EXECUTIVE INSIGHTS

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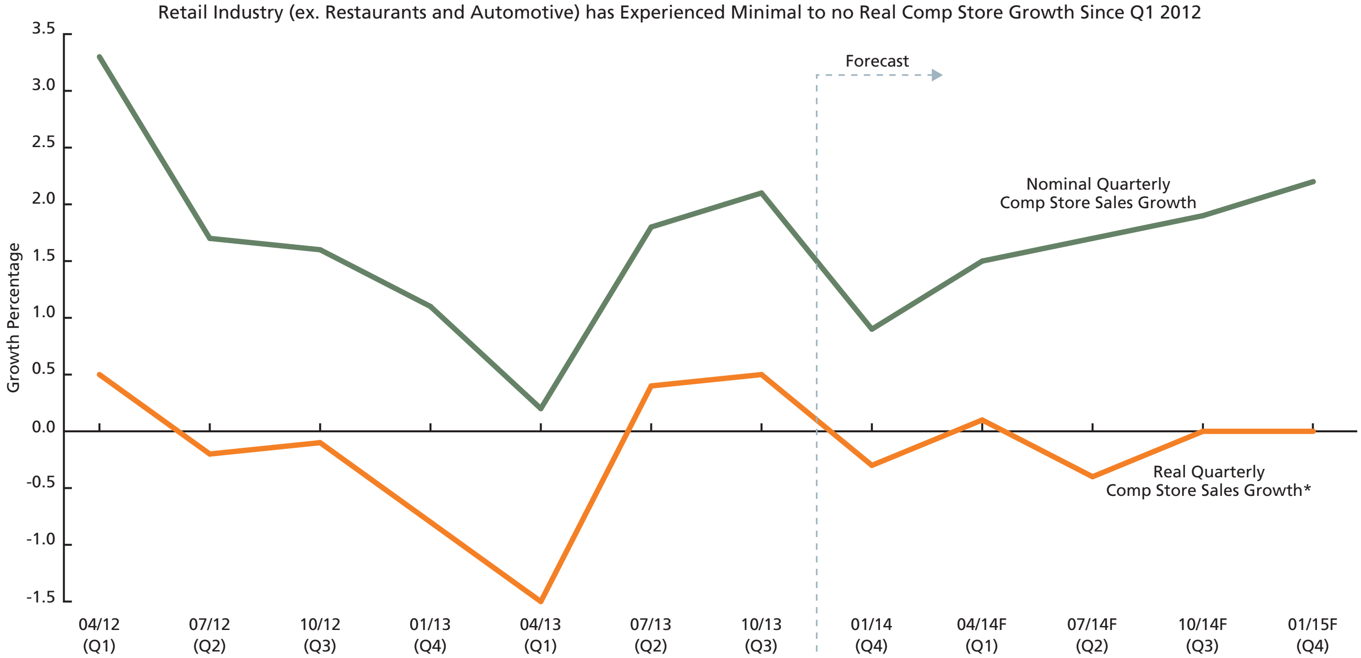
Cracking the Retail Conundrum: Positive Comps In A Digital World

Many retailers who are expecting continued growth in comparable (a.k.a. "comp") store sales at their brick & mortar locations will likely be disappointed – especially if they rely solely on what has worked historically. For one, the challenging economic environment of the past several years is expected to continue to hinder spending for the majority of U.S. consumers into the foreseeable future. Negligible inflation and wage growth won't help either. Increasingly savvy consumers are armed with instant access to mobile technologies, social media tools and a multitude of online alternatives for every product imaginable, which is changing how, where and how often they shop. Given these realities, it's hard to imagine how anyone could actually expect comp store sales to grow. There's just a lot of adversity for physical stores to overcome... and in fact, we believe "too" much for most.

Figure 1

Average Quarterly Comp Store Sales Growth

Retail Industry (ex. Restaurants and Automotive) has Experienced Minimal to no Real Comp Store Growth Since Q1 2012



Note: Compares revenues earned over the quarter to revenues earned over same quarter of the previous year, excluding restaurant and automotive retail; *Includes estimated quarterly inflation percentage growth over same period of previous year (non-seasonally adjusted)
Source: FactSet Research Systems SSS report card for 175 U.S. retailers, Euromonitor, L.E.K. analysis

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The baseline expectation should be negative comp store performance in brick & mortar locations for any retailer that isn't aggressively innovating. The fact that comp store sales have seen little to no real growth since 2012 (see Figure 1) supports this. In the face of this economic gravity, retailers should reconsider the balance of their physical vs. online assets and find solutions that deliver compelling and differentiated value propositions in aggregate. This is a complicated exercise and extends into the far corners of a retailer's business model and cuts across channels – what roles they play and where and how they interconnect. In this *Executive Insights*, we urge retailers to completely rethink the *store format* and proactively shift to a new end-state; one that plays a distinct and relevant role given new consumer behaviors that are here to stay.

Brick & Mortar Stores Reach Market Saturation

For decades, a "build it and they will come" strategy proved prosperous as successful retailers capitalized on underlying economic growth and the massive buying power of baby boomers. However, the building spree overshot and recent headlines from a host of major retailers confirm continued store closings after approximately 30,000+ retail doors shuttered between 2004 – 2014 (see Figure 2).

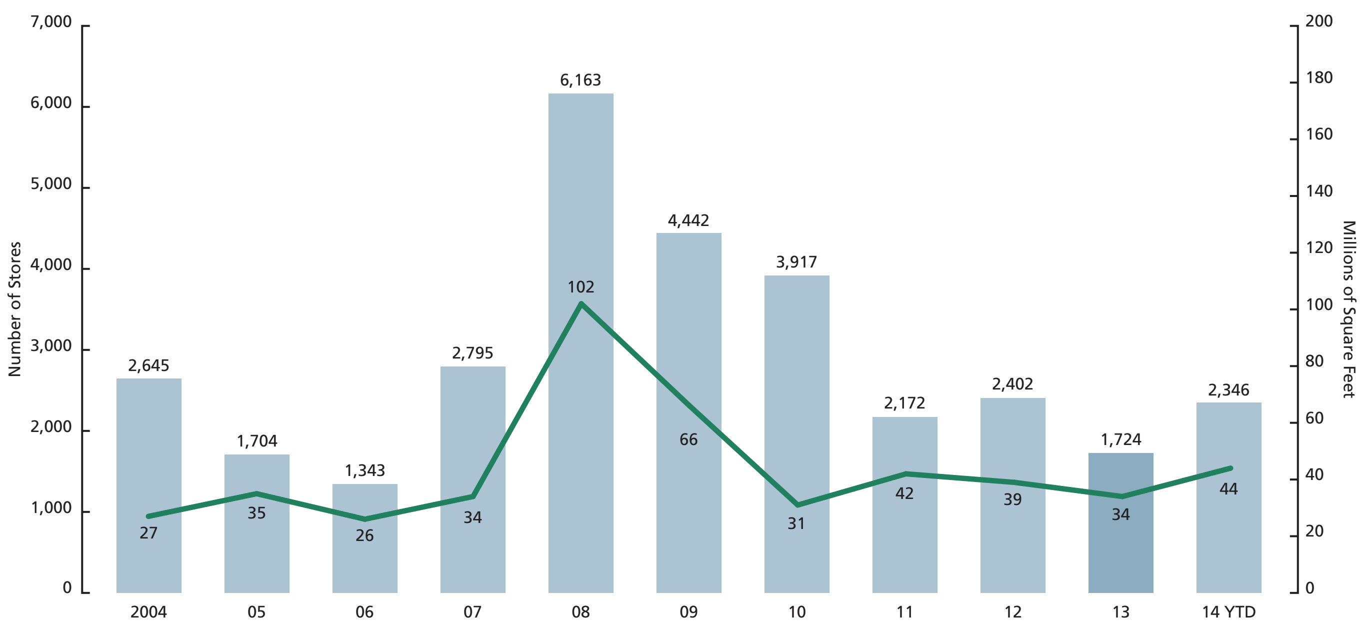
The Giant Sucking Sound

There's no question that digital technology continues to dramatically alter the retail industry as shoppers buy online more and more, and visit physical stores less. In fact, virtually all growth in retail sales is being captured by e-commerce (see Figure 3). The widespread adoption of e-commerce and mobile technology has fundamentally changed what was once a relatively linear purchase cycle centered on the store. Today's consumer follows a dynamic, multi-faceted customer journey, where they interact with various touch points – stores, desktop or mobile websites, social media and apps.

Rethinking the Physical Interface

As empowered consumers are using myriad shopping tools and enjoy flexible channel alternatives, traditional brick & mortar locations cannot thrive with old strategies. Thus, there

Figure 2
Store Closing Announcements (2004-2014)



Note: YTD = total announcements as of June 12, 2014
Source: Credit Suisse – 2014 Survey of Retail Industry Capital Spending and Returns report, L.E.K. analysis

is a clear call to action in the retail industry to transform the definition of a physical store. It begins with challenging the status quo and asking: "Are we really delivering a compelling customer proposition in this newly enabled world?"

Here are five strategic factors to consider:

1. **Re-think the store model:** With waves of store closings, the role, size and overall number of stores will likely shift dramatically for retailers. For some organizations, this can mean smaller sized stores that demonstrate the product but not the whole range. Less frequently, it can even mean fewer but larger stores for a higher-impact showroom effect. More importantly, the role of the store will change dramatically to more actively sync with digital transactions. A good example is adding online fulfillment to retail stores to meet customers' desire to pick up purchases right away instead of waiting for shipping.

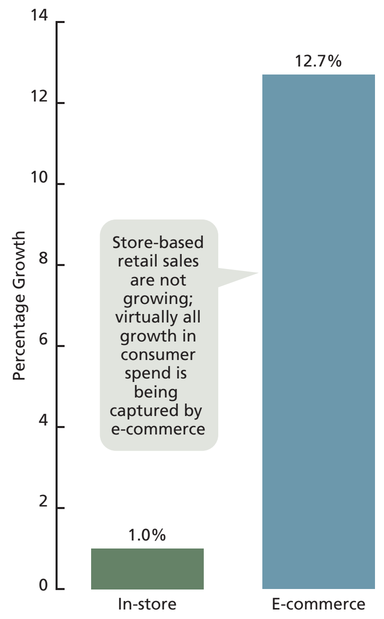
2. **Drive tighter connections between stores and digital:** Digital infrastructure must proactively drive customers to the store and deliver the multichannel flexibility that is vital to attracting and retaining discriminating shoppers. For instance, offering "extended aisles" to sell merchandise that is not located in the store yet (for example, via swatches or samples) allows customers to order either in-store or online.

3. **Elevate the in-store brand experience:** Today's modern shopper walks into a store possessing a wealth of information. They're not only looking to make a purchase, but also want store associates who can relate to them and offer value-added advice. In return, store associates need to raise their game by becoming both brand advocates and sales consultants. Retailers should leverage technology to put detailed product information and customer purchase history at associates' fingertips. By walking in step with the customer digitally, retailers can go beyond transacting to creating memorable brand experiences.

4. **Reboot the merchandising process:** Determining how products should be merchandised in a multichannel environment may require a revamped approach and revised pricing and promotion strategies. Defining which products are offered in-store, online or via extended aisles is an integral part of this exercise. Retailers should also reassess whether more content is needed on their digital platforms to enhance the in-store shopping experience – especially given the rise in both showrooming and "webrooming" (reverse showrooming).

5. **Challenge traditional organizational structure:** Retailers should build a channel agnostic organization. This involves breaking barriers that protect one channel's sales at the expense of another. It also means building incentives that encourage cross-channel support and reward aggregate sales targets. Ultimately, engagement should be orchestrated in a way that allows customers to enter and exit any channel seamlessly. This strategy must acknowledge the customer's ongoing access to product information, promotions and support.

Figure 3
Change in U.S. Retail Sales (2006 – 2012)



Note: 2012 is the most recent year with annual figures; analysis excludes electronics and appliance stores, building materials and supplies stores, health and personal care stores and general merchandise stores because of data limitations, and nonstore retailers, miscellaneous stores and gas stations because of relevance
Source: U.S. Department of Commerce, L.E.K. analysis

Although physical stores are slipping as the anchor channel in today's multi-dimensional purchase cycle, a revamped store format can still play a critical role in driving profitable growth. Equally important, retailers cannot afford to wait too long before responding to the new realities of smarter, more agile consumers in a fast-changing digital world.

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