, leading indicators (such as interest rates, gas prices, and surging housing prices) have warned of further economic slowdown causing retailers to potentially think twice about expansion into the country.[8] Real estate prices have also become a major concern in Hong Kong, where rent has risen to levels comparable to those on New York's 5th Avenue and as a result has chased away major retailers.[9] Anticipating these challenges and having a strategy to address them can signal strength to investors and in turn help increase shareholder value.

7 *Mango Executive Shares Global Expansion Insights,* NRF Blog, January 3, 2013

8 *China's Premier Warns of Economic Slow Down,* Associated Press, July 8, 2012

9 *Hong Kong rents rivaling 5th Avenue Chase Retailers Away,* Reuters, July 24, 2012

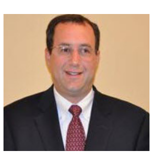
Conclusion

Global expansion is not a passing fad. As more and more retailers take advantage of international markets, global expansion might not just be an option, but may become a requirement. International expansion can present a significant opportunity to many retailers looking for new growth drivers. Luckily, there are numerous examples to learn from and with some well-thought-out plans and execution, future retailers might be able to avoid the pitfalls that their predecessors have faced thus far.

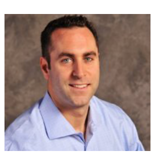
Findings show, though, that U.S. retailers who have taken their companies abroad have not necessarily always fared well. Choosing to go global is not a guaranteed solution for effective growth and development of shareholder value. All first movers may provide key learnings that should be carefully considered by retailers considering global expansion. Even expansion into "safe" markets such as Canada can produce complexities, including higher prices for typically low cost retailers due to fewer economies of scale, higher import duties, and higher gas prices.[10] While many expansion efforts have not been accretive in shareholder value creation, there are numerous examples of retailers who have seen exceptional returns from their efforts. What sets them apart from the failed attempts are well-developed strategies and execution. Creating a plan that incorporates the nuances of each market and provides methods for reacting to unexpected challenges, is a fundamental aspect of global expansion. Retailers should seek to understand their unique circumstances and how to leverage their strengths to drive effective growth abroad. Entering new markets adds complexity and significant strain on the organization, so it is recommended that retailers take a well-thought-through approach to market selection, entry method, and the development of a global operating model in order to deliver value to shareholders. A well-developed roadmap and executable strategy are two keys to growth abroad. The retailers that can achieve this can deliver improved shareholder value creation, outperforming the typical return retailers have seen thus far.

10 *Canadian-U.S. Price Gap*, The Globe and Mail, August 23, 2012

Co-Authors

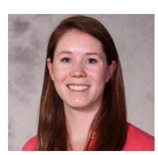


Rob Grossman
Principal
Deloitte Consulting LLP
rgrossman@deloitte.com
+1 212 492 4219

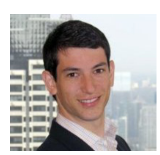


David Nakashian
Senior Manager
Deloitte Consulting LLP
dnakashian@deloitte.com
+1 917 557 1356

Contributors



L. Summers Nelson
Consultant
Deloitte Consulting LLP
launelson@deloitte.com
+1 816 686 8609



Jared Olkin
Consultant
Deloitte Consulting LLP
jolkin@deloitte.com
+1 919 624 0117