



RETAIL

The Evolution of Retailing: Reinventing the Customer Experience

KPMG LLP

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INTRODUCTION

The contracting global economy, advances in technology, a proliferation in the number of shopping channels, and an increasingly well-informed and mobile consumer base are altering the means, modes, and manner in which consumers shop.



As consumers change so must the industry. The retail sector that emerges over the next five to ten years will likely be far different than at the beginning of the century—marked by greater innovation, integration, and responsiveness. Yet getting there is no easy task. Signs of recent fallout include high-profile bankruptcies such as Circuit City, Linens 'N Things, and Mervyns; consolidation in the chain store footprint; and extreme pricing pressures.

The result of such upheaval is a sharp reappraisal of the traditional retail industry business model. With disruptive innovation comes systemic shifts.

Those taking place in the retail sector reach deep into the industry's structural foundations, rocking everything from how the industry sources its products, to how it markets, to an increasingly fragmented demographic. While the dust has not fully settled, the outlines of the 21st century retail model are beginning to take shape.

Produced by the Retail practice of KPMG LLP, this paper examines the key trends that are actively shaping the industry landscape, discusses their implications, and offers perspectives on how companies across the sector can make the necessary transition.

Current State



This section offers a brief historical context for the retail industry, examines the macro-economic challenges that have tested it in recent times, and the role of the consumer in leading the next wave of disruptive innovation.

Newspaper accounts bring daily banner headlines about an industry in the throes of change. For some, business models and financial practices that have stood the test of time for many decades are now under siege. Even the most resilient retailers have felt the strain of rapidly deteriorating market conditions, and have worked to find new ways of satisfying an ever more fragmented and value conscious consumer base. Among the most pivotal economic challenges affecting the industry today are:

Weakened consumer spending and cautious consumer attitudes

The recessionary environment that gripped the world's economy for most of the last 24 months has stripped away jobs, eroded home values, frozen credit, and dealt a blow to personal investment portfolios. This, not surprisingly, has constricted consumer spending in major markets across the globe. In 2008, the rate of private consumption expenditure growth declined in France, Germany, United Kingdom, Italy, Russia, Canada, and the United States. (see Exhibit 1).

Within the United States, the Federal Reserve has suggested that the world's largest economy is not yet out of the woods. In October 2009, U.S unemployment rates rose to 10.2 percent, the highest rate since April 1983.¹ The gross domestic product, the broadest measure of the nation's economic activity, recorded a negative growth of 0.7 percent in Q2 2009.²

Exhibit 2 shows a gradual easing in consumer anxiety from the sharp levels witnessed in 2008, perhaps hinting that the bottom may be near.³

Exhibit 1: Growth in Private Consumption Expenditure (2007-2008)

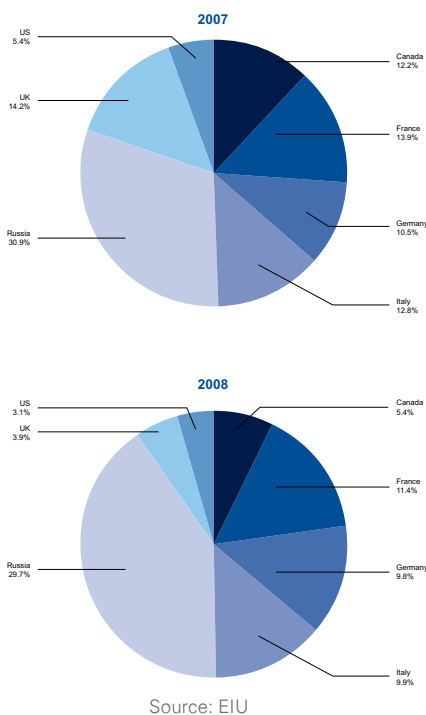
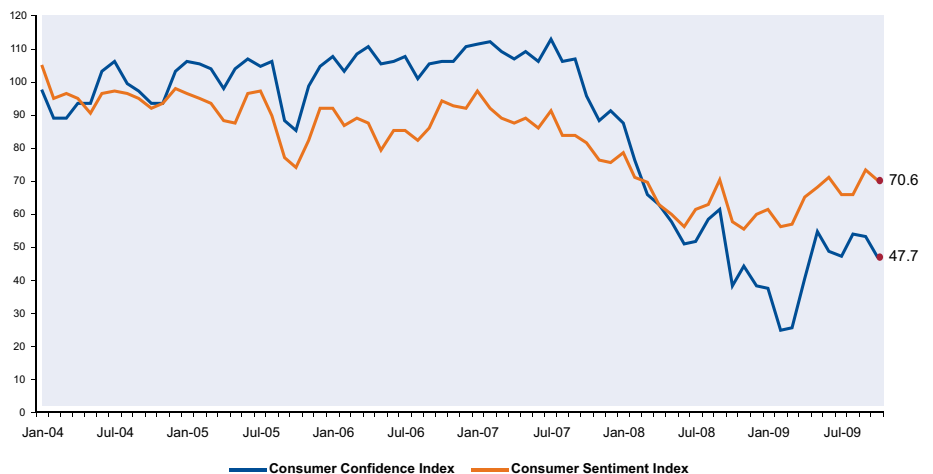


Exhibit 2: Consumer Confidence Indices



¹ Bureau of Labor Statistics, Employment Situation, October 2009

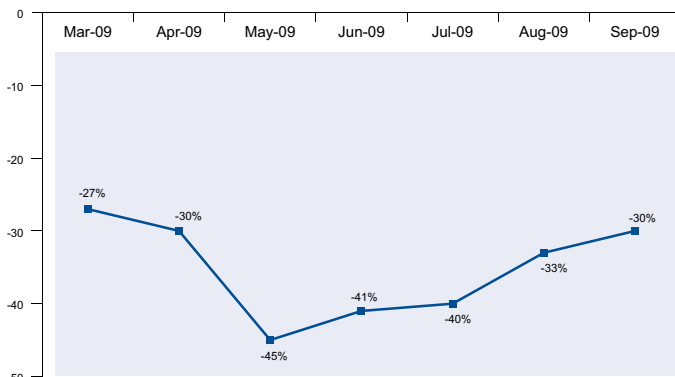
² Bureau of Economic Analysis, GDP, Q2 2009 Revised Estimates

³ "U.S. Economy: Consumer Confidence Down on Job Concern (Update1)," Bloomberg, October 27, 2009
 "U.S. Michigan Sentiment Index Fell to 70.6 This Month (Update1)," Bloomberg, October 30, 2009



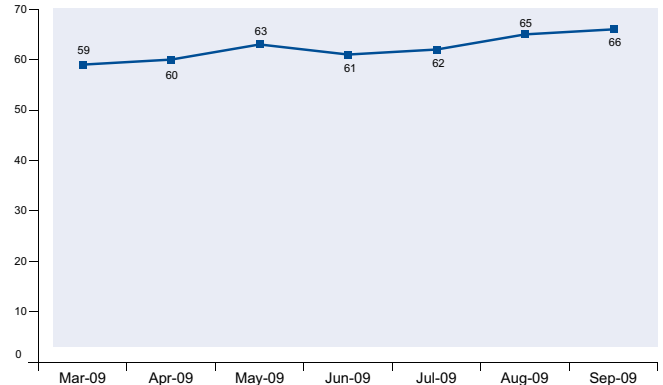
But although the mood may be less sour, consumer confidence remains at historically low levels. And consumers are still clutching their wallets. According to the same Gallup poll, consumer spending improved slightly during the summer, as self-reported average daily spending in stores, restaurants, gas stations, and online increased by \$5 per day from June to September (see Exhibit 3). However, spending over the first nine months of 2009 remains in the range of \$59 to \$66, with September spending down 30 percent from the daily average of a year ago (see Exhibit 4). Early estimates from the National Retail Federation suggest that 2009 U.S. holiday sales are likely to fall 1 percent this year to \$437.6 billion, a less precipitous decline than in 2008, but a figure that shows a slower recovery than many retailers would like.⁴

Exhibit 3: Y-o-Y Percentage in Consumer Spending



Source: Gallup

Exhibit 4: Self-reported Daily Spending (monthly average) – in US\$



Source: Gallup

Retail sales suffer as consumers pull back on spending

For retailers, the sharp decline in consumer spending has had severe consequences. According to researchers at Northern Trust Global Economic Research, retail sales increased at an annual rate of 1.6 percent in the third quarter of 2009 after plummeting 1.4 percent in the second quarter of 2009.⁵ Luxury retailers have felt the effects most keenly as consumers pulled back from discretionary and big ticket items. Bain & Company reports that worldwide sales of luxury goods are expected to fall by 10 percent to about \$201 billion in 2009.⁶ Nondiscretionary retail shopping has fared better. Yet wary, budget-conscious consumers are making more deliberate choices over where to shop and what to buy, trading down to outlets that offer higher value for money and favoring private and store labels over many national brands (see Exhibit 5).

⁴ "NRF sees 2009 U.S. holiday retail sales falling 1 percent," Reuters, October 6, 2009

⁵ "Minutes of September 22-23 FOMC Meeting," Northern Trust Global Economic Research, October 14, 2009

⁶ "Sales of Luxury Goods Seen Falling by 10%," The Wall Street Journal, April 11, 2009

A volatile, illiquid economic environment

Nearly 7,000 stores shuttered in 2008, according to the International Council of Shopping Centers.⁷ Bankruptcies in the retail industry will likely continue to be a near-term reality. Rising competition and the current business climate could spur consolidation among niche, regional, and specialty retailers, whose business models may make their cash position more vulnerable. Analysts predict that as many as 10 percent of the retail businesses, both national and global players as well as smaller, regional outfits, may face significant restructuring, bankruptcy, or liquidation into 2009.⁸

For the sector at large, liquidity constraints create a vicious cycle, squeezing those retailers reliant on debt to fuel their business. With consumer spending stagnant, retailers are caught between the need to pay for ongoing operations and finance seasonal inventories but lack the liquidity to make these purchases. Such cash constraints can have a crippling effect. A vendor may halt merchandise delivery if it fears the retailer will not be in a position to pay.

To improve their credit standing, retailers can lower costs by trimming overhead, closing stores, or reducing staff, but these actions may hinder future growth. Alternatively, they can increase revenue; however, this option depends heavily on consumer spending. Even those with solid credit find themselves facing higher borrowing costs as banks raise interest rates and tighten payment terms. Given these factors, ratings agency Moody's anticipates that the number of defaults in the retail industry will grow over the next 12 months, well into 2010.⁹

Exhibit 5: 2009 Comparable Store Sales

Store Types	2009 Comparable Store Sales		
	August–October	May–October	February–October
Department stores	-6.4%	-7.8%	-8.2%
Premium department stores	-11.5%	-14.1%	-15.7%
Midline stores	-3.0%	-4.6%	-5.8%
Warehouse clubs	-1.2%	-0.9%	0.7%
Specialty stores	-4.9%	-6.6%	-8.0%
Mass merchants	-3.5%	-3.8%	-4.1%

Source: The Goldman Group

⁷ ICSC Business Conditions Retail Report, April 2009

⁸ By Ann Zimmerman, December 13, 2008, <http://www.pressdemocrat.com/article/20081213/BUSINESS/812130379>

⁹ By Parija B. Kavilanz, CNNMoney.com, May 22, 2009, http://money.cnn.com/2009/05/22/news/economy/retail_creditrisk/

A Historical Overview of the Retail Industry

The evolution of American retail

Imagine the typical townscape of independent specialty or single-product stores that governed the late 1800s and early 1900s. That scene gradually changed with the introduction of department stores. For the first time, shoppers had a range of services, brands, and products available in one location. Similarly, customers in rural locations heralded the advent of catalog retailing as pioneers Sears, Roebuck & Company and Montgomery Ward put an abundance of choice in reach of those who might otherwise be denied access.

For consumers, the appeal was immediate. In addition to convenience, department stores and other retailers offered something new, a *customer experience*, an intangible, but appealing environment where shopping was more than just a transaction, such as buying a yard of fabric, but an occasion.

Taking their cue from these developments, grocers transformed their models as well, moving from the small general store format to a bigger, broader form of hyper- or super-market. Within the space of a few decades, the shopping landscape changed from one dominated by category-specific outlets to one that featured integrated “one-stop” shops.

At the century’s midpoint, innovations in food processing and synthetic material fabrication led to a wave of new products, from TV dinners to Tupperware. After World War II, practicality and efficiency became driving trends. Aided by rapid advances in mass distribution, many retailers turned to warehousing, and interest in discount stores flourished. As discounters found ways to undercut traditional store pricing—by stripping overhead costs and operating on a high-volume, low-cost basis—a new retail category was born.

Developments in direct marketing and technology combined to make it easier for retailers in the latter part of the 20th century to experiment with different ways of reaching the customer. Catalog shopping experienced a resurgence, especially among boutique retailers such as Pottery Barn, Williams Sonoma, and Victoria’s Secret. Others pioneered such things as television infomercials, and in the process, created whole new business models and another extension in the channel environment.

These methods paved the way for online retailing. With the advent of the Internet, e-Commerce took the industry by storm beginning in the 1990s. The dot-com boom led to a host of pure play online retailers and an era of fast-moving technological innovation that touched virtually every aspect of the retail value chain, from product development and sales to operations. As these technologies entered the wider populace, a host of new channels emerged, many at the hands of the end consumer. Social-networking sites, online product reviews, viral marketing, and other forms of interactivity launched what is a still unfolding phase in the industry’s development.

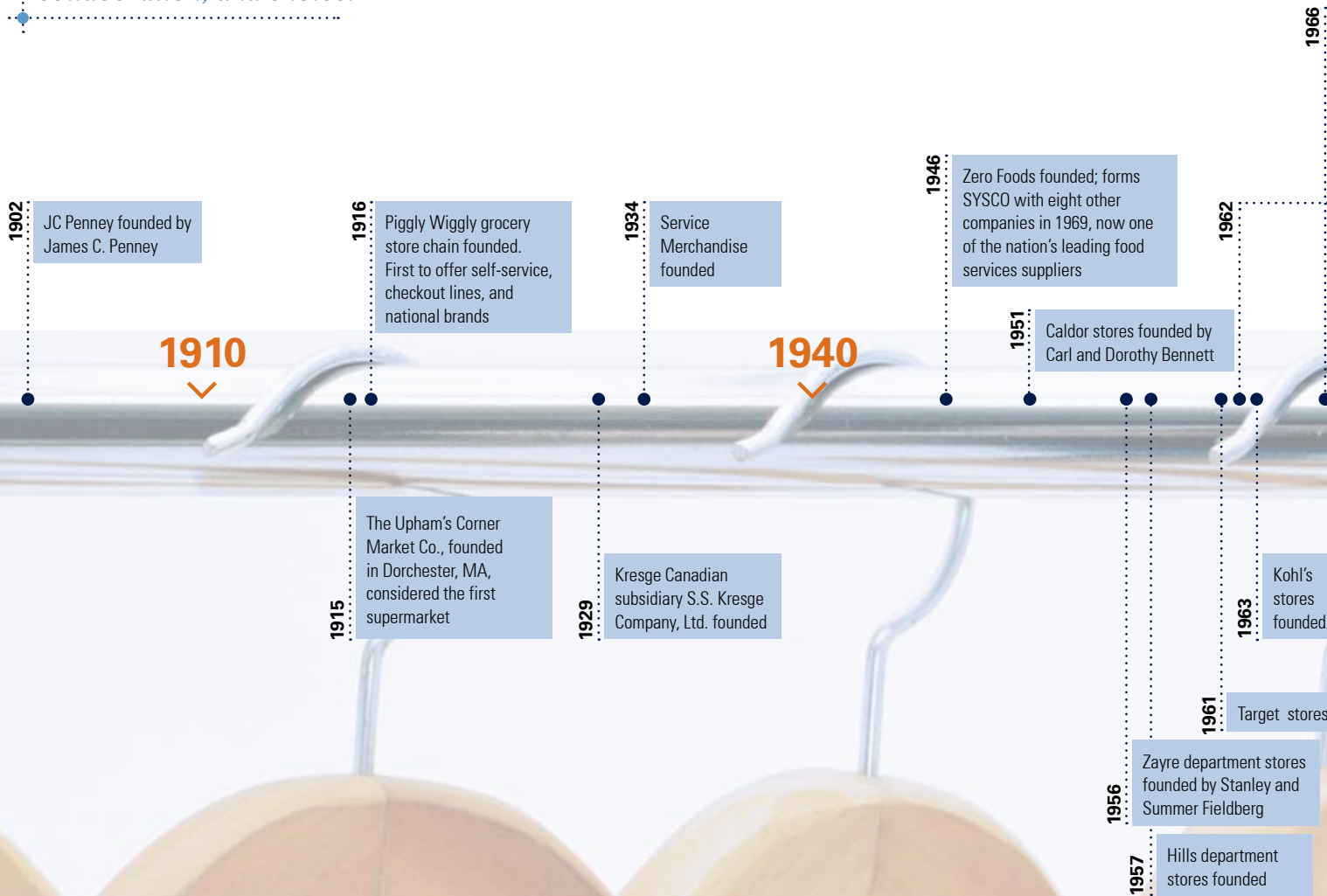


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As we look to the future, the retailers best positioned for success will focus on offering consumers a value-based experience marked by convenience, collaboration, and choice.

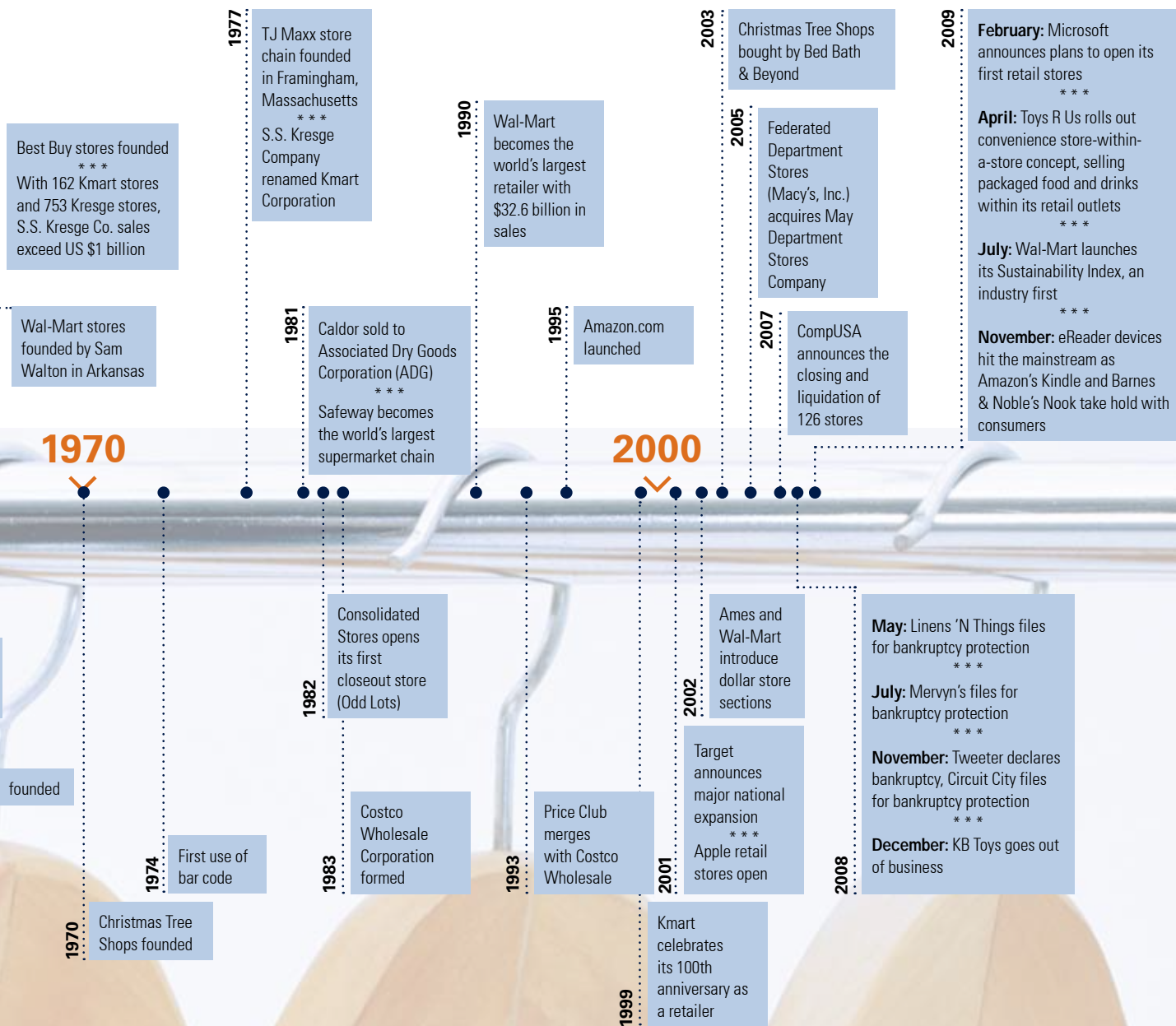
Time Line: The History of Retail

While some of the macroeconomic changes roiling the retail sector have touched all industries, many others are a reflection of the rising influence of today's global consumer. With consumer spending a major factor in the industry's health, understanding the needs, wants, and buying attitudes of the 21st century shopper will be critical in helping the retail industry emerge from this period of tumult.



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Source: Various media, company, and industry sources



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Future State

This section offers our perspective on the changing face of the retail industry, and presents what we believe to be three defining characteristics of the 21st century consumer and their implications for the sector.

Observation: The retail industry is at a key inflection point

Present day economic realities are forcing many to rethink traditional industry business models. Yet, in some ways, the industry is struggling to keep pace. In part, this is because the operating environment has become far more complex and interconnected. Consider the typical shopping mall, a concept born in the 1930s. The combination of convenient parking spaces, air conditioning, and eye-level displays made the formula an instant success. Chain store and franchise models offered similar appeal for a mobile, suburban consumer-base. But with fuel prices volatile and consumers faced with myriad new shopping channels, familiar buying patterns are beginning to change.

Where brand-based models used to predominate, today's consumers have more choice and far more product information than ever before. In an open information environment, national and global brands may no longer have the huge sway they once did. While radio frequency identification (RFID) and related tools helped retailers gain a better understanding of consumer buying habits, social networking and other online tools put consumers in touch with one another, creating a new and influential stakeholder in consumer decision making.

That is not to suggest that malls, chain stores, and big name brands will not continue to have a major role in the unfolding 21st century marketplace; it is just that some conventional practices may have been designed for a different consumer in a different era, one in which gas was cheap, shoppers drove, and where information channels were largely closed and one-dimensional.

To that end, understanding what drives consumer buying decisions has never been more important or more challenging. Meet the 21st century consumers and the three characteristics that increasingly define them.

Characteristics of the 21st Century Consumer

The Powerful Consumer

Gone are the days in which retailers by and large controlled the communication channel with consumers. The advent of online and related technologies has democratized the flow of information, shifting power outward from producers and retailers into the hands of everyday consumers. These changes are forcing greater openness in the way products are created, brands are marketed and buying attitudes are shaped. Implications for retailers include:

- 1. In an age of increasing customer power and activism, retailers need to be part of the conversation with the consumer.***

Consumer feedback is not a nice-to-have but a must-have means of anticipating product, packaging, and pricing priorities. Yet, a recent study finds that many





companies are not monitoring feedback from online sites such as blogs, Twitter, and other social networking outlets. A report by the Chief Marketing Officer (CMO) Council reveals that of 500 senior marketers surveyed, only 16 percent review online sources for comments, complaints, and suggestions, despite the fact that 58 percent believe that online-generated media have a major influence on consumer expectations and buying attitudes.¹⁰

Companies that are active in managing their online reputations will likely outperform those who do not. A 2009 report by the research firm Aberdeen found that best-in-class companies, those that regularly engage in online monitoring and analysis, are over 12 times more likely than industry laggards to see a year-over-year increase in shareholder value.¹¹ Today's real-time environment means that news, both good and bad, travels quickly. It behooves retailers to actively gauge customer feedback, taking note of influential sites, blogs, and message boards, and responding to issues quickly.

At the same time, retailers must forge opportunities for meaningful dialogue and interaction. When it comes to communications, context and authenticity drive credibility. In an information-rich world, consumers want retailers to be transparent, telling them what they need to know but can't find out on their own. This type of openness builds trust, a central element in fostering brand loyalty.

2. Retailers must continue to fashion customer-centric product and service models.

Retailers have been experimenting with ways to make the end user not just a receiver but also a shaper of products and services for well over a decade. Companies like Ikea make customer engagement a fundamental part of its go-to-market strategy. In return for high-end design, consumers receive lower-end pricing. But since consumers are also responsible for transporting and assembling their purchases, they are directly enmeshed in the company's operations. In practice, they form a vital element of Ikea's own value chain.

This example of closer consumer involvement is one aspect of the changing retail industry. In their book, *The Future of Competition*, C.K. Prahalad and V.J. Ramaswamy observed that value is increasingly co-created by the firm and the customer, rather than being created entirely inside the firm. This insight is fairly radical. Borne by the increasing influence of the consumer, we are moving from a company- and product-centric view of value creation to one in which the customer's experience in the process plays a fundamental role. As the authors state, "These personalized co-creation experiences are the source of unique value for consumers and companies alike."¹²

Consumers increasingly have a hand in creating brands many different ways, from consumer-generated advertising to beta-testing new products, to suggesting new innovations or packaging formulations.

¹⁰ "Turning Customer Pain into Competitive Gain," CMO Council, January 2009.

¹¹ "Report shows monitoring online reputation boosts companies' brand and shareholder value," <http://www.reuters.com/article/pressRelease/idUS203659+07-May-2009+BW20090507>.

¹² *Future of Competition: Co-Creating Unique Value with Customers*, C.K. Prahalad, V.J. Ramaswamy, HBS Press Book, 2003.



Some companies are working to put such guidance into practice. Adidas allows customers to walk the walk literally at its interactive store in France. Shoppers jog or stroll on a treadmill-style scanner as the machine analyzes their foot pressure, shape, and size. The data is then used to develop a custom online prototype. Customers can choose their desired color and try on their new shoes aided by a “virtual mirror.”¹³ If they like what they see, they can purchase their co-creation.

High-quality interactions like these can help retailers unlock new sources of competitive advantage. As the branding consultancy, Landor, puts it, “For better or for worse, consumers are now collaborators in brand development. Those brands that embrace and act on this shift will likely be the winners.”¹⁴

The Value-conscious Consumer

Consumers are making deliberate lifestyle decisions based on a desire to better manage their spending, reduce their environmental impact, and improve their quality of life. They expect the companies they patronize to be equally deliberate in their choices. In a challenging economy, many will spend for needs, not wants. Implications for retailers include:

1. Consumer perceptions of value are shifting.

Consumer spending has long served as an essential scaffold for the U.S. and global retail industry. Yet, even as the recession eases, signs are that it may have left more permanent changes in its wake. Analysts at the Strategic Resource Group believe consumer spending could remain weak for four to eight years and lead to a “downturn generation” that learns to scrimp and save permanently.¹⁵

But broader social, cultural, and environmental considerations are also at play. Demographic changes, prompted by the needs of active, vocal, and sizeable baby boomer populations, as well as younger, hyper-connected, and influential millennials, add to the industry’s challenge. Because each generation defines value in their own terms, retailers must be attuned to their distinct product and service needs as well as their preferred methods of communicating and collaborating.

What’s more, today’s multichannel environment gives them more power to act. In a democratized retail environment, consumers can vote with their feet and their dollars. Whereas before shoppers may have been limited to a defined set of products, regardless of preference for such things as fair-trade coffee, recycled paper products, or ethically manufactured garments, today’s consumers have unprecedented choice, and the ability to exercise their heightened consciousness.

2. Retailers that demonstrate socially responsible practices will be viewed as more credible and trustworthy.

Retailers that demonstrate a sustained commitment to socially responsible business practices engender greater trust, affinity, and brand loyalty. That is particularly relevant now, with consumer confidence at low ebb.

¹³ <http://tinyurl.com/njg54w> and <http://nextup.wordpress.com/category/co-creation>

¹⁴ “Power Shift: Thinking differently about consumers,” *Superbrands*, Cheryl Giovannoni, Landor, November 2007 http://www.landor.com/pdfs/k9/CGiovannoni_PwrShift_U.S._13Nov07.pdf

¹⁵ “Private Label Winning Battle of Brands” <http://www.massogroup.com/cms/content/view/5713/313/lang,en>

When it comes to building credibility, open communication is a low-cost, but highly effective way to demonstrate a retailer's core values. The Timberland Company, for instance, began shipping all of its products with a "nutrition label" applied to the shoe box in 2006. The label defines the environmental impact created by the footwear's production, from inception to delivery. Jeffrey Swartz, Timberland's president and chief executive officer, explains, "This packaging and labeling initiative is intended to make our industry more transparent and give consumers the information they need to make smart buying decisions."¹⁶

Trust and engagement lead to bottom-line results as well. Research by the IBM Institute for Business Value found that customers made anxious by the recessionary environment are more likely to buy from retailers they trust.¹⁷ The retailer, Best Buy, concerned about attrition rates among its female employees, launched The Women's Leadership Forum (WoLF), a platform that allowed women in its workforce to suggest how to improve the customer experience. Ideas included changing the layout and product set to cater to female shoppers. The results not only improved retention rates, but also significantly boosted sales.¹⁸ Women inside and outside the company felt they were heard, that their feedback mattered, and saw the outcome reflected in the company's own actions.

3. Lower-, middle-, and up-market retailers must appeal to a more discerning consumer base.

Many department and chain stores are under intense pressure to elevate foot traffic, boost sales, and increase market share. At the same time, consolidation among department and chain stores has resulted in rising competition among apparel makers who must vie for remaining shelf space or consider pursuing their own retail channels.

In response, retailers such as Macy's, J.C. Penney, and Kohl's Corp. are burnishing their own store brands or striking deals with designers to sell exclusive lines of merchandise. Macy's signed Tommy Hilfiger in October 2007 to be the exclusive department-store retailer of its brand. Kohl's sells an exclusive line of Tony Hawk. And Polo Ralph Lauren inked a similar agreement with J.C. Penney, giving the chain exclusive rights to its "American Living" collection. These stores hope that such high-profile exclusive brands will give consumers another reason to shop at the department store.

Higher-end outlets face additional pressure to justify their pricing premium and keep shoppers returning to their stores. The upscale grocer, Whole Foods, tackled this issue head-on. To ensure that cash-conscious consumers didn't cross the grocer off their shopping list, the retailer doubled down on its marketing and communications, using newsletters, coupons, and even in-store guides to make customers aware of the value in Whole Foods stores. Rather than mark down products across the board, the grocer varied its sales offering, discounting new products each week while also promoting store-label products with prices comparable to those in other supermarkets.



¹⁶ "Transparency: What's really inside the package and the company," <http://www.hartman-group.com/hartbeat/transparency-what-really-inside-the-package-and-the-company>

¹⁷ "Shopper Advocacy: Building consumer trust in the new economy," IBM Institute for Business Value, <http://tinyurl.com/nmmxgg>

¹⁸ "Valuing Social Responsibility Programs," http://www.mckinseyquarterly.com/Valuing_social_responsibility_programs_2393

Organizations like Hasbro not only follow their customers, but let them crawl around the company floor. Their FunLab, in which children engage with a roomful of toys, allows the company's researchers to gauge what features appeal and what don't. While not every retailer can get down on the floor and play with their customers, the simple act of being present where they are, from stores to social networking sites to blogs is necessary to understand what those unmet needs are.

The Crossover Consumer

In today's multifaceted marketplace, it is harder than ever to label consumers by any one category. This is the era of the "Instavidual" where consumers trade up to high-value premium brands in some instances and down to low-cost commodity goods in others. The mass consumer has become a hybrid consumer. As retailers adapt to this environment, the leaders will be those that align their offerings with consumers' ongoing quest for value. Implications for retailers include:

1. Traditional customer segmentation strategies will change as companies engage in total customer experience management.

Retailers have to work harder to expand not only their market share in a given category, but also their share of a customer's wallet. Where companies may once have focused on an individual area, a consumer's hair, skin, or nails, for instance, many are widening the lens to take in the whole customer. That is because lifestyle considerations, work-family pressures, and the desire for personal and family wellness will increasingly drive portfolio and retail strategy. As a result, some companies are expanding beyond product delivery into a range of different lifestyle oriented services.

Panera Bread, for instance, offers a welcome spot for telecommuters and the self-employed. Their coffee and bakery establishments provide free WiFi and a comfortable place to work or meet a client, making it the equivalent of a temporary office. Apple Computer not only sells wonderful technology, but also leads one-on-one tutorial sessions to help consumers leverage the full use of their gadgets. One New York carpet retailer even offers a range of meditative and spa services that go along with its Eastern themed rugs.

To foster the total customer experience, organizations must elevate their consumer knowledge. As P&G head, A.G. Lafley, and management guru, Ram Charan, observed in their 2009 book *The Game Changer*, "Great innovations come from understanding the consumer's unmet needs and desires. Regardless of the market, innovation must be consumer-led."¹⁹ But "knowing your customer" in today's world extends beyond conventional demographic information requirements such as age, gender, and income. Psychographic segmentation, studying the traits, opinions, attitudes, and other psychological and emotional characteristics of consumers, is also critical.

2. In a multichannel world, retailers must provide more seamless interaction.

According to Forrester Research, two-thirds of online consumers engage in some form of cross-channel shopping behavior when purchasing apparel, wireless products, consumer electronics, personal computers, and large appliances.²⁰ Shoppers want retailers to provide them with the convenience of online formats along with the touch-and-feel product experience conferred by a physical storefront setting.

¹⁹ http://money.cnn.com/2008/03/07/news/companies/lafley_charan.fortune/index.htm

²⁰ "How Satisfied Are Shoppers When Moving Across Channels?"; Forrester Research, 2008

As consumers clamor for an integrated multichannel experience, some retailers are turning to the Point of Purchase to help. Ralph Lauren's kiosk innovations, for instance, gave a new twist on window shopping. The clothing maker unveiled a touch sensory window projection in its Manhattan storefront. This allowed customers to shop 24 hours a day, seven days a week just by touching the window glass. The integration between online and offline worlds seems to pay off. According to Summit Research, retailers that use self-service kiosks show a 6 to 8 percent increase in incremental sales when kiosks are placed in store.²¹

That act of being present where consumers are means that retailers need to think cross-channel when it comes to customer segmentation. Online and offline behavior can offer important insights into consumer buying attitudes. Click-through activity, response to print and television advertising, feedback from surveys, and purchasing patterns offer retailers a holistic means of understanding what resonates with different types of consumers. Taken together, the results can guide more effective messaging, marketing, and related activity.

3. As private-label and store brands gain traction, retailers need to rethink how they package, price, and promote their product portfolios.

It used to be that private labels served as low-cost and generally low-quality substitutes for national brands. Today, nearly 75 percent of all U.S. consumers rate private-label offerings as excellent in overall quality and 91 percent say they will keep buying store-brand products after the recession ends.²³ According to a study by The Nielsen Company, about 40 percent of consumers earning over \$50,000 per year are in the "switch to private label group."²⁴ What once was the purview of discount shoppers, is now attracting middle- and up-market buyers as well.

Whereas in the past, many private-label products sought to mimic existing national brands, some are now staking out their own distinctive ground. For instance, when 7-Eleven introduced its own product line, the intent was to make the offering comparable to other national brands. "But, as we get deeper into it and understand the business, our goal is to develop products unique to 7-Eleven with new flavor profiles and packaging that is more designed for customers on the go," according to Tom Gerrity, senior product director.²⁵

But in the push to reap the benefits of store brands, retailers need to be careful not to cannibalize other products in their own portfolio. "One thing you don't want to do is create a consumer who shifted to private label and then have to spend a lot to get them back," said Kimberly-Clark Corp. Chairman-CEO Tom Falk at the 2009 Consumer Analysts Group of New York.²⁶ Toward this end, some companies are "destocking." They are whittling back their Number 3 or Number 4 brands in an effort to give more attention and resources to their top performing categories.

Research from the Private Label Manufacturers Association finds that the percentage of consumers who say that they buy private label products frequently has increased dramatically over the years: from 12 percent in 1991 to 41 percent in 2006 to 55 percent in 2009.²²



²¹ "How to capture the spending power of the Hybrid Consumer" *IT Reseller*, <http://tinyurl.com/ktclmr>

²² "Store Brands and the Recession," <http://tinyurl.com/dczve2>

²³ "Private Label Deemed Equal to Store Brands – Nielsen study," <http://tinyurl.com/5wjowr> also <http://tinyurl.com/megh5p>

²⁴ "Reaching the Recession-Proof Consumer: Finding Opportunities in Tough Times," *Nielsen Wire*, April 2, 2009

²⁵ "Retail's private label programs take off" *Adweek*, <http://tinyurl.com/lov9xc>

²⁶ *AdAge*, <http://tinyurl.com/kvzd97>

Transition State



In order to prepare their internal organization for the changes ahead, retailers need three things: Flexibility; Visibility; and Sustainability. Taken together, these qualities will allow best-in-class companies to whittle away at waste and focus on meeting the needs of their consumer base. This section offers KPMG's insight on key actions to make that transition smoother and more successful.

Flexibility

Flexibility is key to responsiveness. To keep pace with market movements, retailers need to maintain financial fitness as well as lean, highly efficient operations.

Financial flexibility

Maintaining margins and preserving cash are essential, not only in the current economic environment, but also as retailers prepare for a rebound in the market. Historically, the sector has struggled to implement broad-based inventory and cash planning. Silo-driven decision making among divisional groups often exacerbates the problem. The lack of cohesion can impair inventory productivity and, as some have found, inventory shortages can have a big impact on working capital. While over 94 percent of all companies forecast their cash flow, and nearly 50 percent of all companies achieve an accuracy rate between plus or minus 10 percent, that falls sharply in the case of retailers.²⁷

Part of the reason that retailers have had mixed success with cash management is the industry lifecycle itself. A retailer can be out of business in three months. The pressure to manage quarterly margins along with rapidly changing inventories can cause thinking, planning, and execution to hew to the short-term.

As always, crisis makes the best change agent. The difficult economic climate has propelled comprehensive liquidity planning and cash optimization to the forefront. Retailers know that in order to flex their business in response to what will likely remain a volatile operating environment, they must improve oversight and integration of costs, cash, and forecasts across the business.

Beyond broader cash concerns, SKU rationalization is another way to significantly improve performance. For many retailers, it used to be that the more SKUs the better. That is now changing. For instance, a national office supply chain retailer knew it had a problem when its books revealed that an average store carried \$1.5 million in inventory against only \$5 million in revenue. The company implemented an Enterprise Resource Planning (ERP) system to analyze the profitability of each SKU it held. In doing so, the retailer was able to halve its inventory stocks, lower its working capital, and free additional cash to reinvest in other areas—giving the company considerably more financial flexibility.

Likewise, a military exchange store found that it could save \$10 million annually just by reducing the inventory stocks of its LLadro figurines, a high-margin, but low-volume product. Instead of keeping these items in its back room, as it had done before, they moved them to a central warehouse and simply shipped the product overnight whenever an order was placed. What the exchange paid in extra shipping costs they more than made up for in inventory savings.

TIPS

The following practices can help boost financial flexibility:

- Identify and monetize underused, underselling or aged assets.
- Understand exactly how much you are making on each product that you sell.
- Conduct liquidity analysis to chart the company's current and anticipated cash position, as well as access capital from the sale of non-core assets. By reaching across divisions and unifying the reporting structure, management can significantly improve the accuracy of their estimates.

²⁷ "Making your capital work harder," Consumer Currents No. 5, KPMG International, 2008



As companies plan for an economic rebound, those best able to manage their balance sheets and cash position will be in the strongest position to seize share as the market recovers.

Operational flexibility

Whether it means getting top brands to market faster than the competition or maximizing key seasonal and holiday shopping periods, supply chains are a critical organ for nearly every retailer. Supply chains serve as a vital link to low cost procurement and manufacturing destinations and are essential to helping retailers manage their margins.

Because they play such a vital role, vulnerabilities in the supply chain can quickly expose a company to key risks. Volatile commodity prices, transportation and distribution costs fueled by sharp swings in raw material, and energy costs have reinforced the urgency many retailers feel in making their supply chains as efficient as possible. In satisfying these collective needs, however, supply chains have run the risk of becoming overly extended and complex.

To address these risks, a retailer must integrate its transportation, distribution, and labor network in order to capture the true “landed cost” of a given product. This requires much greater collaboration and information sharing among external stakeholders, suppliers, carriers, and other merchants. The best will fine-tune their distribution map, taking into consideration internal needs such as fuel, transportation management, and speed-to-delivery, as well as customer imperatives such as getting the right product, with the right features into the right hands.

Format flexibility

If the economic challenges presented over the last 24 months have shown anything, it is the importance of right-sizing the retail footprint. Retailers, from jewelers, to apparel, to electronics understand that unnecessary overhead and inventory can challenge a business in the best of times and cripple one in the worst. Yet, many companies struggle with finding the right balance of stores and formats to maintain.

Traditional “destination” shopping formats, such as large malls, suburban shopping plazas, and big box retailers rely upon consumer willingness to travel to shop. In the boom and bustle of an up-economy, many did so happily. The spending slowdown that marked the recent sluggish market may have accelerated a shift in buying habits away from mall and warehouse store locations toward a mix of channel options. While many buyers are still attracted to the range of products and prices offered, retailers want to hedge the risk of losing even a portion of their current customer population.

As a result, some companies are experimenting with smaller, more focused formats. OfficeMax, for instance, has tested a series of small, niche stores, called “Ink, Paper,

TIPS

In our experience, creating a flexible, dynamic supply chain requires:

- **Integration** – Merchandizing and the supply chain remain among the more silo-based retail activities. Fostering greater linkage between procurement, manufacturing, logistics and the end-user will become both a competitive and operational necessity.
- **Minimization** – Identifying and eliminating overlapping systems and processes, recognizing that excessive complexity, wrought from business growth, market expansion and M&A, often slows down supply chain performance.
- **Optimization** – Understanding where the key vulnerabilities are in the distribution network and building in contingencies.
- **Alignment** – Leveraging the movement of product across the supply chain to reap other bottom line benefits, such as tax effective routing and the use of favorable foreign trade zones.

TIPS

When it comes to right-sizing the retail footprint, consider the following:

- Before deciding on any remodel, establish an ROI hurdle that a given format must exceed.
- Use demographic information to identify the most profitable locations for new stores and product offerings.
- Analyze a combination of point-of-sale, demographic, and competitor data to improve product positioning and traffic flow.
- Be disciplined. Ask yourself, “What business am I in?” and focus on those elements that are truly core.

TIPS

Business intelligence helps retailers turn information into insight. The best:

- Leverage advances in technology, partnerships, and information processes to improve inventory management.
- Recognize that for speed in decision making, collaboration is key. This requires sound risk-profiling, scenario modeling, and a good corporate response team, for internal directives and external communications.
- Shift focus away from creating an efficient back room to eliminating it altogether. To keep the shopkeeper front of store and increase profit opportunities, retailers must integrate business intelligence across their operations to get the right product in the right place at the right time.

Scissors.” These outlets, predicated upon convenience, serve as a counterpoint to what are often planned rather than spontaneous excursions to traditional office supply stores. Likewise, Best Buy plans to open 40 stand-alone “Best Buy Mobile” stores during the 2009–2010 fiscal year with hopes of quintupling its share of the U.S. mobile phone market to 15 percent.²⁸ In experimenting with these smaller formats, retailers are hoping to benefit from lower capital, inventory, and operating costs; the ability to be present everywhere consumers are, both at home and at work; and the ability to offer a more targeted product offering to cater to specific “instavidual” needs.

Retail is fundamentally about consistent execution. It’s tempting to seize the opportunity to capitalize on new buying trends, but in so doing, a retailer can drift away from its core business. As leading retailers look to optimize their margins and foot traffic, they are moving from being good at everything to being great at a small number of things.

Visibility

Managers are awash in a flurry of data, from economic indicators, to stock levels, to point of sales transactions. Employees, from the store level on up, need much greater visibility into core operations, especially inventory, and the customer. Otherwise, the maelstrom of minutiae can cloud big-picture thinking.

Better business visibility

Managing information is a key element to managing risk. That is one reason why more retailers are expected to turn to business intelligence (BI) tools. These applications can help management teams gain greater visibility into the streams of data they get from customers, suppliers, distributors, and analysts and use that information to fine-tune demand forecasting, and develop more accurate customer spending patterns.

Across the board, retailers are concerned that they are making stock-keeping decisions based on inaccurate forecasts and faulty inventory management systems. A Harvard Business School survey of 3,000 SKUs at a major retailer found that perpetual inventory counts were inaccurate 65 percent of the time.²⁹ This is not an isolated incident. Within the warehouse, systems overly reliant on historical data can peg suggested orders too high or too low. Within stores, items left in changing rooms can go unaccounted for. Others may be shelved in the wrong location. Aside from the high cost of loss, shrinkage also impacts shelf availability. In all, a recent Aberdeen study reported that 70 percent of retailers rate themselves average or below average on their inventory management processes.³⁰

To address these issues, retailers are using new approaches, such as Radio Frequency Identification (RFID) tags. As a good travels through the supply chain, retailers can track its location, verify it against expected order quantities, and account for its final purchase with the customer. In a Wal-Mart-sponsored study at the University of Arkansas, researchers found that RFID technologies can reduce the degree of understated perpetual inventory by 13 percent, thereby helping retailers to lower their costs.³¹

²⁸ “Radio Shack teases new ‘Shack’ branding,” *FierceWireless*, Aug 3, 2009. <http://tinyurl.com/looksgj>

²⁹ “Seeing Through Economic Fog: How Visibility Enables Retailers To Prosper,” *Integrated Solutions for Retailers*, Prasad Putta, June 29, 2009.

³⁰ “Inventory optimization: Strategies for eliminating stock-outs and overstocks,” Aberdeen Group, 2009., <http://tinyurl.com/r233xw>

³¹ “Wal-Mart-Commissioned Study Shows RFID Improves Store Inventory Accuracy,” *RFID Journal*, March 13, 2008 <http://www.rfidjournal.com/article/articleprint/3969/1/1>

In addition, some retailers are employing “pay-on-scan” techniques to lower inventory risk. Under this arrangement, the merchant pays only for what is bought. Take the magazines sold at the typical corner bookshop. The store does not pay for any of this inventory until the moment of purchase. That means they don’t need to bother counting the inventory in or out. They simply pay the magazine publisher for those copies scanned at the point-of-sale. This approach reduces a retailer’s inventory at-risk and provides an incentive for manufacturers to fine-tune both their forecasts and understanding of consumer buying trends.

Sense-making, or the ability to turn information into insight, is especially important given the rate of change within the retail environment. In this climate, competitive advantage will go to those not first to market per se, but rather those first to identify leading market indicators and marshal that information to effect the appropriate response. The winners in that footrace will invariably be the retailers with the best business intelligence.

Better customer visibility

Acquiring deep customer insight is a multi-faceted endeavor. Customer relationship management (CRM) tools, surveys, and focus groups can yield useful feedback on anything from general satisfaction to the “stickiness” of advertising and the appeal of product innovations. But such data provides only one dimension in helping retailers truly “know the customer.” Just as one wouldn’t ask a prospective date to take a survey in order to get to know him or her better, retailers interested in fostering relationships with their most desirable customers need to get a little bit more personal.

Instead, savvy retailers use a combination of methods. CRM and transaction data can reveal buying patterns. Focus groups, surveys, and ethnographic studies shed light on what consumers are thinking. And person-to-person sessions, whether online or in-store, can test assumptions, offer a forum for direct feedback, a way of gathering perceptions, and a process for creating a personalized retail experience.

A survey by the Aberdeen Group, conducted between February 2008 and March 2009 involving 165 retail enterprises, revealed that customer relationship management programs, and other similar initiatives, are a major differentiator between the “Best-in-Class” retailers and their lower-performing counterparts.³² The survey concluded that successful customer loyalty programs significantly helped the “Best-in-Class” retailers to navigate the downturn impacting on both sales and customer retention performance. At the same time, 47 percent of “Laggard” retailers and 35 percent of “Industry Average” retailers claimed no change in performance from their loyalty programs.³³

In a multifaceted retail environment, the acquisition of customer insight must also be multidimensional. The effective use of advanced data mining technologies, customized outreach, and superior customer service should be a top priority for retailers over the next several years.

TIPS

The effective use of advanced data mining technologies, customized outreach, and superior customer service must remain a top priority. Be sure to:

- Align the customer relationship management strategy with the company’s most profitable or most influential customers.
- Monitor the ways in which consumer expectations are changing and tailor promotional and loyalty programs and coupon processing accordingly, in line with key customer segments.
- Help ensure that customer touchpoints reflect the culture and values of the brand.
- Follow-up on feedback. Customer insight is only as useful as the actions it spawns.



³² Note: Aberdeen Group categorizes the companies in its surveys in one of the following three categories, according to their aggregate industry performance: Best-in-Class (top 20 percent), Industry Average (middle 50 percent) and Laggards (bottom 30 percent)

³³ Best-in-Class Retailers Resort to Customer Loyalty Programs for Surviving Downturn, Reuters, 9 April 2009

TIPS

Going green is good for the environment and the bottom line. To maximize returns:

- Evaluate the company's exposure to climate change policy.
- Prepare a climate change strategy based on the potential for cap-and-trade legislation. Develop contingencies to offset the risk and capitalize on strategic opportunities.
- Think ahead. By identifying energy, carbon, and corporate responsibility initiatives, retailers can reduce costs, improve cash flow, and raise revenue.
- Investigate whether planned improvements are eligible for federal, state or local tax credits or other incentives.

Computer maker Dell, whose products are featured in 30,000 stores around the world, saved \$8 million in costs by adopting a new approach to computer packaging. Using renewable pulp and recycled high-density polyethylene, the company eliminated 20 million pounds of packing materials.³⁴

Sustainability

People, planet, and profit

Going green is good for the environment and the bottom line. By identifying energy, carbon, and corporate responsibility initiatives, retailers can reduce costs, improve cash flow, and raise revenue. Whereas early sustainability efforts were largely driven by ethical concerns, consumers are seeing that eco-conscious products confer positive lifestyle and practical benefits as well. As shoppers snap up "green" electronics, they are spurred not only by energy savings but cost savings too.

Despite the difficult economy, 34 percent of American consumers indicate they are more likely to buy environmentally responsible products today, and another 44 percent indicate that their environmental shopping habits have not changed as a result of the economy, according to the 2009 Cone Consumer Environmental Survey.³⁵

Beyond this, the topic of climate change may be a game changer for many industries, including retail, because of the potential implications of cap-and-trade legislation, both positive and negative, on affected businesses. Most analysts, including those at KPMG, believe that stricter regulations governing carbon emissions are likely only a matter of time. Whether out of environmental concern or enlightened self-interest, retailers will be wise to act preemptively.

The best way to do this is by first taking stock of one's carbon footprint, then modeling the company's risk profile with respect to proposed emissions caps. For instance, suppose cap-and-trade legislation were to limit a retailer's carbon emissions to 1,000 metric tons. If the store's analyses pegged its actual projected output at 5,000 metric tons, the retailer would face a financial penalty for the 4,000 additional metric tons emitted. To offset that risk, the retailer might consider several different scenarios, ranging from internal changes to reduce its energy consumption to purchasing credits on a cap-and-trade market.

Another retailer, by contrast, might run through the same exercise and discover that its emissions were likely to come in under the mandatory emissions cap. That insight could allow it to plan ahead for how to monetize that advantage, i.e., selling the difference as a credit.

Going green is good for the environment and the bottom line, but those who plan early reap most. For instance, REI's new Boulder location serves a prototype for the company's sustainability program. Materials for the building and interior were chosen for their minimal impact on the environment. A full 98 percent of the store's energy needs are wind-generated. In addition, high-tech skylights called Solatubes funnel light from domes on the roof into the store, saving the company 120,000 kWh per year in lighting costs. High-efficiency facilities also draw 30 percent less water than traditional stores.³⁶

Aside from lowering their carbon emissions, there are other economic benefits to eco-friendly store design. State and local municipalities in many areas of the United States offer tax credits and other incentives to encourage businesses to invest in low-impact, eco-friendly building practices. In addition, some jurisdictions will accelerate the permitting process and reduce or waive fees.

³⁴ "Dell foresees big savings with greener packaging," InfoWorld, December 29, 2008.

³⁵ 2009 Consumer Environmental Study, <http://www.coneinc.com/content2032>

³⁶ REI.com

Green is gaining traction in the supply chain as well. Wal-Mart's involvement with the new Sustainability Consortium is likely to have a far-reaching effect on the retail sector. In conjunction with the Consortium, Wal-Mart recently launched a sustainable product index to oversee the eco-practices of its supply base and minimize the amount of waste produced. The company will roll out the initiative in three phases, beginning with a 15-question survey focused on energy and climate, material efficiency, natural resources, and people and community.³⁷ Arguably the most ambitious industry program to date, the index will assess the environmental impact of every product the company sells and present that data in a consumer-friendly rating system for shoppers.

Because Wal-Mart has over 100,000 suppliers around the world, its standards could have a widespread impact. Supplier scores, for better or worse, will affect how favorably they stand with the world's most powerful retailer. In addition, as the heavyweight in the discount market, the company's efforts will likely trigger other retailers to take similar moves to improve their eco-friendly practices.

People are the linchpin in getting sustainability programs to stick. Change initiatives often fizzle once the rollout period winds down. Influencing long-term change usually requires that stakeholders be engaged, empowered, and rewarded. This involves clear communication to customers, suppliers, employees, and even local communities. Human nature is such that the more involved we are in solving a problem, the more committed we are to putting those solutions into action and seeing the results. Those who go out of their way to institute socially, ethically, and environmentally responsible practices should be recognized. This includes partners and suppliers as well.



³⁷ "Wal-Mart announces Sustainability Index," *U.S. News and World Reports*, June 16, 2009

Conclusion



Recent dynamics suggest that the industry is on the cusp of foundational change. These issues have been brought to the fore by the difficult global economic environment and the sweep of fast-moving social, technological, and demographic change. Together, they have created a perfect storm of sorts.

But the turbulence should leave the sector in a stronger position to take advantage of a rebound in growth. Although some retailers are closing stores, curbing spending, and repositioning themselves to ride out the tough times, many others see the market changes as an opportunity to capture market share from weakened competition. As retailers strive to satisfy their customers' evolving search for value, they may need to adopt different ways of operating.

Because customers can engage at many different stages of the value chain, companies must successfully learn not only new ways to team, internally and externally, but also new techniques to assess performance along the way. Over the coming years, the ability to identify and satisfy the unmet—and occasionally unarticulated—needs of customers will be a hallmark of leading companies in the sector. The experience-centric view of value has the potential to affect many aspects of the traditional retail business structure. Players who can continue to attract consumers with a differentiated offering, a high-quality shopping experience, and appropriate pricing will emerge winners.

Players who can continue to attract consumers with a differentiated offering, a high-quality shopping experience, and appropriate pricing will emerge winners.





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