Harvard Business School

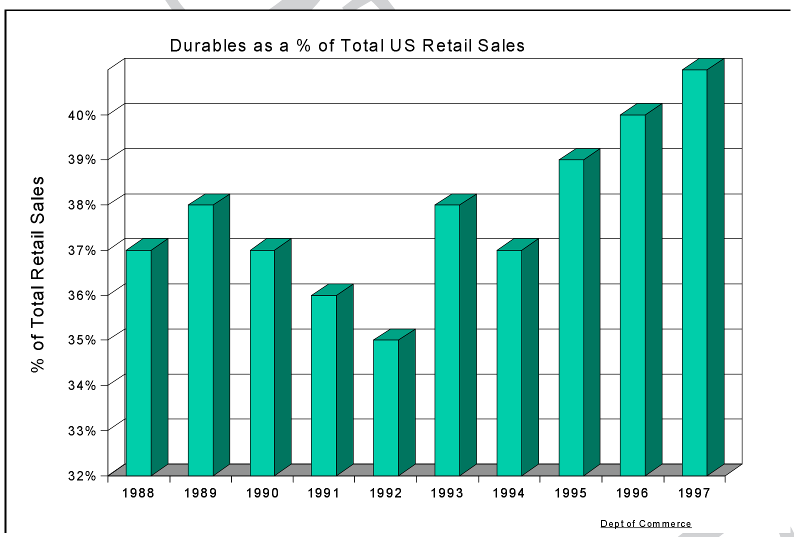
9-598-148

May 13, 1998

Note on the Retailing Industry

Retailing is a huge and varied part of the economy. Everything from Home Depot to the newspaper kiosk in the T station retails its products. The U.S. Department of Commerce defines retail trade as: "… sell[ing] merchandise for household consumption. In general, the stores in this sector operate at fixed places of business and take part in activities to attract the general public to make purchases." More succinctly put, retailing links the producer of goods to the consumer.

Retailers are classified into two main subsectors; durable and non-durable goods. Durable goods last more than three years and their sales are historically more volatile. In times of high interest or unemployment rates, the purchase of a new car or carpet is easier to postpone than that of food or clothing. The graph below shows that durable sales as a percentage of total retail sales falls dramatically during recessions (1990-1992) and has risen of late in response to the persistent recovery.[1]



1 Standard & Poor's *Industry Surveys - Retailing: General*, 2/5/98, p. 10.

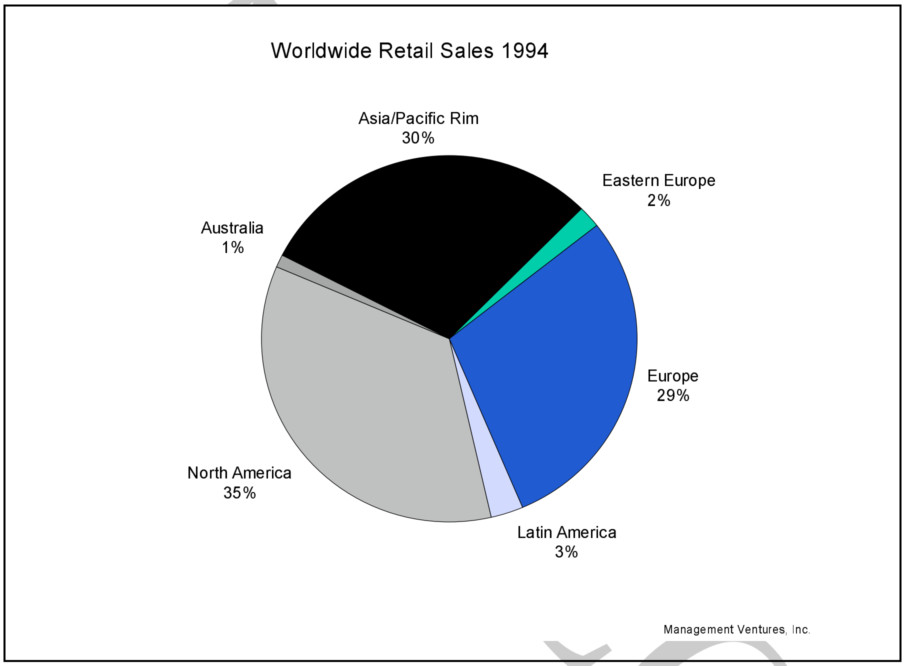
Research Associate Ann Leamon prepared this note under the supervision of Professor David Bell as the basis for class discussion.

Durable goods include building and garden supplies, automobiles, computers and home furnishings and furniture. Non-durables are best described by where they are sold; general merchandise stores, food and drug stores, apparel and accessory stores, and eating and drinking places. Miscellaneous retail stores sell both durable and non-durable goods, such as "artists' supplies, medical equipment, pets, tombstones, and religious devices".[2]

Since 1988, retail trade in the U. S. has grown at a 4.7% annual rate. Durable goods sales have grown faster, at 5.6% annually, while non-durables rose at a 4.2% rate.

International Retailing

Retailing occurs, like bank robberies, where the money is, but also, unlike those less legitimate activities, where people are. Thus, it is little surprise that the wealthiest and most populous parts of the world have the most retailing activity, as shown in the following graph.[3]



The top 10 global retailers are listed on the following page.[4] Wal-Mart dominates the world retail scene, with revenues and profits 2 ½ times those of its nearest rival. Along with most American firms, Wal-Mart, operating in only Argentina, Brazil, Canada, China, Indonesia, Mexico and the U.S., is less international in its scope than its European counterparts. In contrast, Metro, the #4 firm, has a presence in 16 countries, including Turkey, Hungary, and the U.K.

[2] U.S. Department of Commerce, *Standard Industrial Classification Manual*, 5999, Miscellaneous Retail Stores, Not Elsewhere Classified, Division G, Major Group 59.

[3] U.S. Department of Commerce/International Trade Administration, *U.S. Industry and Trade Outlook, 1998: Retail Trade* , (DRI/McGraw -Hill, Boston MA) p. 42-0.

[4] Deloitte & Touche, "Global Powers of Retailing", survey article in *Stores*, January 1998, Section 3, pp. S4.

Rank	Base	Company	Type	1996 Rev. ($MM)	1996 Profit ($MM)
1	US	Wal-Mart	Discount, Warehouse	104,859	3056
2	US	Sears	Department, Specialty	38,236	1,271
3	Germany	Rewe Zentrale	Supermarket	37,442	NA
4	Germany	Metro	Department, Specialty, Supermarket	36,578	406
5	Germany	Tengelmann	Drug, Specialty, Supermarket	33,688	NA
6	Germany	Aldi	Supermarket	32,000	NA
7	US	Kmart	Discount	31,437	(220)
8	France	Carrefour	Discount, Hypermarket	30,277	767
9	Japan	Ito-Yokado	Department, Discount, Specialty, Supermarket	27,752	683
10	France	Leclerc	Home Improvement, Drug, Hypermarket, Specialty, Supermarket	26,466	NA

Other well-known global retailers are Japan's Daiei (#16), a drug, specialty, and supermarket chain, UK's Tesco (#18), one of the loyalty program pioneers in the supermarket industry, Otto Versand (#27), the German mail order giant, and Marks & Spencer (#41), a private label giant in the U.K.

The U.S. has the largest retail market in the world, and the most large retailers. Its retail climate is fairly open, with large plots of land available for development in most areas and relatively lenient zoning laws. The recent record low unemployment rates have tightened the supply of low-skilled labor on which retail depends, forcing employers to offer higher wages or better benefits. Government regulations of opening hours are minimal, since the demise of "Blue Laws" that prohibited sales on Sundays.

The situation in Europe is different. Europe's strong social welfare legislation has curtailed both the sizes and the shopping hours of its retailers. In Germany and Belgium, these restrictions have essentially precluded the establishment of "big box" retailers. In the U.K., longer shopping hours are slowly being allowed.[5] Labor supplies are tight there, now, too, and the power of unions in some countries - Germany, for one - has led to strikes, short work weeks, and high wages even when unemployment is high.

The American style of "big box" strip centers is less welcome in Europe, after an unsuccessful experiment with strip mall development in the 1980's. Concerns about repeating the U.S. experience

[5] Euromonitor, *Retail Trade International 1995*, 8th ed., (London, 1995), p.3.

of downtown decay has led to tighter planning laws throughout Europe.[6] Most shopping center development in Europe occurs in downtown areas, with the establishment of pedestrian zones or covered walkways between co-located stores. In Japan, the Large Store Law, although weakened, still complicates the establishment of big stores and regulates opening hours.

Retailing in the U.S.

Retail sales in the U.S. accounted for $2.2 trillion in 1997, or 27% of the country's Gross Domestic Product. Non-durables made up $1.5 trillion (65%) of that. The 1.6 million retail establishments in the country employ over 20 million people, or 18% of the workforce. While Wal-Mart and other mega-firms may grab the headlines, the vast majority of firms (88%) have fewer than 20 workers, and 90% of retail establishments are just one store[7].

Retailing in the U.S. is a mature industry, suffering from over-capacity. Between 1976 and 1995, retail square footage soared from 8 sq. ft. to 19 sq. ft. per capita. While the baby boomer's voracious appetites for consumer goods, especially in the 1980's, supported this strategy, subsequent trends opened it to question. In particular:

- Time stresses have made shopping a chore rather than a source of recreation. Trips to the mall are down more than 50% since the early 1990's, and shoppers visit fewer stores once they arrive. [8]

- Priorities have shifted. Boomers are saving for their own retirements and their children's education. Rather than buying *things* for holiday gifts, consumers are giving *experiences* (family vacations, lessons).

- Consumers are more price conscious. A Kurt Salmon survey in 1996 revealed that 84% of respondents felt that department store prices were too high. In reaction, 25% said they shopped at discounters and 70% bought clothes on sale. Indeed, the last few Decembers have seen frenetic markdown activity, which has trained consumers to wait for the last minute. Swimsuits, historically full-price until July 4, have recently been marked down as early as Memorial Day.

- Value is a more complex concept than it once was. Once a function of price and quality, it now includes convenience and entertainment. Thus, some warehouse stores are finding that their low prices are outweighed by the inconvenience of the entire experience.

- Precision shopping has become more prevalent. Consumers target what they need, find it, and leave to spend their time on leisure or entertainment, rather than foraging throughout the store. This reduces impulse purchases, as well as random store visits. The increasing popularity of Internet shopping allows for targeted purchases as well as random, yet uncommitted, information gathering.

In short, the old retail format, in which the consumer purchased the closest approximation to what she wanted from the goods that the retailer offered, has been turned on its head. Consumers have such a dizzying array of choices now that the old "push" method of purveying goods has

---

[6] *Ibid.*, p. 5.

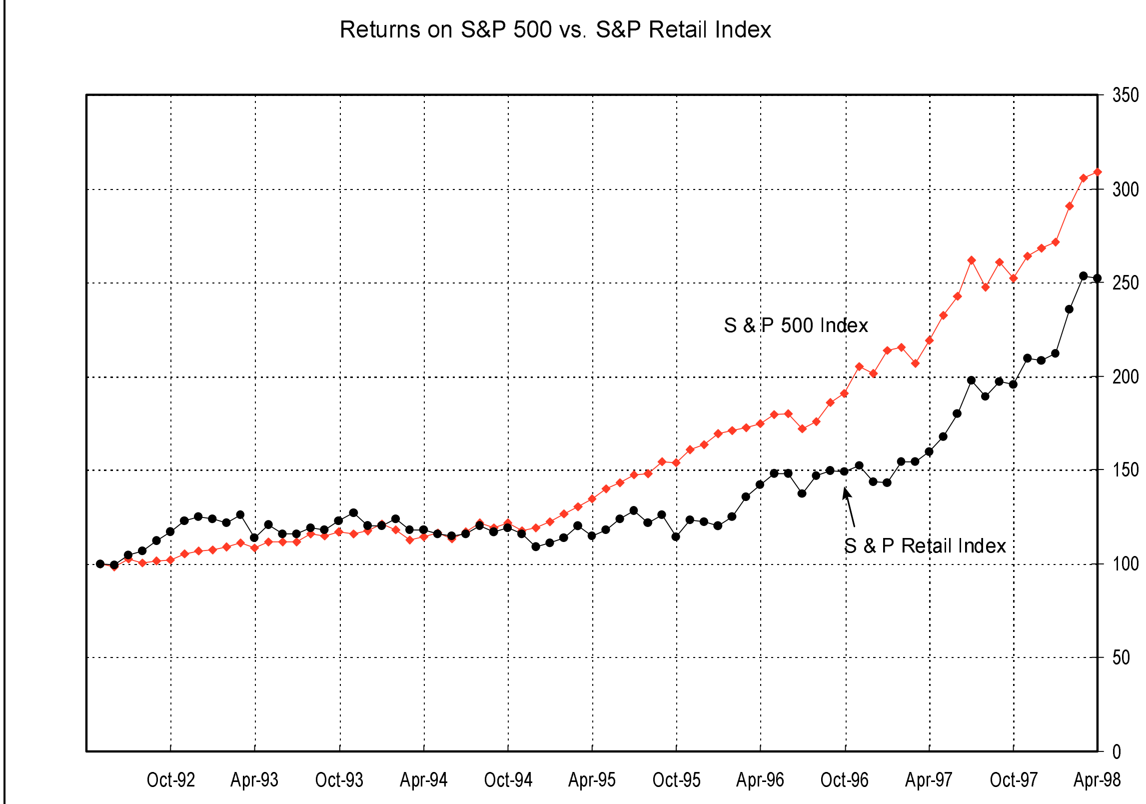
[7] Standard & Poor's *Industry Surveys - Retailing: General*, 2/5/98, p. 5.

[8] Management Horizons in ibid., p. 1.

become "pull". Customer loyalty can no longer be taken for granted. The retail world has become one of cut-throat competition.

In the face of too much retail space and too little customer interest, the most common growth strategy has become purchasing market share. Consolidation has been the watchword throughout the retail industry since the early 1990's. Big chains are buying one another (the attempted merger of Office Depot and Staples) or regional firms (Sears' purchase of Orchard Supply), grand old names are going out of business (Abraham & Strauss, Bonwit Teller), neighborhood formats are folding (the independent hardware store is a rarity), and regional chains are disappearing (Downeast Drug Stores, Zayre's).

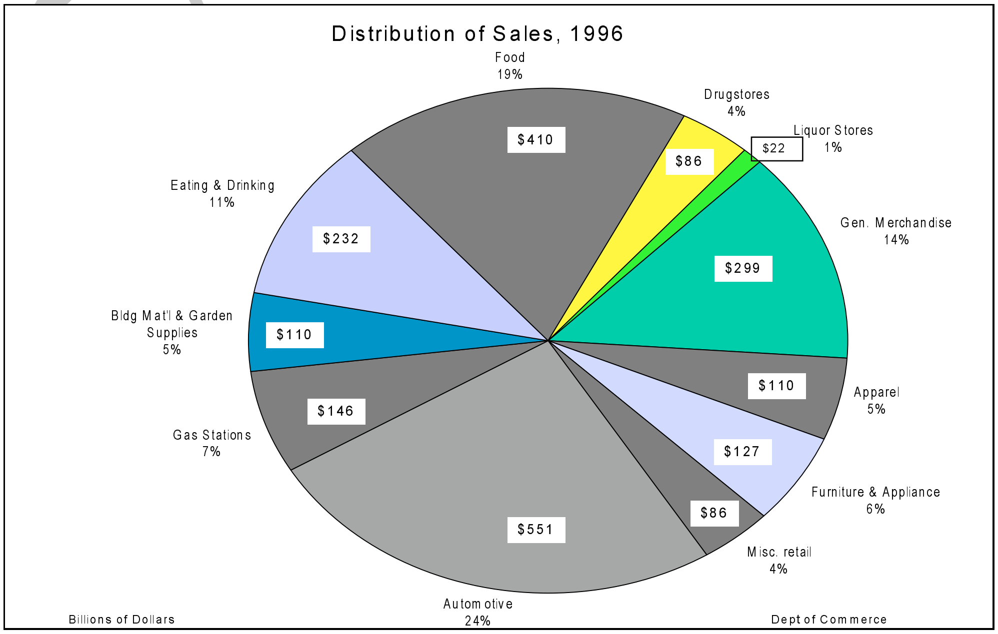
The turbulence in the retailing industry has reflected in its returns. Returns on the S&P retail index of discount, department, and chain stores have under-performed those of the broader S&P 500 for the last four years. The stock market's climb has passed by retail stocks, reacting to the string of bankruptcies, over-capacity, consumer price consciousness, and weak holiday sales.



The **supercenter** and **category killer** phenomena are concrete manifestations of the new consumer trends and the trend toward consolidation. Supercenters combine groceries and general merchandise, allowing one-stop shopping for everything from steak to tires. Wal-Mart pioneered this channel, using its huge scale economies to offer low prices that offset both the inconvenience of the store's size and the oddity of the mix. Warehouse clubs, like B.J.'s, Sam's Club, and Costco, also offer groceries and hard goods. Category killers, on the other hand, offer depth of assortment at low prices. Office Depot, PETsMART, Sports Authority and Toys R Us all provide huge options, but often require a special trip.

While the overall trends are common across the entire retail sector, they manifest themselves differently in the different subsectors. While apparel struggles in the face of a more casual workplace and the aging baby boomers' preference for comfort over fashion, building and garden supply firms reap the benefits of their attention to home and longing for nature. Drugstores, constrained by managed care plans, nonetheless stand to benefit from the inevitability of boomer aging. Eating and drinking places gain from the time-stresses of society as dining out becomes less of a luxury and more of a convenient method of coping.

The following graph shows the distribution of retail sales across the various subsectors in 1996. [9]



The biggest players in these sectors are listed on the following page.[10] In some cases, the overlapping product selections of the biggest chains defeat Department of Commerce definitions; thus, some sectors are not listed because their products are so overwhelmingly sold through general merchandise stores. In others, firms are noted as belonging to two sectors; J.C. Penney not only runs the J.C. Penney chain stores and mail order catalogs, but also owns the Eckerd Drugstore chain.

---

[9] U.S. Department of Commerce/International Trade Administration, *U.S. Industry and Trade Outlook, 1998: Retail Trade* , (DRI/McGraw -Hill, Boston MA) p. 42-0.

[10] Deloitte & Touche, "Global Powers of Retailing", survey article in *Stores*, January 1998, Section 3, pp. S4, and corporate reports for McDonald's and Burger King.

Sector	Firm	1996 Sales ($MM)	1996 Profits ($MM)
General Merchandise	Wal-Mart	104,859	3,056
	Sears	38,236	1,271
Automotive	Autozone	2,240	167
	Pep Boys	1,829	100
Food	Kroger	25,171	350
	Safeway	17,269	461
Apparel	Dayton-Hudson (also Gen. Merch.)	25,371	463
	J.C. Penney (also Drug)	23,649	565
Drugstores	American Stores (also Food)	18,678	287
	Walgreen	11,778	372
Eating & Drinking	McDonald's	31,000	1,572
	Burger King (subsidiary of Grand Metropolitan, PLC)	9,000	261
Building Supplies	The Home Depot	19,536	938
	Lowe's	8,600	292
Miscellaneous	Toys "R" Us	9,932	427
	Woolworth	8,092	169

Retailing Issues

The issues facing retailers in the U.S. today fall into 4 major groups:

- The reality of a consolidating environment.
- Technology and its implications for communicating with customers, suppliers, and internally, and the power it gives consumers.
- Brand perception and ownership. Nike, Levi's, and Calvin Klein are all recognized brands, commanding customer trust and loyalty, but so are store

brands such as L.L. Bean, Lands' End, and Kirkland Signature (Costco).[11] This changes the balance between vendor and retailer, because the customer's allegiance may now be to the store rather than the manufacturer.

- Vendor relationships and the dawning realization that retailer and vendor are in it together, rather than participating in a zero-sum game.

Consolidation

Retail consolidation is widespread. In 1982, the eight largest retail firms accounted for 8.8% of national retail sales. By 1992, this figure had grown to 10.2%. Among department stores, the top four firms controlled 53.1% of the sector's sales in 1992, up from 42% ten years before.[12]

The following five years have simply seen the trend intensify. In the discount ranks, three firms (Wal-Mart, Target, and Kmart) together accounted for $155 Billion in sales in 1997, or 7% of all U.S. retail receipts for that year[13]. In the restaurant industry, 180 mergers occurred, an all-time record - and this includes only chains with 4 or more stores.[14] Autozone, with 1,300 stores, Pep Boys, with 646, and Sears, through its 500 Parts America outlets, are threatening the traditional mom-and-pop automotive store with extinction.[15] These mega-firms intensify the competitive pressures in the industry through their resources, which allow them to invest in cost-cutting technology, and their scale, which engenders the "virtuous cycle of productivity", making suppliers sit up and take notice, both in cutting better deals and in producing private label goods. Consolidation, then, makes these issues, which could be defined as "just the big guys' issues" everyone's issues.

Consolidation in the industry has led to another phenomenon, the blurring of the distinction between distribution channels. Where previously grocery stores sold food and hardware stores sold tools, supercenters sell food and hardware. New formats have developed; 40 years ago, one purchased apparel from department stores, chain stores (such as Sears or Penney's), or specialty stores. In 1997, Wal-Mart, a discounter not even dreamed of in the 1950's, accounted for 7.6% of all apparel sold in the U.S.[16] Just since 1990, apparel sales have shifted markedly from department and specialty stores to discounters and factory outlets, in response to customers' price focus, and to direct mail, reflecting the consumers' desire for convenience, as shown in the following graph. The growth in the Chain segment reflects the impact of Sears' "Softer Side" campaign.

[11] Ira P. Schneiderman, "Brands building bigger base", *Daily News Record*, 27(113), 9/19/97, p. 48, and Tim W. Ferguson, "A revolution that has a long way to go", *Forbes*, 8/11/97.

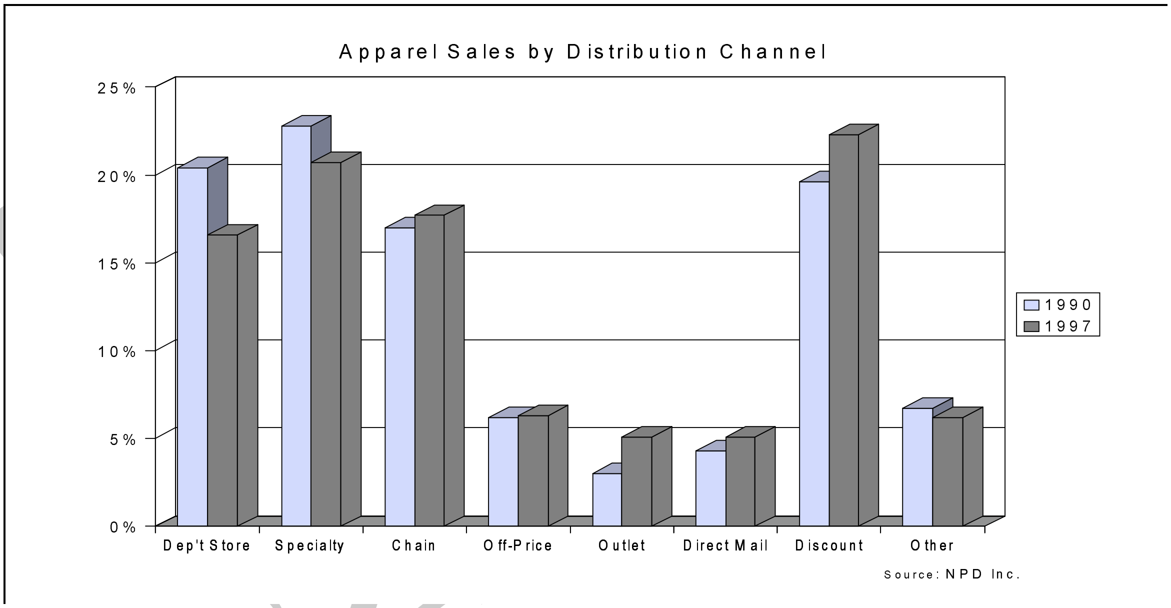
[12] U.S. Department of the Census, *1992* and *1982 Census of Retail Trade.*

[13] Standard & Poor's *Industry Surveys - Retailing: General*, 2/5/98, p. 5.

[14] Milford Prewitt, "Merger/acquisitions survey: Record number of transactions in '97", *Nation's Restaurant News*, 32(13), 3/30/98, p. 3,89.

[15] Mark Edward, "Automotive aftermarket continues to grow", *National Petroleum News*, 90(1), 1/98, p. 12, and Anonymous, "Retailers drive price home in automotive" *Discount Store News*, 36(15), 8/4/97, p. 86.

[16] NPD Customer Survey Panel data, 5/13/98.



The major issues are all attempts to achieve success in retailing; giving consumers what they want when they want it at the price they're willing to pay. Technology and vendor partnerships try to reduce costs and get the right goods in the right place. Branding addresses the other end of the equation, by convincing the consumer to pay more for the item, or that a lower-priced product is equally good.

Technology

Technology allows retailers access to their customers and to their suppliers. Having initially automated their old ways of doing business, many retailers are now rethinking the entire way they communicate, collect, and use information.

Many retailers have started to use the **Internet**, whether to offer information on their products or to provide another distribution channel. Mail order firms in particular have jumped on this medium, putting their catalogs on-line and embellishing their offerings with additional information or bargains -- L.L. Bean's web site includes information on national parks, in addition to the company's catalog goods, while Lands' End liquidates some items in an auction-type situation. Other firms, especially grocery stores and restaurants, use the Net to enhance internal communications.

Loyalty programs, pioneered by grocery stores and airlines, make use of magnetic swipe card technology. In exchange for giving a retailer demographic information, or, by using their credit card, access to their purchasing patterns, customers receive discounts. **Data-mining** or **data-warehousing** is the process of analyzing this huge volume of transaction data and extracting information to help retailers target their most profitable customers. Mail order firms, with their files on customers and history of targeting catalogs to various customer groups, have a natural advantage in this area.

Other aspects of technology are primarily used for communication with vendors. Electronic Data Interchange (EDI), Efficient Customer Response (ECR), and QR (Quick Response) all rely on electronic communication of purchase orders directly from the retailers' system to the vendor. By eliminating keying errors and transit time, EDI and its kin squeeze costs from the system. The cost savings are not free, however. Wal-Mart, Kmart, and Target all have their own proprietary systems, which they require their vendors to install. These big retailers require bar codes and other types of merchandise preparation (clothing on hangers, orders pre-priced), forcing costs on their suppliers and further increasing the returns to, and imperative for, scale.

Brands

Brands have achieved an odd status in the '90's. Consumers like them, claiming that they reduce the uncertainty of choosing products, give a guarantee of quality, and generally simplify their lives. At the same time, consumers have developed a curiously inclusive definition of brands, in which J.C. Penney's Arizona jeans have a cachet close to that of Levi's, and Sears' Canyon River Blues label achieved its 2-year sales target in its first 10 months on the market.

Private label essentially allows the retailer to short-circuit the vendor. It gives retailers control over the quality and design of their products, with the side-benefit of higher margins. Private label is nothing new, growing out of the generic grocery products of the 1970's. The new aspect is the depth and breadth of private label assortments throughout the retail industry and the advertising used to support them. Currently, the private label has a 20% share of revenue for the grocery industry, and some sources expect it to grow to 25-30% in the next five years.[17] In some cases, retailers are discontinuing their branded lines in favor of private label, as Wal-Mart did with car batteries, dropping the Energizer and Champion brands in favor of its Everstart program.[18]

A really powerful **brand** can allow the vendor to short-circuit the retailer and go directly to the consumer. Nike-town is perhaps the most vivid example of this phenomenon. Not only does Nike hold a commanding lead in the sporting goods industry, which requires any serious retailer to carry its products, but the company also runs seven "brand awareness" stores, which generated roughly $100 million in 1996.[19] These stores show the entire brand, in an atmosphere of "retail as theater" with larger-than-life photos of Michael Jordan and other brand athletes. To a lesser extent, Authentic Fitness/Speedo, Timberland, and Reebok have done the same.

Mega-firms are also bringing brands into previously less-brand aware sectors. Convenience stores now offer various types of branded fast food - Subway, Taco Bell, Dunkin' Donuts. Not only does this answer the consumers' time constraint, but it also reduces their uncertainty -- a Subway sandwich at the Quick Mart is less of a risk than a no-name brand.

Vendor Relations

Despite the tensions that may arise between brand and private label products, vendors and retailers are talking about the need to work together in the current competitive environment. The mistrust is deep-seated. Wal-Mart is known for driving hard bargains with its suppliers, as is England's Marks & Spencer. Increasingly, though, retailers and vendors are trying to respond creatively to the challenges posed by the new consumer reality.

Category Management started in the grocery industry and has spread into the automotive and drug sectors. Defined as "managing each department as if it were a strategic business unit", it can lead to the surprising result of reduced selection. Studies showed that customers were overwhelmed by the choices available. By reducing the assortment and offering the highest volume and highest margin products, retailers simplified their lives and satisfied their customers. Some suppliers cite

---

[17] Al Heller, "Retailers look to the bottom line", *Supermarket Business*, 52(5), 5/97, p. S5.

[18] Anonymous, "Retailers drive price home in automotive," *Discount Store News*, 36(15), 8/4/97, p. 86.

[19] Andy Bernstein, "Vertical impact", *Sporting Goods Business*, 30(3) 2/10/97 p. 58.

sales increases of 10-70% and gross margin increases of 1% due to category management efforts.[20] Linking category management with the data from loyalty programs allows the retailers to tailor their products to their most desirable customers.

The consolidation of the retail base has tended to consolidate the vendor base as well. Some retailers are forming **partnerships** with a few key suppliers and rely on them to help manage the categories, even to the point of designing displays with their own and their competitors' brands. Others will collaborate with their vendor partners on design and product development, working together to reduce costs and improve quality or service. Costco, the warehouser, will send experts to its vendors to help them improve their processes, in order to reduce the costs to the consumer. True vendor partnerships, however, are rare, with only 10% of partnerships achieving the status of full strategic alliances.[21]

Exhibit 1 shows the impact of these various issues on the retail subsectors, along with those firms who are considered "Best in Class."

Exhibit 1 Retailing Trends: Best Practices

Issue	Best Practices
Consolidation	Discounters: Wal-Mart's $100 B in sales is 5% of all U.S. retail sales. Building Supply supercenters control 21% of that market. Toys "R" Us sells 20% of the toys in the U.S.
Internet	Miscellaneous Retail: Amazon.com bookstore. Electronics: Dell on-line. Apparel: L.L. Bean, Spiegel, Lands' End. Issue: Consumers are wary of giving credit card information on-line.
Loyalty Programs	Food: Shaw's, Safeway, UK's Tesco and J. Sainsbury. Apparel: Saks 5th Ave, Bloomingdale's. Discount: Costco, Sam's Club.
Data-mining	Discount: Wal-Mart refines store assortments. Apparel: Victoria's Secret, J. Crew target mailings, Talbots sites stores based on data-mining.
Brands	Apparel: Nike, Levi's, Liz Claiborne. Eating & Drinking: PepsiCo's restaurants, Subway.
Private Label	Mass Merchandisers: JC Penney's Arizona and Sears' Canyon River jeans. Apparel: Lands' End, Gap. Discount/Warehouse: Costco's Kirkland Signature, Wal-Mart's Sam's Choice. Food: Shaw's, Meijer
Category Management	Food: Safeway, Drugs: Eckerd
Partnerships	Discount: Wal-Mart, Costco.

20 Linda Purpura, "Leveling the field: wholesalers are teaming with independents in category management game plans", *Supermarket News*, 48(6), 2/9/98, p. 63.

21 Denis O'Sullivan, "ECR - Will it end in tears?" *Logistics Focus*, 5(7), 9/97, pp. 2-5.