

Retail Services: Enhance Your Retail Offering with a Profitable Service Strategy

Services provided by retailers are becoming more popular – with the success of such endeavors as Best Buy’s Geek Squad, a direct reflection of consumers’ changing expectations around the types and sources of the services they find valuable. L.E.K. Consulting attributes these changes to three key factors:

- Increased demand for time-saving solutions
- Frustration with traditional service providers
- Growing complexity of many consumer goods

Many retailers, recognizing the importance and long-term nature of these trends, are introducing services that complement their core products and help to differentiate them from their competitors. The result is bundled products and services that add value to each other, meet customers’ expectations, and generate increased margins and new sources of revenue.

Through our work with numerous clients, L.E.K. Consulting has developed a practi-

cal approach to assessing the potential for a successful retail service extension, identifying four key requirements that provide a framework for evaluating such opportunities:

- Complement the current product mix
- Evidence of sufficient or emerging demand
- Transferable operational capabilities
- Sustainable advantage against other service providers

Those retailers that carefully evaluate their ability to meet these requirements are much more likely to develop a service business into a significant source of profitability and sustainable competitive differentiation.

Increasing Demand for Services

Several long-term drivers are accelerating the demand for services:

Increased need for time-saving solutions

Rising demands both at work and home are

driving consumers to seek service solutions to ease the time constraints placed on them. The number of dual-income married couples increased from 44% in the late 1960s to 58% by 2003, while over the same period the hours spent at work also increased.¹ From 1975 to 2004, the labor force participation rate of mothers with children under the age of 18 rose from 47% to 71% – a significant increase in women balancing the demands of work and home.²

With increasing obligations and less time to fulfill them, more consumers are outsourcing services that traditionally have been self-initiated. This trend is evidenced by the proliferation of take-out kiosks at restaurants, the availability of delivery services (e.g., dry cleaning, mail-order DVDs, groceries), and the mass-market acceptance of customized hired help, such as personal assistants, dog walkers, house cleaners, in-home fitness trainers and personal shoppers.

1. “Women in the Labor Force: A Databook,” U.S. Department of Labor, Bureau of Labor Statistics. May 2005.

2. “Women in the Labor Force: A Databook,” U.S. Department of Labor, Bureau of Labor Statistics. May 2005.

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Frustration with traditional service providers driving consumers to trusted retail brands

Today's consumers are more apt to seek out alternatives to traditional service providers, such as contractors for home repair, maintenance and remodeling, because they generally require considerable time to find and manage. Consumers want to buy from service providers that will complete tasks or projects efficiently and easily. As a result, they are increasingly turning to branded specialty retailers for streamlined end-to-end solutions.

Those retailers that strengthen their brands' unique value propositions can take advantage of increased demand for services because consumers trust them to deliver service solutions in line with their valued product attributes. The success of services businesses offered by such recognized companies as Best Buy (discussed below) and Home Depot reflects this growing trend.

Growing Complexity of Consumer Goods

The increasing complexity of consumer goods has led many customers to require assistance in installation, operation, servicing and/or repair. This is illustrated in the automotive sector (which is increasingly dependent on electronic computer diagnostics to identify points of failure) as well as the consumer electronics category, where tasks can range from home office computer and home area network (HAN)/Local Area Network (LAN) installation to complex audio and home theatre integration.

In a recent survey,³ L.E.K. found that in addressing computer-related problems, 80% of consumers required some form of outside intervention. While survey data shows that in the past many consumers were capable of managing technology-related problems with the assistance of friends and family alone, that option is becoming less viable due to the proliferation of hardware and software products with high degrees of technical complexity and often incompatible operating systems and accessories.

We believe there is a market opportunity for many retailers to add a profitable service component to their product mix. Numerous retailers have already done so, and many of those that have not are considering ways to leverage their business by including a service component.

Services Benefit Consumers & Retailers

Table 1 summarizes the services offered by several retailers and outlines the benefits to consumers and to the retailers.

PetSmart and PETCO are good examples of retailers that have successfully broadened into service offerings that complement their existing product lines. The services they offer range from in-store grooming and puppy kindergarten to boarding and veterinary services.

One-stop shopping provides convenience for customers and minimizes the potential aggravation of managing multiple service appointments. Moreover, customers may receive the benefit of lower prices by retailers who are able to lower costs by

effectively using floor space and increasing labor utilization across product and service lines.

Likewise, offering a complementary service platform provides multiple benefits to the retailer. Loyal customers can be counted on for repeat business and referrals to others. Adding a service line provides incremental sources of revenue and may boost sales of core products through the increased service-generated traffic. A complementary service offering allows for increased margins on commodity products (since the retailer is no longer competing exclusively on price) and can provide a significant advantage over competitors.

The profit contribution from strategically planned and well-executed service strategies can be significant:

- PetSmart has seen its service business grow at a 24.3% CAGR over the last three years (versus total company CAGR of 12% during that same time) with service revenues increasing from \$193.5 million in FY2003 to \$298.9 million by FY2005. PETCO, whose service business is growing at an annualized rate of 22% versus total company growth of 10%–12%, is realizing service business gross margins that are as much as 25% higher than the food category.
- Analysts estimate Best Buy's "Geek Squad" computer installation and repair service achieved a \$600 million revenue run rate in the 12 months following rollout, with gross margins of approximately 50%.

3. Online Survey, L.E.K. Analysis, Sept. 2004.

Table 1

| Company | Services | Benefits | |
|---|---|---|--|
| | | Customer | Retailer |
| PetSmart; PETCO | <ul style="list-style-type: none"> In-store grooming Canine education Veterinary services Classes Pet photography Doggie day camp | <ul style="list-style-type: none"> Enhances customers' experience in an area of interest, e.g., pet knowledge and care Provides convenience Minimizes potential aggravation of multiple service appointments May generate dollar savings in the form of bundled pricing | <ul style="list-style-type: none"> Differentiates from mass discounters offering pet food/supplies Generates gross margins as much as 25% higher than commodity categories Allows the retailer to price competitively across product lines |
| Lowe's; Home Depot | <ul style="list-style-type: none"> Installation of purchased products for home construction, renovation, and repair | <ul style="list-style-type: none"> Provides "one-stop shopping" for product and installation needs Provides confidence that the job will be done correctly and on a timely basis Eliminates frustration sometimes associated with repair/renovation projects | <ul style="list-style-type: none"> Provides new revenue source to bolster slowing same store sales Allows retailer the ability to compete on basis other than price Allows for retailer to differentiate itself from competition |
| Best Buy "Geek Squad"; Circuit City | <ul style="list-style-type: none"> PC installation and trouble shooting services | <ul style="list-style-type: none"> Provides "one-stop shopping" for product and installation needs Provides confidence that the job will be done correctly and on a timely basis Facilitates ease of acquiring add-on products when needed | <ul style="list-style-type: none"> Allows for retailer to differentiate itself from competition Increased sales of commodity PC products Provides enhanced margins through increased sales of accessory products Creates a new and significantly higher margin (~50%) revenue stream |

Understanding product use and customer perception is a critical first step in defining the complementary nature of service offerings. What are consumer sensitivities and preferences? How well are they currently served? How does customer behavior differ between categories? A targeted customer research effort aimed at assessing a retailer's strengths, as well as customers' unmet needs and frustrations, can provide a foundation from which to develop and assess potential service offerings.

Evidence of Sufficient Demand

A retailer is far more likely to succeed in offering a service for which there is existing demand through alternative channels or where there is a quantifiable market requirement for a particular service innovation.

In the residential satellite, HTI (audio/video) and HAN (home area network) market, for example, L.E.K. quantified the dollars that were being spent on installation and repair services through all channels available to the consumer. Demand in the installation and in-home repair segment of the residential satellite, HTI, and HAN markets was estimated to be approximately \$2.3 billion (Figure 1), verifying alternative channel sales as well as the total market size and potential for growth.

Surprisingly, verification of demand through market sizing and other quantitative analysis techniques can be overlooked in the rush to get to market. Attention to this requirement, however, is a key prerequisite to a successful services business launch.

- Home Depot has successfully complemented its DIY offerings with a Do-It-For-Me service that allows a customer to purchase a product and arrange for in-home installation in one transaction. Home Depot's service business, at \$4.3 billion in FY2005, has an impressive 3-year CAGR of 23.9% versus a 12% CAGR for total company revenues.

A Framework for Identifying and Evaluating Service Offerings

While profit potential for services offerings is high, so is the risk of making significant and expensive mistakes. L.E.K.'s

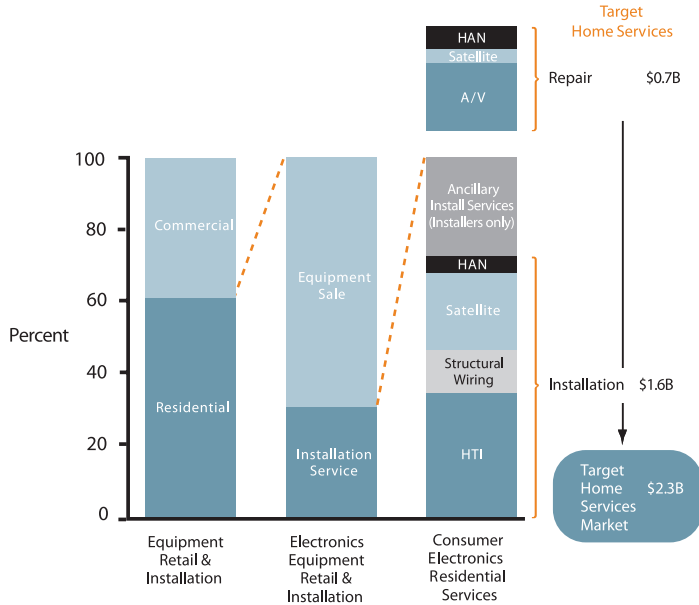
work in retail service expansion has identified four factors critical to the commercial success of a long-term service strategy.

Service Complements Current Product Mix

Services are most successful if they initially complement existing products purchased by existing customers. In the home PC market, for example, the installation and repair service business initially supported in-store PC sales, establishing a solid platform from which to serve its existing customer base. This business has been so successful, however, that now it is often the service component that draws customers into the store to purchase a PC.

Figure 1

US Consumer Electronics Residential Services Market



Source: L.E.K. Analysis

Operationally Capable

Most retailers are merchant focused, their primary concern being “getting the product right.” Selling services requires that retailers also possess the operational capability to transfer and scale resources to meet demand and ensure effective service execution. The more existing resources can be utilized to provide the service, the lower the utilization risk and the greater the probability for higher margins.

Using the HAN example, L.E.K. found that while a certain retail service provider’s business was generally aligned with opportunity in terms of number of installs, the value of the market was highly skewed toward a subsegment of high-complexity installations. A comprehensive assessment of operational capabilities allowed the retailer to reallocate resources and make business decisions regarding training and labor deployment to ensure

technical proficiency in the high-profitability segments.

Likelihood of Sustainable Advantage

Lastly, it is important to evaluate objectively whether the proposed service

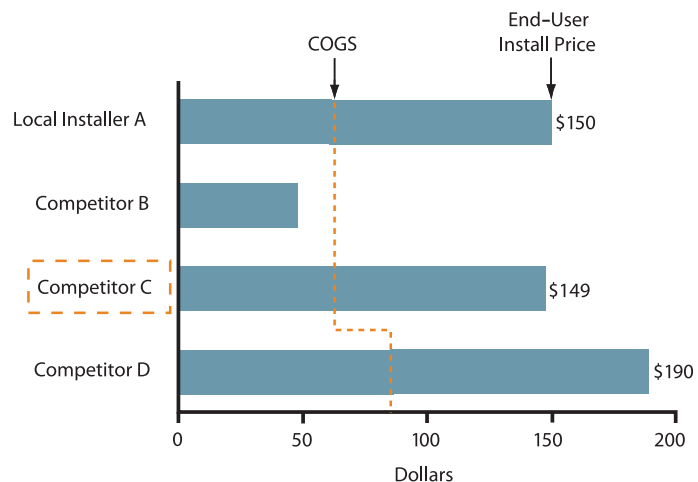
business offers an advantage over existing service providers. How is the service going to be different, more value-added and/or lower cost than what is currently available? Are there economies of scale a retailer enjoys that competitors do not?

Figure 2 shows that the cost of providing services to the HAN installation market can vary dramatically from company to company. Local Installer A provides a viable price point reference. Competitor B, while having the lowest end-user install price, is shown to use the service as a loss leader – independently, their HAN

installation offering was not sustainable. Competitor D could not compete on price due to its reliance on subcontractors. Competitor C realized that, by leveraging in-house expertise, existing infrastructure and resources, it could match local installer prices and provide a superior level of service – thus ensuring a sustainable advantage over the competition.

Figure 2

HAN Installation Profitability by Channel



Source: L.E.K. Analysis

Of course, additional business-specific criteria must also be evaluated. Meeting the above requirements, however, significantly increases the probability of developing a profitable service offering while minimizing risk.

Framework in Action: Best Buy's "Geek Squad" Case Example

With the rollout of its highly successful "Geek Squad" installation and repair service,⁴ big-box consumer electronics giant Best Buy has redefined the competitive landscape for PC sales. Examining the performance of Best Buy's "Geek Squad" within the context of L.E.K.'s framework, one can see that Best Buy's expansion into PC services met all the requirements likely to engender commercial success:

Service Complements Current Product Mix

The service naturally complements Best Buy's core business of PC and consumer electronic product sales.

Evidence of Sufficient Demand

Personal computers fail, and most customers cannot repair them. The business satisfies an unmet need within a category in which the company is strong.

Retailer Is Operationally Capable

The scale of the initial rollout heavily leveraged existing resources. Many repair desks become "Geek Squad" kiosks and existing repair technicians become "Geek Squad" Agents.

Likelihood of Sustainable Advantage

Relative to substitute service providers, Best Buy enjoys lower customer acquisition costs, better access to inventory than stand-alone competitors and a channel through which to sell higher-margin PC accessories. "Geek Squad" achieved a \$600 million revenue run rate within 12 months of full rollout. Analysts believe that comparable store "Geek Squad" sales will continue to see triple-digit growth through the next 12-24 months. Since launching "Geek Squad," Best Buy has greatly improved its competitive position in personal computers and generated a services-based revenue stream with gross margins of approximately 50%.

"Geek Squad" service (encompassing 12,000 "Geek Squad" agents and 1,500 home theatre installers) is currently available in all US and Canadian Best Buy stores as well as twelve stand-alone "Geek Squad" stores. Best Buy has announced plans to open 20 to 50 stand-alone "Geek Squad" stores in the coming years, confirming services as an integral part of Best Buy's operating strategy going forward.

Conclusion

From home improvement to pet services, consumer electronics and personal computers, retailers across many different product categories are adding services to enhance core product offerings. Service enhancements elevate switching costs, defend market share and generate customer loyalty. When executed well, services can create an independent, higher-margin revenue stream and provide a platform from which to generate add-on sales of other product offerings.

A directed, thoughtful expansion that takes consideration of the above requirements can vastly increase retailers' chances of launching a successful service strategy while avoiding costly mistakes. By applying this framework, L.E.K. has helped clients successfully develop their service business into a significant source of profitability and competitive differentiation.

4. The "Geek Squad" is a 24-hour computer support service that targets residential and commercial clients. Consumers can bring their PCs into the store for drop-off repair or schedule an in-home service visit from a "Geek Squad" Agent. New PC sales within the store are referred to the "Geek Squad" counter for installation of software and, frequently, upselling of additional higher-margin accessories.

L.E.K. Consulting is a global management consulting firm that uses deep industry expertise and analytical rigor to help clients solve their most critical business problems. Founded more than 25 years ago, L.E.K. employs more than 900 professionals in 20 offices across Europe, the Americas and Asia-Pacific. L.E.K. advises and supports global companies that are leaders in their industries – including the largest private and public sector organizations, private equity firms and emerging entrepreneurial businesses. L.E.K. helps business leaders consistently make better decisions, deliver improved business performance and create greater shareholder returns. For more information, go to www.lek.com.

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