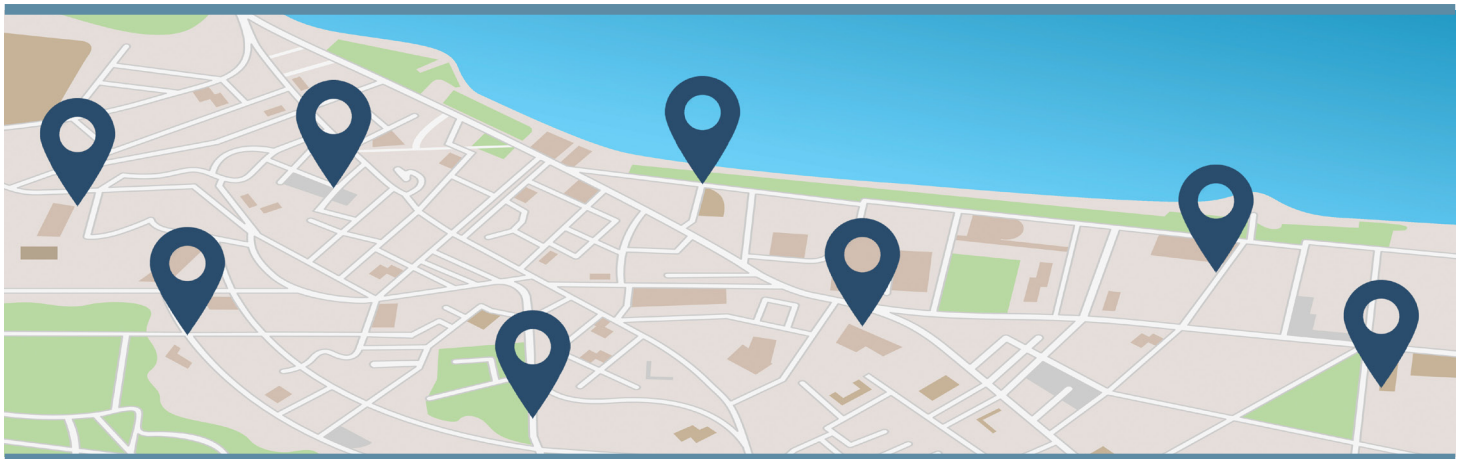

Executive Insights

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Planning a Profitable Store Network in a Multichannel World

The constantly changing relationship between online and offline retail channels is making the task of store network planning ever more difficult as retailers strive to protect and maximize profit margins. Excess space is a problem facing many retail businesses, with ecommerce success cannibalizing in-store sales. In addition, changing consumer behaviors and experience expectations are further hampering efforts to plan efficient store networks while also requiring additional investment.

In the past, traditional tools for consumer demographic catchment analysis could be relied on to plan store networks effectively, but these are no longer sufficient to analyze the complex forces at work. Retailers relying on these outdated tools are handicapping themselves because they fail to take into account the pace and degree of change in the market.

For example, the growth of multichannel means that ecommerce is both reducing in-store sales and also stimulating traffic via click and collect; store openings in new locations generate an uplift in online sales in addition to in-store revenue; and changes in retail location, particularly to retail parks, introduce different shopping missions and traffic characteristics.

Today, retailers need to answer a complex set of questions, including:

- How can I assess network strategy when the product or service is for a niche market and not captured by traditional gravity analysis models?
- What influence do store locations have on consumers' shopping plans and habits?
- How can I adapt planning tools that only provide a "static" picture, and do not accurately capture the impact of store closures or relocations in terms of the potential market share shifts to / from competitors in the geographic area?
- What is the relationship between stores, my business model and local customer demand?
- How do any changes impact the profitability of the overall business?

To plan accurately, retailers need a deep understanding of how market dynamics impact shopper behavior across different location types, exactly how each individual store in their network is used and its revenue streams, and the cost base of the business.

Adopting the right network modeling approach

L.E.K. Consulting utilizes sophisticated network planning tools and advanced data analytics to address these issues. We work with retailers and other network-based businesses, from pubs, restaurants and cinemas to garage chains and building products suppliers to help them increase profitability.

Planning a Profitable Store Network in a Multichannel World was written by **Jonathan Simmons**, a partner in L.E.K. Consulting's Consumer Products and Retail practice. Jonathan is based in London.

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By adopting a strategic approach to network planning, retailers achieve a number of benefits:

- The creation of a more accurate model for new store openings
- A deep understanding of the drivers of store segmentation and performance, and the associated impacts on and of ecommerce / multichannel
- An assessment of relative store performance and remedial actions for underperformers, such as location change, format modification and closure
- Detailed performance analysis by store category type within specific geographic areas

The examples below show how our retail network planning methodologies have been used to develop innovative value-creating network strategies for our clients — one through network growth; the other through network reduction.

Case study 1: Network reduction for a national garage chain to unlock significant profit uplift

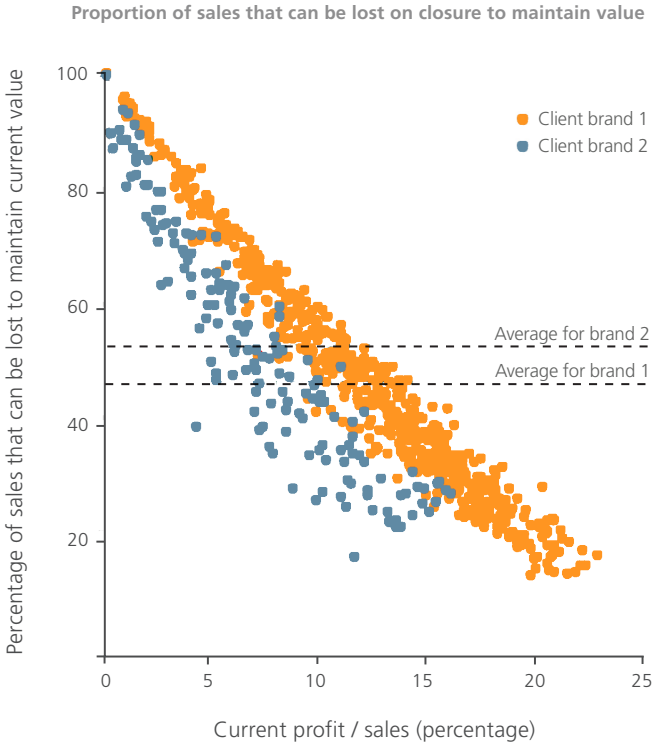
A national garage chain had built a network of hundreds of outlets over a period of time when market growth and a lack of competition made its "land grab" the winning strategy. However, sales and profit growth had slowed, and there was evidence of excessive cannibalization between the business's own outlets.

The company's management felt that it did not sufficiently understand the decision-making behavior of its customers to answer a critical question: "If we close an outlet, how much business will go to our other outlets nearby, and how much will be lost to our competitors?" This was understandable — they had not closed many outlets up to that point and believed that if consumers were asked "Where would you go?" the answers would be unreliable for strategic planning purposes.

The garage chain asked L.E.K. to advise on its network planning options. Our first step was to analyze the organization's customer postal codes to understand where they lived and where they took their car for servicing or repair. We then combined this data with detailed mapping of all competitor locations and analysis of drive times. This allowed us to develop an algorithm that traded off the brand pull of our client versus the proximity of nearby competitors; in other words, the likelihood that customers would drive past a nearby competitor and visit our client due to its brand strength. The third step was to test and modify the algorithm until its prediction of customer behavior matched actual behavior across all outlets in a region with a statistically high level of accuracy.

We then used this predictive model in reverse; by "removing" a garage we could model whether its customers would prefer to go to a nearby client outlet or a competitor's location. This degree of customer "loss" was coupled with an economic analysis of the fixed / variable cost base of each outlet to determine which outlets would be profitable to close, and which should be retained (see Figure 1).

Figure 1
Network rationalization model



Source: Management data; L.E.K. analysis

Our client used the model to reduce its outlet network by one third — and significantly increase its profitability.

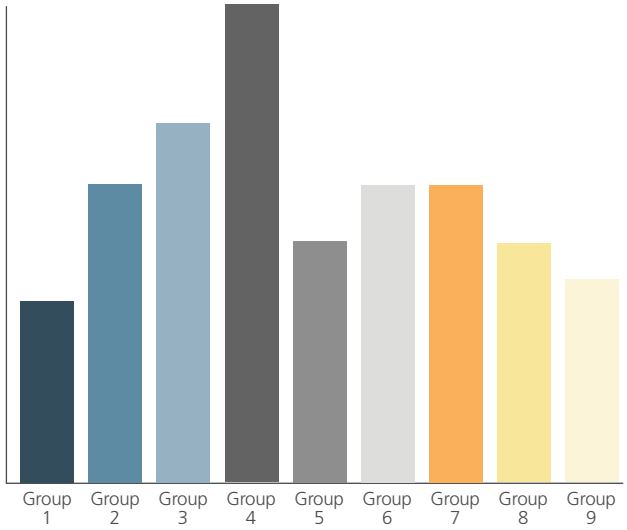
Case study 2: Creating value through outlet rollout for a national building products chain

The appropriate strategy for many retailers is to close stores to maintain and increase profitability. For others, their customer proposition means that growing the number of outlets in the network is critical for the next phase of business expansion. The question then becomes "How far can the network be expanded before profitability is diluted?"

We were asked to address this issue by a successful national building products retailer, which had built a network of several hundred stores and needed to know if there were underserved parts of the U.K. into which it could expand.

We analyzed thousands of the retailer's customer records, linked to the most-visited outlet(s). Our work clearly showed that while the geographic market of a typical store spread to several miles, 75%

Figure 2
Expected profit of additional store groups



Source: Management data; L.E.K. analysis

of its revenue came from a narrow radius. It also highlighted that the market share of our client by postal code was highly variable, leading to the conclusion that if high market share could be achieved in some areas, there was an opportunity to replicate that success through the creation of stores in underserved areas.

We developed a network planning strategy that segmented U.K. locations into a number of groups based on different market drivers, such as customer type, demand density and product mix. This allowed us to model the effect of placing additional outlets in underserved locations while maintaining a profitable market share in all local geographical areas relative to the performance of other outlets in the same group type. The model also enabled us to account for the overlapping geographic areas of the new and existing outlets to evaluate any cannibalization. Returns were maximized by flexing both the location and the format type (e.g., store size). The resulting analysis provided our client with a detailed rationale for new store openings, including the expected profitability of new store groups (see Figure 2).

Our analysis showed that the retailer's network could be expanded significantly, far more than management had anticipated, while still achieving incremental returns substantially in excess of any reasonable hurdle rate.

Conclusion

Many retailers are losing competitive edge and economic opportunity by using outdated network planning models. Leveraging sophisticated strategic planning models requires extensive analysis of individual stores, target customers, the competitive environment and the overall strategic direction of the organization — and the outcome for retailers can be an increase in profitability.

About the Author

Jonathan Simmons is a partner in L.E.K. Consulting's London office. He has almost 30 years of strategy consulting experience and leads L.E.K.'s European Retail and Consumer Products Practice. Jonathan has provided strategic advice to a broad range of U.K. and European-based companies, and companies from other regions seeking European market entry, with a particular focus on specialty retail, apparel and accessories, sports retail and brands, airport retail, automotive services and grocery retail. He has also advised on consumer-facing issues such as pricing, yield management and marketing strategy to a wide range of transport companies covering bus and coach, ferries and rail.