

## Foundation for success: Restoring and leveraging the physical store's competitive advantage

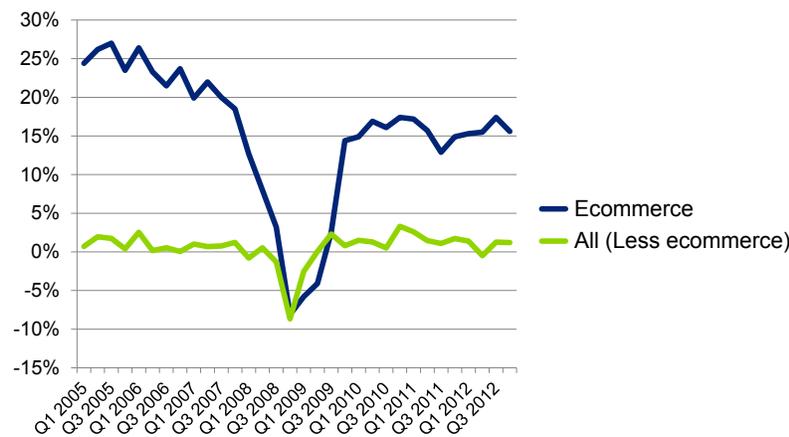
Before the advent of ecommerce, the real estate industry's mantra of "location, location, location" held particular relevance for retailers, who leveraged a store's "convenient location" as a competitive differentiator. As consumers have increasingly embraced the benefits of online shopping – 24-hour access, an unlimited array of products, and compelling prices – convenience has become commoditized. Retail real estate that once was an asset is becoming a liability, with significant risk of further decline. Some big box retailers, particularly those in segments with little product differentiation, have been among the first to feel the fallout: In the past few years, Circuit City, Borders, and CompUSA have gone bankrupt. As traditional retailers view the exponential growth of online competition they may wonder: Are traditional brick-and-mortar stores doomed to become quaint, irrelevant relics; outflanked by the immediacy, economy, and ubiquity of digital storefronts?

Deloitte proposes a different scenario: Physical stores are here to stay, and they are more important than ever in their ability to connect the customer to the product and deliver the full brand experience. However, retailers must reconsider how to most effectively use their store footprint to regain omni-channel competitiveness and restore financial performance.

### Online sales growth outpacing traditional retail

Over the last 10 years, online retail sales growth has dramatically outpaced that of traditional retail channels (e.g., brick-and-mortar [BAM] stores, catalogs, etc.). And while the recent recession hurt all retail sales, online retail growth rebounded more quickly and once again is outpacing traditional retail (Figure 1).

Figure 1: Year-over-year quarterly sales growth: Ecommerce versus traditional retail

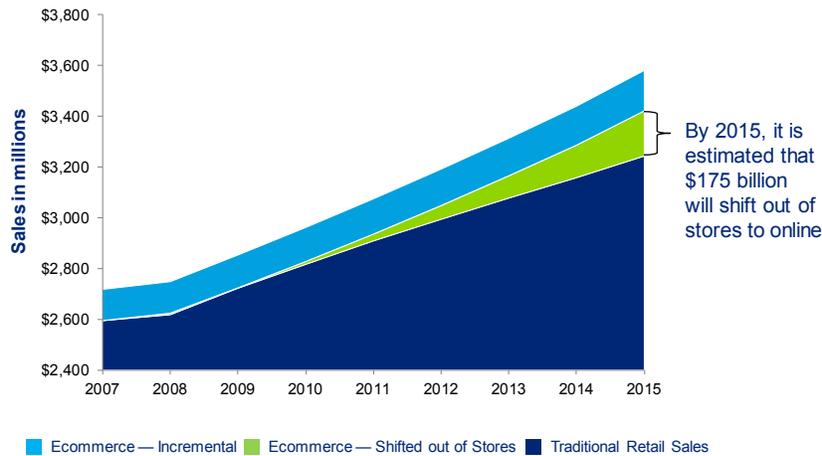


Source: U.S. Census (Quarterly ecommerce reports, Monthly Retail Trade reports)

While some online retail growth is incremental new business, much of the online sales volume is the result of consumers redirecting part of their purchases from BAM stores to online. In light of this trend, there is growing concern among retailers about managing their current physical footprint to maintain traditional profitability levels and to regain a compelling competitive advantage as BAM stores establish their place in today's retail reality.

According to Gartner, the overall retail market is forecasted to grow between three and four percent through 2015. Mail/catalog orders – once the main competitive channel to in-store sales – are expected to decline at six percent CAGR; BAM stores are forecast to stay steady at three percent; however, as expected, mobile/electronic commerce will outpace physical store growth by five times (15 percent).<sup>1</sup> The projections for ecommerce growth to dramatically outpace traditional retail channels portend a dramatic shift in consumer shopping habits and corresponding sales volume over the next few years. Deloitte estimates this shift to be approximately \$175 billion annually by 2015 (Figure 2). As a result, retailers will need to understand the implications for their physical stores, reevaluate their overall store strategy, and adjust their physical footprint accordingly.

**Figure 2: Ecommerce sales are reshaping brick-and-mortar economics**



Source: Multi-channel Forecast for the U.S. & UK. Gartner Oct. 2011 (U.S. only), Deloitte Analysis

The sales shift across retail channels can have both financial and strategic impacts: As a store's sales volume decreases, short-term profitability will be directly affected, given that staffing levels, rents, and SG&A costs will generally hold steady, especially as most locations are locked into 10- or 15-year leases. Sales per square foot (SPSF), one of retail's most traditional and widely accepted performance benchmarks, will take a direct hit; operating margin and sales per labor hour also may be significantly affected. The strategic impact comes from the declining value that consumers place on the store and the retailer's resulting efforts to reimagine and repurpose their physical space to deliver a new, compelling in-store experience.

Some retailers have begun reacting to the sales shift by building smaller-format stores, decreasing square footage, and adjusting to smaller footprints. (Since ecommerce sales volumes have affected formats and categories differently, the range of excess square footage may depend on the retailer.) Deloitte analyzed a sample of top retailers to try to help translate the sales shift into an estimate of potential square foot reduction needed to regain traditional profitability levels. The analysis reviewed past and current performance, calculated three-year growth rates, noted current ecommerce revenues and forecasted marginal growth rates, and analyzed store footprints and SPSF. In some cases, a certain retailer's BAM sales are rising — and will continue to do so — so in-store growth was factored against the ever-increasing ecommerce projected sales to calculate the "shifted" sales number — the estimate of online sales that arguably would have previously come through the physical channel.

<sup>1</sup> "Multi-channel Forecast for the U.S. and the U.K.," Gartner, October 13, 2011

Based on Deloitte’s analysis, department stores may have up to nine percent overcapacity by 2015, with specialty retailers up to 15 percent — due to the type of products many sell and those products’ comparative sales volume online. However, another complexity should be added to the mix: While some retailers have been proactive and reduced their footprint, others are behind the times. Those retailers who have not yet reduced their footprint are already operating at excess capacity and are only going further down that road. These retailers are looking towards 2015 with even greater excess capacity — potentially up to 25 percent for department stores and 35 percent for specialty retailers.

### No silver bullet to improving store performance

When building a strategy to improve the performance and competitiveness of BAM facilities in an omni-channel retail marketplace, there is no silver bullet – each situation is unique. However, looking holistically at a specific ZIP code or defined geographic region, the retailer’s response to some pointed questions may help determine how to proceed:

- **Customer experience:** What are the customer’s expectations of an in-store experience? Does the customer expect immediate product receipt, or is the in-store visit designed more for experiencing product, browsing options, and ordering for same- or next-day delivery? How is the customer experiencing the brand across the retailer’s other channels? How is that experience shaping in-store expectations?
- **Competition:** Who are, and will be, the competitors most impactful to the retailer’s BAM business? How will this competition be felt — regionally, globally, across certain product categories or across the entire store?
- **Marketing efforts:** What effect is the retailer’s marketing efforts having? How well is the retailer able to reach the customer given new and improved marketing and analytics?
- **Logistics:** How is the retailer managing its supply chain, given new multi-channel fulfillment requirements? Are stores becoming mini fulfillment centers? Are stores increasingly able to leverage enterprise inventory to reduce back-of-house inventory requirements?
- **Economics:** What is the retailer’s economic outlook given the macro environment? How is the store performing compared to the target sales for the ZIP code/geography?

### Leveraging the power of a physical presence

Deciding whether to eliminate, reduce, or maintain a retail location can be a complex process with many factors to consider. Defining and tracking sales metrics and forecasting trends will be critical to understanding the impact on overall profitability the shift to online channels may have. Many retailers will need to respond in the short and long terms to compete in the new omni-channel reality and recover traditional profitability. As they weigh their options, retailers may reduce and reinvent, as well as reimagine and repurpose. For example, consumers seek a shopping experience that is personalized, convenient, and consistent. Since online shopping is generally perceived as having the edge in convenience, traditional retailers should consider a strategy that leverages a BAM store’s greatest advantage over ecommerce: the ability to deliver a superlative, personalized customer experience. Retailers can leverage this advantage by identifying opportunities to use their existing store infrastructure to attract customers to the brand, increase conversion rates, and build loyalty (Figure 3).

**Figure 3: Options for enhancing return on store infrastructure**

Attract customers to the brand	Increase conversion rates	Build loyalty
<ul style="list-style-type: none"> <li>• Create an experiential destination</li> <li>• Develop a store-within-a-store</li> <li>• Establish the brand as a beacon</li> <li>• Extend into new categories</li> </ul>	<ul style="list-style-type: none"> <li>• Own your own “showroom”</li> <li>• Enhance store talent</li> <li>• Offer flexibility and convenience</li> </ul>	<ul style="list-style-type: none"> <li>• Focus on customer service</li> <li>• Excel at personalization</li> <li>• Expand into new brands</li> </ul>



#### *Attract customers to the brand*

- **Create an experiential destination:** Setting aside in-store space that is configured to entice customers to try specific products has long been a retail tactic. Real differentiation, however, comes from providing an experience that showcases the product without making it the focus. REI, Bass Pro Shops, Nike, and Guitar Center are a few brands that have pursued this strategy with success.
- **Develop a store-within-a-store:** Retailers with excess space, or who simply have a desire to augment their existing product portfolio, might consider looking into the store-within-a-store concept. This could be a play to bring complementary products or services into the store (e.g., hair salon, eye care) or a chance to partner with another entity to differentiate in the market. J.C. Penney has started to revamp its existing store locations from a typical department store concept to one with “shops” or individually branded spaces,<sup>2</sup> such as the one for cosmetics retailer Sephora. Sears has been very successful with its Lands End partnership, as well.
- **Establish the brand as a beacon:** Using BAM stores strictly for their marketing benefits likely does not justify the overhead. However, physical stores can bring a brand to life in a multisensory way not possible through a digital screen and serve as a visible brand beacon. Victoria’s Secret has long been an attractor within malls and commercial centers, driving traffic into the stores for initial and repeat visits, and reinforcing customers’ online purchases. Apple’s retail stores provide another excellent example of attracting foot traffic through a complete brand experience.
- **Extend into new categories:** Some retailers have shifted excess store capacity into new categories that will drive traffic, even creating new concepts or formats to specifically emphasize those traffic-drivers. For example, Walmart, Target, Walgreens, and other retailers have added fresh produce and grocery sections in some stores, delivering convenience to the customer and reducing the number of stops on the way home from work. As another example, The Home Depot has added household cleaning products to its stores to capture incremental sales.

<sup>2</sup> “J.C. Penney Carves Stores Into Mini-Boutique Shops,” The Huffington Post, July 25, 2012. ([http://www.huffingtonpost.com/2012/07/23/jcpenny-shops-mini-boutiques\\_n\\_1695630.html](http://www.huffingtonpost.com/2012/07/23/jcpenny-shops-mini-boutiques_n_1695630.html))

<sup>3</sup> “Best Buy’s Earnings: Still Facing Showrooming And Product Mix Challenges,” Forbes, November 19, 2012. (<http://www.forbes.com/sites/greatspeculations/2012/11/19/best-buys-earnings-still-facing-showrooming-and-product-mix-challenges>)

<sup>4</sup> “Amazon’s Showrooming Effect And Quick Growth Threaten Wal-Mart,” Forbes, September 27, 2012. (<http://www.forbes.com/sites/greatspeculations/2012/09/27/amazons-showrooming-effect-and-quick-growth-threaten-wal-mart/>)

#### *Increase conversion rates*

- **Own your own “showroom”:** One of the most publicized threats to physical stores from online retailers has been “showrooming,” in which customers explore options in-person then go online to purchase their selections at lower prices. This has been a large factor in the decline of big-ticket electronics sellers.<sup>3</sup> It is even a practice that Amazon encourages, which prompted both Walmart and Target to pull Kindles from their shelves.<sup>4</sup> Retailers can do more to convert their in-store traffic and discourage mobile price shopping, or at least funnel digital shoppers to their own channels. Many have started by increasing the “show” in their space, enhancing displays to better feature key products. A more direct approach is to offer alternatives to mobile lookups. Stores can arm floor staff not only with training, but also with tablets, to offer customers a guided tour through third-party reviews, in-stock information, and even mobile point-of-sale, complete with shipping options. Finally, packaging in-store product with additional services, such as delivery or installation, provides additional incentive to buy from the store.
- **Enhance store talent:** Akin to arming floor personnel with tablets and training, retailers can differentiate their physical presence by touting their sales force’s expertise to guide shoppers through the purchase decision, providing both factual information and objective insights on the functionality and applications of product features. This approach may require enforced transparency to negate potential customer perceptions that these associates may have a hidden agenda to sell specific products or features.

- **Offer flexibility and convenience:** Integrating a physical presence with robust online capabilities, such as flexible ordering and fulfillment, offers traditional retailers a customer-friendly option to utilize excess floor space by turning it into distribution capacity. This combination provides flexibility and convenience by giving customers the ability to make purchases through their preferred channel and receive product at their most convenient and timely location. For example, a shopper could make a purchase in the store or online using a computer or mobile device and have it delivered to their home or pick it up in a store of their choosing. This approach uses stores as fulfillment centers, retaining both the convenience of purchase-anywhere technology and the immediacy of in-store pickup. As this method expands, many retailers may need to evaluate their store and distribution footprint holistically; ideally, with analysis that also layers in online sales by geographic distribution, to fully understand the gaps and cross-channel cannibalization risks associated with changes to their physical locations.

### ***Build loyalty***

- **Focus on customer service:** Well-informed floor personnel who can offer genuine consultative support and a focus on relationship-building enable a retailer to use its physical footprint as a differentiator. However, exemplary customer service needs to extend beyond the sales staff to post-sale support, contact centers, in-store wayfinding, and other personnel to make the in-store and post-purchase experience one that customers want to repeat.
- **Excel at personalization:** Along the lines of enhancing customer service, it will be imperative that retailers capture, aggregate, and leverage shopper data to help personalize the customer experience. Online retailers have excelled at leveraging such information to make purchase recommendations. Retailers with a physical space should match that focus and add an omni-channel perspective that the online-only shops do not have. This will contribute to a richness of information that can support a differentiating level of customization. The information can also feed into geographic footprint planning by incorporating customer insights mapped against block-level demographics to target specific locations and match them with the right brand, format, and assortments.
- **Expand into new brands:** Personalization can also take the form of refining brand targeting and launching brands focused on adjacent segments. While many retailers may be considering scaling back the number of stores within their footprint in response to an increasingly online retail world, others, such as American Eagle (Aerie), have launched or rebranded spinoffs that enable more specific customer targeting, not only for the spinoff, but also for the legacy brand. The end result for total footprints may mean market contraction but not necessarily contraction by total store numbers.

### **The path forward**

As retail sales continue to shift out of stores, retailers will increasingly need to reevaluate their overall store strategy. Retailers should view their options through the eyes of their customers, focusing on using real estate to attract, convert, and build loyalty. A suggested path forward is to:

- Identify and qualify evolved customer expectations and competitive pressures
- Develop a holistic strategy for channels and enhanced customer experiences
- Measure current and projected shifts of sales volume from traditional to online, and assess impact on traditional operating margin and profitability
- Assess real estate position – e.g., the number of stores and their size
- Develop a real estate strategy led by the customer experience to be delivered in stores
- Manage existing locations: Select from the menu of options to reshape the store experience
- Project future stores: Develop new formats and forecast continued pressures

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