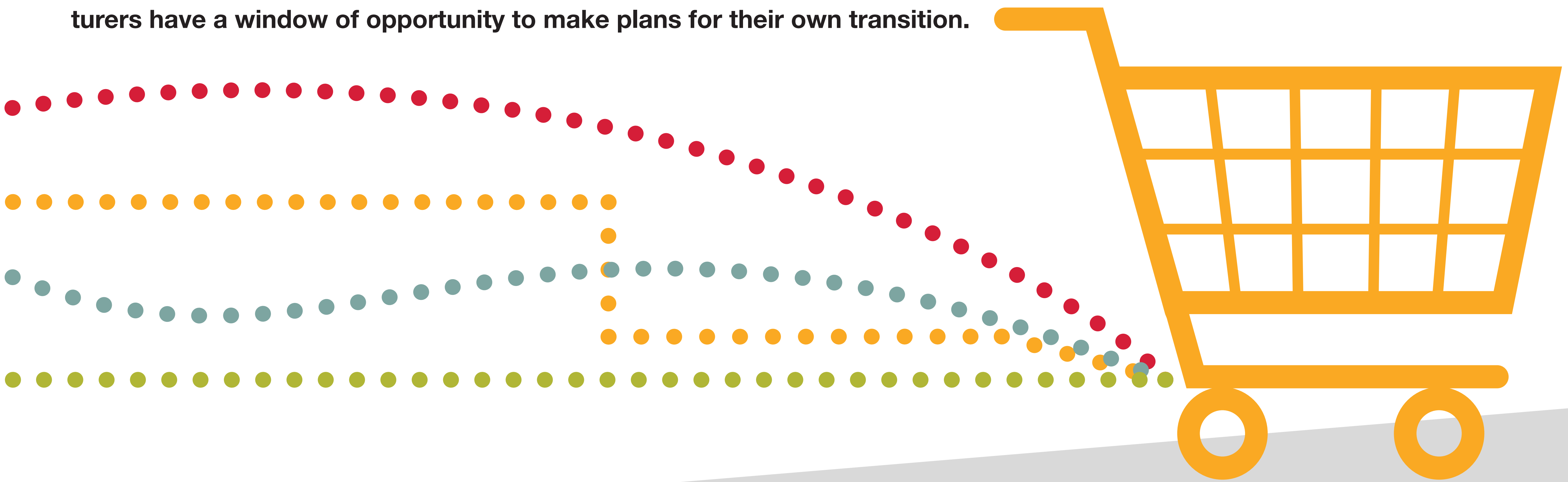
CLARKSTON CONSULTING

Navigating the Retail Revolution

Insights for Consumer Products Manufacturers

A new consumer reality is quickly changing the face of retail. The retail leaders that have been so dominant over the last thirty years may not make the transition. And while it is not often covered by analysts or the trade press, the retail revolution is going to have an immense impact on Consumer Products manufacturers. As the balance of power in the retail value chain tips, manufacturers have a window of opportunity to make plans for their own transition.



SUMMARY

A new consumer reality is quickly changing the face of retail. The retail leaders that have been so dominant over the last thirty years may not make the transition. And while it is not often covered by analysts or the trade press, the retail revolution is going to have an immense impact on Consumer Products manufacturers. As the balance of power in the retail value chain tips, manufacturers have a window of opportunity to make plans for their own transition.

Consumers rule today's retail value chain – they are more connected, more educated, and more demanding than ever. Consumers cannot be managed in mass, but have to be engaged individually. Even a single bad experience given voice through Twitter, YouTube, or Facebook has the potential to go viral and significantly damage a company and its brands. Neither manufacturers' marketing muscle nor retailers' superstores can rival consumers empowered by the internet.

The new consumer has changed the basis of retail competition. The traditional value proposition of selection, price and convenience afforded by traditional retail is less and less compelling as compared to internet retail. As a consequence, physical stores are no longer the consumer's default choice. In their recently found motivation to become more consumer focused, retail leaders will reconsider everything from the layouts of their stores to the products on the shelves. There's no choice. Every retail dollar spent online erodes the economies of scale underlying their physical stores.

Management theory suggests that many of today's retail leaders will struggle with the internet format and eventually fail. It is remarkable that Walmart, Target and Kmart all celebrated fifty years in business during 2012. Ironically, while most of the growth in retail over the past decade has been online, these well run companies and their peers have only recently begun to embrace the opportunities in a significant way. Why is it that none of these industry leaders became Amazon?

So what should Consumer Products manufacturers assess in light of this revolution? Almost everything. In a world where consumers and the retail landscape are changing fundamentally, the full breadth of the consumer product manufacturers' enterprise deserves a reexamination. It may strike many as unspeakable, but a key element of the conversation must be manufacturers' longstanding patronage of large retail accounts through trade spend, dedicated account teams, and labor shifting. But don't think that it is business as usual for the operations. New distribution channels, customer fragmentation, and item customizations are also in the mix.

New Consumer Reality

Retail Revolution

Disruptive Innovation

Manufacturers Impact

NEW CONSUMER REALITY

The consumer is now king in the retail value chain and the large retailers, which have been dominant for over three decades, have little choice but to reshape their businesses accordingly. Internet technologies have enabled consumers to become more educated, more connected, and more demanding. This new consumer reality is the driving force behind the retail revolution.

Educated Consumer

Consumers today are far more educated about their purchases than at any time in the past. The power of the internet gives consumers seamless access to detailed information on products, pricing, and services. They can quickly read reviews from fellow consumers and rapidly compare specification and pricing with single clicks or touches.

Busy Consumer

Consumers are busy, and find themselves with very little unallocated time to shop. Consumers are compressing shopping activities into smaller windows of time, as well as putting pressure on retailers to be available at their convenience, day or night. And, of course, consumers expect this to be done efficiently while still fulfilling their individual preferences for selection, style, color and composition.

Connected Consumer

Consumers today are connected via social media and feel empowered to express their experiences, values and beliefs. There are more than 500 million active Twitter accounts, 1.1 billion Facebook accounts, and millions more on Instagram, Pinterest and other social channels. A single viral post can either build up or tear down a product, brand, or company in a matter of days, if not hours. Digital natives, or those that are instinctively wired to these new ways of living, shopping and buying, will soon become the primary consumers. Simply saying that every consumer matters is no longer just a slogan, it is a reality.

A Day in the Life of an Average American[1]

American consumers are busy, educated and connected. According to the Bureau of Labor Statistics Time Use Survey, here are the primary activities of an average American ages 15 years and older.

Sleeping	8:44
Working	3:32
Watching TV	2:50
Household Activities	1:44
Eating	1:15
Engaging Online	:54
Reading, Educating	:48
Socializing	:44
Shopping	:43
Caring for Others	:42
Exercising	:19
Other	1:45

RETAIL REVOLUTION

The new consumer reality has changed the basis of retail competition. Consumers are all increasingly receptive to alternative shopping experiences – trading off price, convenience, selection, and the shopping experience as suits their own individual preferences. For most consumers, national chains are no longer the default choice. Internet retail allows them to choose from a broader selection, customize products and assortments, and ensure they get the lowest price all from the convenience of a home computer or smartphone. Ultimately, the big box retailer's conventional value proposition of price, convenience and selection is less and less relevant. Consumers are in the early days of the revolution, but a few key impacts are evident and worthy of consumer product manufacturers' attention.

Store Formats

The economics underlying large, self-service stores are eroding. Online retail is cannibalizing the volume which has afforded economies of scale and profit. With every online purchase, brick-and-mortar retailers experience reduced volumes, reduced economies of scale and reduced profit. To retain their profit, retailers are compelled to increase prices, which further drives down volume. This has the potential for a very negative downward spiral.

In due course, retailers will question their existing store layouts and look to smaller, more profitable formats. Nothing can replace authentic human interactions, so savvy retailers will leverage stores for new consumer-centric offerings. Just like some categories lend themselves to online retail, there are others that consumers want to experience before purchase. In response, some department stores are reallocating store space for warehouse storage to support post sales services. Whatever the formula, brick-and-mortar retailers have to reconcile the economics of big boxes (property, buildings, sales associates, cash registers, distributed inventory, etc.) with the new consumer dynamic.

Assortments

As retailers reassess store formats, they will rationalize listings in proportion to the reduction in shelf space. There has always been a battle at the shelf and for the shelf. Looking forward, it seems evident that many product categories will experience fewer items displayed on the shelf, with the balance of the portfolio relegated to the long tail of online retail. Even grocery stores are not immune. While consumers want to touch and smell the fresh produce, meats and dairy on the outside aisles, that rationale does not hold for the categories in the center aisles.

Branding

Manufacturers are increasingly in competition with their retail partners. Manufacturers are selling directly to consumers, and retailers are manufacturing and promoting their own brands. Either way, consumers have the same expectations. The new consumer dynamic implies that store brands, which have become a crucial source of retail profitability, are far less impactful online. Outside the confines of a physical store, why would consumers buy mediocre product with a retailer's store brand? Retailers will need to either invest heavily in their own brands or risk losing volume as it shifts online.

Mom & Pop Shops

FULL SERVICE RETAIL

- Dependent on customer loyalty and charging for outstanding customized service
- Characterized by direct advertising and manufacturer brand strength

1970's

TARGET · Walgreens · Walmart · Kroger

SELF SERVICE RETAIL

- Dependent on trade spend and economies of scale
- Characterized by big boxes, store brands, and trade spend

2000's

amazon.com · overstock.com · NORDSTROM · Zappos.com

INTERNET RETAIL

- Dependent on selection, customization and efficiency
- Characterized by customer focus, omni-channel and big data

2

DISRUPTIVE INNOVATION

The internet retail format is a disruptive innovation, stealing share and displacing established retail giants. Harvard professor Clay Christensen's defining work on disruptive innovation[3] outlines what happens when an emerging market segment is not well served by the incumbents. Market leaders struggle to cannibalize their legacy business, fall short on capital allocation, and in the end, many of these companies fail. Business texts are replete with case studies of well-managed businesses that missed what, in hindsight, were obvious trends. Consider Eastman Kodak. Despite having invented the core technology in digital cameras, Kodak's transition to digital photography lagged the market, and today, the company has abandoned the digital camera market altogether.

While online retail has accounted for nearly all the growth in retail over the last decade, industry leaders have belatedly jumped on the internet retail bandwagon and are struggling to capture a material share of the sales. As if to emphasize the point, the Securities Exchange Commission is now pressuring large retailers such as Walmart, Target, PetSmart, and Fifth & Pacific to disclose hard facts about their web sales. While impressive growth rates are shared regularly, the underlying sales volumes remain veiled even though it is a consistent focus area for investors.

Some top retail partners will successfully make the transition—others will not. Nordstrom, for example, has been recognized for its success in online retail. In 2011, they acquired HauteLook, a "flash sales" site for $180M. More recently they have partnered with internet pure play Bonobos to create innovative men's clothing showrooms inside of Nordstrom stores. Showroom sales consultants help consumers find the best fit and then take their order for home delivery. Jamie Nordstrom has stated his company's intent plainly--"E-commerce is going to be where the majority of our future growth comes from, period."[4]

Why didn't one of the retail industry leaders become Amazon?

- **Missed Opportunity:** Amazon's $60 billion in sales equate to the online business of the top ten traditional retailers combined. This year, Amazon was at the top of the National Retail Federation's list of retailers, and Amazon's CEO, Jeff Bezos, was given the Gold Medal Retailer of the Year award.
- **Lack of Vision:** Asked if one of the traditional retail leaders could have built a great internet business, Amazon's Jeff Bezos said, "You have to be a really long term thinker because for a long time it will be a tiny slice of your company. The key thing is to be willing to wait 5, 7, 10 years. And most big companies aren't."[5]
- **Late to the Game:** It was not until 2011 that there was a meaningful increase in capital allocated to retailer's online assets.

MANUFACTURERS IMPACTS

While the business press has become enamored with the retail revolution, manufacturers of consumer products have been strangely left out of the conversation. This is understandable in that a few retailers have been so dominant for decades, but, it is also unfortunate. As the new consumer dynamic tips the industry's balance of power away from retail, manufacturers need to carefully assess and prepare for the impacts across their enterprise.

Products

Manufacturers should consider that products designed for the store shelf are not necessarily optimal for internet retail. Instead, attributes that impact online sales will become a focus, and some products will need to change in form, size, shape or packaging. For example, laundry detergent manufacturers may decide to concentrate their formulas or start producing laundry pods to make their products lighter for home delivery.

Removing the constraint of eye-catching shelf displays will allow companies to provide consumers more of what they really want in terms of product and packaging. Blister packs have long provided an effective theft deterrent on the shelf, and concurrently frustrated consumers after the purchase. If products are purchased online, blister packs are no longer required and customers can experience what Amazon calls "frustration-free packaging."

Many consumers have an expectation that shopping online should provide them options to customize products. Continuing with the laundry detergent example, consumers may want a special blend combining features of the product that are not in a standard SKU (e.g., hypo-allergenic, stain-fighting, wrinkle-preventing, high-efficiency with a light lavender aroma). Moving away from the myopic focus of traditional retail will open the door for these types of innovations that the new consumer reality requires.

Sales and Marketing

If the retail revolution is tipping the balance of power away from established retail leaders, then perhaps consumer product manufacturers should begin to reassess their patronage to these customers. It is estimated that over $200 billion is spent annually on trade promotions, typically about 15% of gross sales. With many of the top retailers, manufacturers must pay to play. Never mind that promotion effectiveness is often veiled, and that trade spend dollars are a real chore for manufacturers to manage. The new consumer reality is changing the game so that no amount of investment in traditional media may prove to be effective. Only 47% of consumers around the world say they trust paid media. However, 92% of global consumers say they trust earned media such as product reviews, glowing successes on social media, and consumer demonstrations posted to retail sites.[6]

MANUFACTURERS IMPACTS

The cross-functional teams that many manufacturers have allocated to their largest accounts are another form of retail patronage. Bentonville, Arkansas is a town populated by thousands of consumer products professionals and their families exclusively serving the needs of Walmart. Procter & Gamble alone has more than a hundred staff residing in Bentonville focused on category management, data mining, predictive analytics, collaborative forecasts, vendor managed inventory, item synchronization and RFID. Taken together, it is a labor shift of immense proportion based solely on the retailer's ability to pull the consumer through their doors.

As volume shifts online and manufacturers increasingly compete with retail partners, the question becomes, at what rate should manufacturers transition their sales and marketing spend to competing opportunities?

Operations

Complexity in the consumer products supply chain is growing as manufacturers struggle to get their arms around demand and supply planning for the emerging internet retail channel.

Demand forecasts are the primary driver of operations, and it seems evident that manufacturers will be less accurate predicting internet sales than the brick-and-mortar business. Beyond Amazon, the internet retail format is far more fragmented than traditional retail. If most of a company's sales come from a few top accounts, it is practical to understand the promotions and events which lift demand from a historical baseline. Few if any manufacturers have cracked this code online. There is likely not two years of historical sales from which to build statistically significant models. Further, while online promotions are eminently measurable, sales may soar or fall sharply as a result of new factors such as competitive price transparency or consumer reviews.

All that demand variation implies the need for a more responsive supply capability. In the course of Clarkston's supply chain consulting, we have observed highly efficient supply networks that consumer product manufacturers have knitted together with low cost to serve and high inventory turns. As these same companies experience the retail revolution, the game for operations will change. New internet customers and existing customers growing their internet channel will challenge manufacturers to develop supply capabilities better suited for web sales – improved demand visibility, shorter planning cycles and flexible manufacturing and deployment.

Manufacturers who choose to venture down the path of selling direct to the consumer face an incremental set of challenges. Supply networks built for distribution to customer warehouses are not optimal for distribution to consumers' homes. These manufacturers will need to decide whether to build new networks or to sacrifice margin to pay for third party distribution services.

Manufacturer Impacts at a Glance

- Product Properties
- Product Packaging
- Product Customization
- Corporate Innovation
- Customer Engagement
- Key Account Teams
- Trade Promotion Spend
- Demand Forecasts
- Supply Networks
- Manufacturing
- Distribution

JOIN the DISCUSSION

About the Authors

Bruce Twery is a senior manager with Clarkston Consulting and a leader in the firm's Consumer Products practice. His experiences span over 25 years applying process and technology to drive performance in marketing, supply chain, and business systems.

David Watts is a senior manager with Clarkston Consulting who has a passion for helping organizations achieve their corporate strategies. He has over 15 years of experience leading organizations through transformative business projects that align people, processes and technologies to the corporate vision.

With very few exceptions, the retail revolution will change how Consumer Products manufacturers go to market. The impacts will vary by product category, distribution channel, and each company's unique product mix.

Clarkston has over 20 years of experience helping Consumer Products companies align their operating practices and systems to their evolving strategic intent. For further discussion on The New Consumer Dynamic and how Clarkston Consulting can help your organization embrace the Retail Revolution, contact **Bruce Twery** / btwery@clarkstonconsulting.com or **David Watts** / dwatts@clarkstonconsulting.com.

References

1. Bureau of Labor Statistics, American Time Use Survey, 2013
2. HBR Blog Network, The End of History or Retail 3.0, 2011
3. The Innovator's Dilemma, When New Technologies Cause Great Companies to Fail, 1997
4. Shop.org Annual Summit, 2012
5. Wired Disruptive by Design event, 2009
6. Nielsen's Global Trust in Advertising Survey, 2012

CLARKSTON

Headquarters
2655 Meridian Parkway
Durham, NC 27713
Phone: 800-652-4274
Fax: 919-484-4450
www.clarkstonconsulting.com

About Clarkston Consulting

Clarkston Consulting is a different kind of management and technology consulting firm. We deliver a unique experience for market leaders within the Consumer Products and Life Sciences industries. Considering professionalism, expertise, and value as prerequisites, we take service a step further through our unyielding commitment to the success of people as individuals, both our clients and our employees. By combining integrity, adaptability, and a whatever-it-takes attitude, we have achieved an extremely high rate of referral and repeat business and a 10-year average client satisfaction rating of 97%.