



## **The New Economic Environment**

As the year comes to an end, we at Booz & Company wanted to provide our perspective on how the watershed events of 2008 will reshape the executive agendas of retailers in 2009 and beyond. The only certainty in today's global economy is that nothing is the way it was. Commodity prices shot up, and then settled back as the economic downturn took hold. The formerly safe assumptions of low costs for energy and transportation, cheap labor and little environmental regulation in developing nations, and advantageous currency exchange rates now require reevaluation.

What is clear is that we are staring into the jaws of a global economic recession, and plans for 2009 that were predicated on soaring oil, packaging, and commodity prices need to be adjusted to reflect greater volatility and potential deflationary pressures. Consumer spending fueled by easy credit drove the economic boom. Now, retailers are reeling from the impact of the current credit crunch on consumer spending during a challenging holiday shopping season. Higher inventory levels, shoppers' increasing demand for discounts, and fundamental changes in consumer spending behavior make retail a challenging environment in which to operate. But as with all challenges, this one is accompanied by opportunity. Leading retailers will simultaneously sustain themselves during the downturn and build capabilities for the next wave of success.

## **Calls to Action in 2009**

As recessionary pressures squeeze consumer spending, retailers are taking numerous measures to handle the crisis, especially in the realm of cost cutting. The danger in a downturn, however, is that a focus on costs will preclude positive action in other arenas.

Our extensive work with retailers of all varieties tells us that leaders in the field will intensively focus on four areas to help them survive in the short term and thrive in the long term.

- Price and promote to capitalize on consumer spending and switching trends.
- Implement "smart allocation" to increase profit and improve the shopping experience.
- Boost efficiency to strengthen profitability.
- Build capabilities for the long term.

*Price and promote to capitalize on consumer spending and switching trends.* In September 2008, Booz & Company surveyed nearly 1,000 U.S. households to assess how consumers have altered their spending behavior and how they expect to change it further as a result of the current economic crisis. Responding to the triple hit of sharply higher oil prices, significantly lower house values, and the sudden credit crunch, the vast majority of consumers have made substantial cuts in their spending and expect to make even deeper cuts over the next six months as the economy worsens.

The spending areas that are hit hardest are high-cost, less structural expenditures such as dining out, impulse shopping, and nonessential driving, even though consumers value many of these activities highly. Over the next six months, survey respondents anticipate reducing expenditures on personal durables (clothing), indulgences (coffeehouse purchases, alcohol), household durables (electronics), and services (salon treatments, housecleaning).

While consumers are shopping more frugally in general, they continue to be relatively brand loyal in categories that are important to them, such as personal care and liquor. What we're starting to see, however, is a greater willingness to shop for those brands at less expensive retail outlets. Moreover, our research suggests that if consumers are satisfied with these options, they may well stick with them when the economy bounces back.

Although longstanding preferences for convenience and premium products may eventually reverse some of this frugality, what is particularly interesting is the number of consumers who do not believe they will substantially reverse their new, cost-conscious spending patterns when the economy rebounds. The truth probably lies somewhere in the middle, as some consumers stick with new, thriftier choices and others revert to premium preferences. Meanwhile, retailers and their manufacturing partners must work hard to provide value-brand alternatives and solutions that suit consumers' new shopping preferences.

In the current environment, retailers must react to changing shopper patterns by constantly monitoring their assortment and use of space. Providing the right SKUs to meet shoppers' demands will offer greater opportunity to take advantage of the trends toward frugality and spending time at home. Consumers are getting back to basics in their food preparation, making purchases that provide for entertainment at home, and prioritizing purchases for their kids. These trends provide opportunities for nearly all retail channels: The more flexible your model, the easier it will be to capitalize on them.

It is also imperative for retailers to reassess how they are using pricing and promotions to drive traffic and differentiate themselves from their competition. The temptation may be to engage in a race to lower prices and compete primarily on that basis. Eventually, though, that approach erodes value: In addition to cutting margins, it sends a message to consumers that low price is the primary

differentiator. That strategy will backfire when the economy begins to recover. Instead, retailers should carefully balance finding the opportunity in private-label products, thus meeting consumers' need for lower prices, and looking toward the long term by emphasizing other value propositions and keeping a carefully selected stock of branded products.

*Implement "smart allocation" to increase profit and improve the shopping experience.* The retail market in the U.S. has become inordinately complex, as consumer product companies and retailers push the envelope on product proliferation. Between 1980 and 2007, the average supermarket assortment tripled from just under 15,000 items to 45,000, despite the fact that the typical household still purchases only about 650 of these items on an annual basis. In fact, recent studies indicate that consumers purchase less as assortment increases. The total number of consumer product SKUs available today is nearing 1 million and continues to grow, even though 90 percent of new product introductions fail.

A recent Booz & Company study with a leading grocery retailer on store shelf complexity found that 25 percent of stocked items accounted for nearly 100 percent of the profits in the six categories examined. The slowest-moving 25 percent of items each lost money, and we determined that removing these items would grow category profitability by more than one-third. The balance of the SKUs – the middle 50 percent – required further analysis (e.g., segmenting shoppers by their attitudes and behaviors and understanding which stores serve each segment) to identify the "smart" mix of items that would effectively – and profitably – meet the needs of store, shopper, and category.

As an example, take Alpen cereal, manufactured by Weetabix Ltd. in England. At first glance, it appears to be a rather slow-moving item and hence a candidate for delisting. However, further analysis reveals that Alpen buyers tend to purchase natural and organic items at a far higher rate than other customers and with significantly larger basket sizes. Delisting Alpen could effectively turn away these highly valued shoppers. Smart allocation takes into account these related variables.

With profitability falling, and consumers overwhelmed by the choices available, many retailers will be dramatically culling assortments. They will ensure that they have the products that matter in stock, and use extensive point-of-sale and other data about individual stores to get the assortment right for each.

Success in the increasingly changing retail environment will be largely determined by the extent to which retailers master the art of smart allocation – arguably the biggest trend in retailing since the arrival of the big box.

*Boost efficiency to strengthen profitability.* The boom of the past economic cycle fueled consumer spending, giving retailers a significant increase in store traffic and in the size of customers' shopping baskets. In response, retailers opened more stores, expanded their assortment, and increased the number of services they offered to consumers.

However, the economic downturn is reversing this dynamic. Retailers now find themselves hard-pressed to maintain profitability, as store traffic and consumer spending fall. For years, their focus has been to increase top-line performance, but the new environment calls for aggressive action to make the most of operating efficiencies and boost return on capital. The pressure to deliver higher profits per square foot is driving consolidation (such as Gap Inc.'s decision to close stand-alone GapBody stores and fold the brand into the main stores to save costs), the reevaluation of store performance, and the closure of unprofitable locations.

In addition to a renewed focus on profitable operation, the current environment calls for retailers to reexamine their expectations for the coming year, the changes in the competitive landscape, and their own strategies. How will you address potential changes across your labor model, inventory, space, corporate operating model, store footprint, and supply chain? What if volume drops by 25 percent? Fifty percent? What if margins get cut in half? Who among your competitors has the cost model to sustain continued pressure? Which of your categories and geographies are most vulnerable? How flexible are you prepared to be in the face of tectonic shifts in the landscape? The companies most likely to survive are those that are able to adapt quickly – for instance, by reassessing their operating models to streamline processes and practices, reduce work, and improve efficiency, or by determining which store services are really necessary to drive consumers back into the store and foster ongoing loyalty from the most profitable customers.

*Build capabilities for the long term.* The downturn will bring about an initial shakeout, as some retailers may not survive the immediate pressures. But the long-term winners will be those retailers that have built capabilities allowing them to form closer bonds with consumers and emerge as stronger players when the economy improves.

Many retailers have shown a lack of focus in determining which capabilities are most important: space allocation and assortment, labor and service models, purchasing and distribution processes, the ability to develop new channels and formats, consumer insight. The real question is this: Which capabilities will offer the most value and create the most loyalty in target customers? Investing in everything, rather than choosing the most critical capabilities, is typically an expensive and losing venture.

For retailers that own multiple brands or formats, the question of capabilities is even more critical. How can you gain scale around capabilities across your portfolio, thus getting the maximum impact from investments in those capabilities? If your brands require fundamentally different capability sets, does the portfolio make sense? Would some businesses create more value if they were sold off into another retailer's portfolio? When situated in a well-designed portfolio, capabilities naturally drive value for a company.

### **Looking Ahead**

Retailers find themselves facing a welter of uncertainty as they wait to see how changes in credit availability, commodity prices, and consumer demand will pan out. The one thing that is clear, however, is that waiting is the last thing they should do. It is only by taking decisive action now that companies will offset pressures on their top line, enhance their profitability, and emerge in a stronger financial position to make the investments required for long-term value creation as the economy eventually rebounds.

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