



THE ONLINE CONNECTION TO AMERICA'S HIGHEST-VOLUME RETAILERS

Retailers: Are You Ready for the Recovery?

(Jun. 1) By Andrew Rees, VP and head of L.E.K.'s Retail and Consumer Products Practice and Jon Weber, VP

Many retailers have labored to ensure their near-term survival. This required preserving cash and minimizing operating losses—particularly reducing operating costs, delaying major capital projects, tightly controlling working capital and fully exploiting existing credit facilities.

In addition, despite a drop in demand the more astute retailers maximized sales in the short-term by persuading reluctant customers to spend by quickly making some critical changes (e.g., pricing, promotion, etc.).

However tomorrow's market leaders will be those retailers who are now taking a fresh and critical look at their strategic options and considering bold moves that will create meaningful and lasting strategic advantages. Once the recovery is underway, they will be well positioned to steal market share from their competition.

Economic downturns have always resulted in a new set of companies emerging as leaders. The best management teams look for opportunities even in the worst of times. The bold moves they make translate into their becoming winners in the post-recession marketplace.

Right now the market is wide open and looks nothing like it did a year ago. Just look at your competitive landscape: the weakest players are battling for survival (or perhaps have already lost the battle). Some have pulled out of specific markets or scaled back their operations in other ways. And nearly everyone is operating very conservatively.

Now look at your customers: unlike past downturns, this one is likely to redefine their value equation—from where they shop, to when and how often and at what price point. And finally look at your distributors and suppliers: they are more willing than ever to modify or revamp their existing business practices and terms. These changing dynamics, coupled with the availability of discounted assets, spell huge opportunities. Strategic options that you never considered or were not viable even a year ago may now be available and could provide significant competitive advantage. Now is the time to start planning.

While there is no universal prescription for capitalizing on these circumstances, there are at least five areas that deserve consideration:

1. Grab Share by Buying/Merging with a Major Competitor

If you're convinced your business is focused on the right market opportunities, your primary goal should be to increase market share and gain scale. An economic downturn can turn the weaker or non-core assets of other companies into potential targets that can immediately deliver on this goal.

It is not enough to acquire cheap assets (though this could play a role in your broader strategic plan). You should also look to take advantage of a transaction that will propel you into a leadership position. Many companies have successfully employed this strategy. For example, consider TJX's acquisition of Marshalls over a decade ago. In 1995, Melville Corporation considered Marshalls one of its lowest performers after several quarters of declining operating profits. TJX was able to acquire Marshalls for \$550 million, an attractive price for a business with \$2.8 billion in sales at that time. The acquisition immediately transformed TJX into the clear market leader and in two years its share price more than doubled, creating \$2 billion in shareholder value.

2. Diversify by Buying into Adjacent Sectors

As you plan your bold strategic moves, take a close look at your value chain. You may find that the lines between segments have blurred, that some adjacencies have been more resilient to the downturn than others, or that you have the unique ability to extract more value by extending beyond your current domain. Diversifying within the value chain may provide top-line growth, protection against future downturns and incremental value for your customers.

CVS's acquisition of Caremark is a prime example. Combining CVS, the largest U.S. retail pharmacy chain, and Caremark, one of the top pharmacy benefits managers, was not an obvious play at the time given the two entities compete in prescriptions fulfillment. However, CVS saw a significant opportunity in combining pharmacy benefits management capabilities with its large retail distribution network.

After battling hostile counter-bids from rival pharmacy benefits company Express Scripts, CVS ultimately prevailed in combining the two entities. This bold strategic move has undoubtedly been a game-changer for CVS, transforming it into a comprehensive pharmacy services organization whose reach spans employers, health plan providers, and consumers. The combined company is now the country's largest buyer and distributor of prescription drugs, providing it much greater leverage with drug makers. More broadly though, CVS/Caremark has its eyes set on leveraging the two companies' capabilities, including a massive prescription database to improve patient compliance.

3. Expand into New Geographical Markets

Virtually every market in the world is being redefined by the global nature of this downturn. Global as well as regional players have experienced a weakening of their dominance in the markets they serve. Now is the time to reconsider your existing global footprint and determine which geographies are good prospects for gaining market share.

This expansion into new geographical markets is different from placing bets on emerging markets where your company's growth will be highly correlated with GDP. Instead it involves identifying and exploiting pockets of unmet customer demand in mature markets which, if successful, could be hugely profitable.

Take the German discount grocery chain ALDI. It is seizing on the disruption created by the economic downturn to ratchet up its expansion into the United States. ALDI is launching an aggressive strategy to enter mature markets and steal share from Wal-Mart, other discount stores and traditional grocers. Many of its 75 new store openings in 2009 will be in the heart of Wal-Mart territory, with prices between 15% and 20% lower than Wal-Mart. ALDI is able to price so low because nearly 95% of goods sold in its stores are private label compared to a reported estimate of 15.5% of goods sold at Wal-Mart. ALDI's vast and global purchasing power allows it to secure contracts with suppliers at a lower cost than its competitors.

Furthermore, as ALDI expands into the U.S., it is also refining its offerings to better meet

the needs of its target consumers based on valuable learnings from ALDI's current stores. With a business model perfectly suited to the economic environment, ALDI is in a prime position to steal market share.

4. Dramatically Re-engineer the Supply Chain to Systemically Reduce Risk

Many strategic options focus on external growth (e.g., new markets, new products and services), but bold strategic moves can also be focused internally to make your existing business more nimble and profitable. You will need to retool your business model to reduce exposure to risks inherent in the current business.

Spanish retailer Zara has systematically reduced its fashion risk by bringing virtually every function across the value chain, from design to manufacturing, in-house. By creating a more efficient value chain, Zara is now capable of taking a design from concept to shelf within two-weeks. No retailer can beat that.

Zara's model of quick inventory turnaround mitigates one of the greatest risks for any retailer: unsold inventory. The reasons for this are two-fold. First, designers can build out a line after seeing which fashions have already succeeded in the market. And second, no line is ever produced in significant quantity. This has made Zara one of the most flexible and dynamic retailers in the world.

5. Enhance Your Channels of Distribution

As you gain a greater understanding of your customers, you will find that your current customers no longer purchase the same way and in the same places. Furthermore, the market has redefined which customer segments are the most attractive and you must gain access to them as quickly as possible.

There are many ways to broaden your distribution to reach different customers. For Gap Inc., it has meant looking to its online division (Gap Inc. Direct) to create opportunities beyond simply making the product in its stores available to consumers online. Gap Inc. Direct has built an online-only brand, Piperlime, to sell branded footwear and accessories. It has also acquired the women's activewear company Athleta with the intention of dramatically growing this nascent brand through exposure to its large volume of online traffic. In short, Gap Inc. Direct is establishing a growth strategy independent of Gap's physical stores.

For most management teams, being able to objectively assess how their business, its competitive position and the marketplace have changed due to the recession can be challenging and require substantial resources. There are no short cuts. We believe that every business needs to undertake a thorough situation assessment that will form the basis of a new market view and allow the management team to systematically evaluate and prioritize their strategic options. Companies that successfully execute on them are poised to be the winners in the post-recession marketplace.