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Making stores matter in a multichannel world

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As the role of the brick-and-mortar store evolves, retailers will continually have to refine how they use their real estate.

For decades, the retail industry has followed the same straightforward formula for growth: open new stores. By replicating a proven store format in a new catchment area, retailers could reliably enlarge their customer base and count on healthy increases in sales.

But the world has changed. More than half of consumers now research their retail purchases online, making purely in-store purchase decisions the shrinking minority. In many categories, e-commerce has dramatically lessened the need for physical stores. “Virtual space”—which we define as the floor space that would be required to generate the sales volume that online retail now accounts for, at a sales density equivalent to the industry average—is expanding at a staggering rate. In this new world, what is the role of the brick-and-mortar store?

Many retailers find themselves struggling with the question and saddled with more real estate than they know what to do with. After all, their property departments are geared up for expansion and acquisition. Their finance departments have traditionally focused on reaping investment returns from stores and tend to be jittery about investing in new and unproven technologies. On the flip side, their e-commerce directors are frustrated by this lack of understanding of the pace and mind-set such companies need to become digital winners.

To position themselves for success in a multichannel world, retailers would do well to take a disciplined approach that begins with a reassessment of the role of the physical store. We recommend a five-step approach we call STORE: starting with a clear vision for the future role of the store, tailoring categories and formats accordingly, optimizing the store portfolio using forward-looking analytics, reinventing the in-store shopping experience, and executing systematically across channels.

The incredible shrinking footprint

The effects of online migration in the retail industry are evident in every category. In the United States, apparel retailer Gap closed more than 250 stores in 2013; department-store chain Sears closed almost 200. Walmart’s new stores are about a third smaller than they were five years ago.

Start by redefining the role of the store.

Tailor categories accordingly.

Optimize the portfolio using forward-looking analytics.

Reinvent the in-store experience.

Execute systematically across all channels.

In the United Kingdom, the number of vacant retail shops rose by 355 percent between 2008 and 2013,[1] and in 2013 and 2014, three of the "big four" supermarkets took a combined write-down of £1.2 billion (approximately $2 billion) on the value of their undeveloped property. Perhaps the most affected category has been consumer electronics, where a 20 to 30 percent decline in physical retail space in the UK market between 2006 and 2012 was fully offset by the addition of an equivalent amount of virtual space.

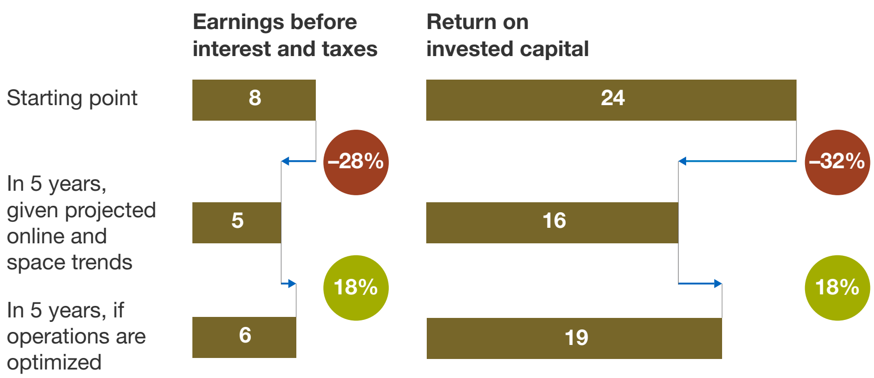
Of course, online retail has affected more than just physical floor space. Amazon, for one, has put intense pressure on retailers' top and bottom lines by having key items priced 13 to 20 percent lower than average, an assortment 17 times larger than the average retailer's, and a cost base that is 3 to 4 percent lower than brick-and-mortar competitors', all while achieving the highest customer-satisfaction scores in the industry. The combined effects of Amazon and other online retailers have rapidly hurt traditional retailers' return on invested capital, as fewer sales flow through existing physical assets.

Many retailers' instinctive response to these headwinds has been to close underperforming stores and to look for operational efficiencies, but these moves only buy time—they can't fully close the performance gap (exhibit). "Shrinking to greatness" is not the answer.

[1] *Openings & Closures Report 2013*, The Local Data Company, 2014, localdatacompany.com.

Exhibit Online migration is hurting store economics, and there are no quick fixes.

Estimates for US retail company, assuming a 5% decline in sales per square foot over 5 years, % of sales



Source: Forrester Research; Internet Retailer; Kantar Retail; retail benchmarks; store plans; 10-K filings; McKinsey analysis

A framework for change

Shifting from a store-focused approach to a multichannel mind-set requires retailers to change their traditional frames of reference and ways of working. As consumers increasingly shop across channels, terms like "convenience" and "efficiency" take on new meanings. Customer expectations are rising: for instance, customers now expect price consistency across channels, the ability to buy online and pick up or return in store, and a range of payment options. Price transparency puts pressure on retailers to develop ultraefficient operating models. The wealth of online information available to consumers raises the bar for in-store service and expertise.

But let's be clear: the brick-and-mortar store is not dead; it just plays a different role now. In fact, in a multichannel world, physical stores can provide a competitive advantage. Some multichannel retailers have seen growth in their online sales and penetration among consumers who live near their stores. In several sectors, "click and collect" is proving a popular and increasingly efficient means of serving the customer. More than 50 percent of Walmart's online sales and around 40 percent of Best Buy's already are picked up in stores. Best Buy's store-within-a-store partnerships with Microsoft, Samsung, and other suppliers capitalize on manufacturers' need to show off their products in a physical retail environment. Former online pure plays such as Oak Furniture Land and sofa.com have opened physical stores that now generate as much as 60 percent of sales.

Some retailers are now reshaping their store networks in response. One approach is to lead with a handful of flagship stores—which essentially become a marketing and service channel for the online business—supported by numerous smaller outlets that offer convenience and a curated product offering. British retailer Argos, for one, is experimenting with a hub-and-spoke distribution system in London, with products being delivered from large stores to smaller-format "digitally enabled" stores—allowing all Argos stores in the area to guarantee same-day or next-day fulfillment on some 20,000 products.

In light of rapidly evolving technology and consumer behavior, we believe retailers that take a forward-looking view and heed the following five imperatives can position themselves for multichannel success.

Start by redefining the role of the store

The first question that retailers should ask themselves at the beginning of their store-network transformation journey is, "What role will my brick-and-mortar stores play in a multichannel world?" To answer the question, retailers must find out what their customers truly care about.

They need to know which aspects of a store matter most to customers and what purpose a store serves for them:

- *Convenience and proximity.* Do they value the ease and speed of being able to visit a store and get what they need?
- *Efficiency.* Do they see the store as a place that helps them make better use of their time—for example, by enabling them to make faster decisions or by serving as a pickup location for something they ordered online?
- *Inspiration.* Are they looking to discover—and be surprised by—new ideas and products?
- *Instant gratification.* Do they look forward to store visits as a chance to make impulse purchases and get things they want immediately?
- *Discovery of a solution, information, or service.* Are they seeking knowledge and expertise above and beyond what they can find via an Internet search?
- *Entertainment and social interaction.* Do they see stores as places where they can be entertained and have fun with family and friends?
- *Experiencing brands and products.* Do they visit stores for a chance to touch, feel, and be won over by products and brands?

Economic considerations are important as well. For each of the purposes above, retailers should ask, "How can stores do this profitably?" There may be more than one answer and therefore more than one winning store format. In any case, the agreed-upon role (or roles) of the store should dictate every decision about the store operating model: location, assortment, staffing, supplier funding, employee training, and so on.

A supermarket chain, for example, had been investing in costly service-led formats in which store staff provided expert in-person advice to shoppers. Customer research revealed, however, that service was a priority to a subset of customers in only one-tenth of its stores. Given these findings, in the other 90 percent of the retailer's stores, it shifted its emphasis away from service and toward efficiency (with fewer service counters and more automated features, such as self-checkout) and instant gratification (for example, by heavily promoting new impulse-buy bargains), which were higher priorities for customers in those stores. The retailer was thus able to reduce operating costs materially while better meeting customers' needs.

Tailor categories and formats accordingly

Customer priorities and store economics should next become critical inputs into ongoing category reviews, to ensure that assortments and space allocations are continually optimized for a multichannel world.

For example, with niche products—the so-called long tail—becoming searchable and available to consumers online, retailers can capture tremendous savings by stocking such products only in central warehouses rather than in stores. That said, some slow-moving products should remain available in stores, including emergency items (for instance, home-improvement retailers should stock tools and spare parts for fixing a leaky sink) and products that are part of a bigger basket (because customers buying paint or wallpaper in the store to complete a home-decorating project will be frustrated if they have to buy a ladder separately online).

Through customer research, an electronics retailer found that the frequency and purpose of customer visits, as well as average driving times, varied significantly by category. Only half of customers were willing to drive more than ten minutes to buy kitchen appliances in person, compared with almost 100 percent of customers buying a TV. Indeed, half of customers said they would never buy a TV without first seeing it, testing it, or comparing it with other models in a store. These insights suggested that the retailer needed different assortments in its in-town and out-of-town stores, as well as different space and service levels for each category.

Format decisions should also be driven by customer needs and priorities. Some retailers are adapting their store formats to the tastes and preferences of certain customer segments. Macy's, for example, has embarked on a major effort to court millennials: it has launched more than a dozen segment-specific brands and created "destination zones" for millennials in its stores.

Optimize the portfolio using forward-looking analytics

The next step is to reevaluate the store portfolio through a multichannel lens. Leading retailers regularly analyze correlations between sales performance and catchment data to identify promising locations for new stores and to figure out the winning formula for top-performing stores; they examine factors such as population density, income, competitor presence, and average tenure of the sales staff. This is a valuable exercise, but in a fast-changing business environment, it's not enough. Retailers must look ahead: they must extrapolate the impact of macro and industry-wide trends on the store network's economics and operating model. And they must understand the impact that channels have on one another. One retailer that already had 100 unprofitable stores in its network found that another 100 would be in the red within three years given competitor trends and the shift to e-commerce.

The most forward-thinking retailers use analytical tools and techniques to reshape their entire store networks. They use financial and geospatial modeling to highlight not only where stores should be opened but also which should be closed, resized, or reformatted. Using geospatial modeling, a grocery chain made the counterintuitive discovery that a critical mass of stores in certain regions was highly correlated with a boost in online sales. The company therefore took a renewed interest in a number of locations that it had previously rejected. Analysis also showed that the grocer's target customer groups were growing rapidly in neighborhoods near those sites, suggesting further upside.

Geospatial analysis is useful for creating a "blank sheet" optimal mix of store formats by location type. In a populous city, for instance, the optimal mix for an apparel retailer might include one or more flagship stores with a long drive time, high-footfall destinations (such as stores in malls or on suburban main streets) with a medium drive time, and "in-fills" (such as seasonal shops or pop-up stores) to cater to small catchment populations. Through geospatial analysis, a big-box retailer discovered significant overlaps in its stores' catchment areas; its flagship stores were attracting customers from far-flung neighborhoods in which it also had smaller stores. It thus realized that it could reduce both the number and size of its smaller stores while still serving the same population.

Retailers can choose which specific stores to keep or close by forecasting future performance, lease profiles, and expected customer retention. For problematic stores with longer leases, retailers may need to make creative moves—such as subletting part or all of these stores or closing more profitable nearby stores with shorter leases and switching customers over to the remaining stores.

Reinvent the in-store shopping experience

Creating the store of the future will mean overhauling the in-store customer journey, in part by using new technology to make the shopping experience as seamless and easy as possible. Some retailers simply copy the in-store moves of multichannel champions such as Apple and Burberry or equip sales staff with iPads to give their stores an updated, high-tech look. But cosmetic changes alone won't result in lasting impact. A multichannel mind-set must be embedded in the store design and in employees' new ways of working.

Retailers could, for instance, give store staff easy access to detailed and up-to-date product information so that they can provide knowledgeable customer service without needing to memorize too many specifics. Mobile devices that tell store employees where exactly in the store an item is located and how many units are in stock could enable them to better assist customers. Handheld payment points would allow customers to avoid long checkout lines. In Nike stores' online "studios" or kiosks, shoppers can not only place orders but also customize products.

Retailers should prioritize the basics: again, focusing on what matters most to their customers and enabling multichannel shopping (for instance, by establishing fast-pickup counters for online orders) while being ruthless about taking costs out of the things that customers don't care about.

That said, even as retailers work on the basics, they should constantly test and tinker with digital innovations. They should rapidly conduct systematic experiments, ideally cofunded with technology providers or product partners, to confirm the game-changing potential of a particular technology—for example, by measuring its effect on overall conversion or customer loyalty—before making big capital investments to roll it out across the network.

Execute systematically across channels

Change of this scale is not easy and affects many functions across the organization. Some retailers make the mistake of developing a store-network transformation plan that extends past 2020, by which time parts of the plan will probably be obsolete, or else they embark on a massive change program that will take so long to roll out that it will be out of date before it is halfway done. Retailers are typically better served by developing a detailed plan for the next 12 months and a high-level road map for the next three years.

Pace and flexibility are critical. "Gold plating" an entire store takes too long and tends to be expensive. Retailers should instead test new ideas quickly, and they should pilot individual aspects of store design to figure out specifically what is working and what isn't.

Given the scale of a network redesign, taking a lean approach can significantly reduce capital expenditures and increase return on investment. By using cost-saving levers such as offsite prefabrication, relaxing fixture specifications to widen the supplier pool, applying principles such as design to value and total cost of ownership, and ensuring disciplined project management, a global big-box retailer completed a major store-transformation program 25 percent faster and with 21 percent lower capital expenditures than similar previous programs had involved.

Of course, capabilities and organizational design, both at headquarters and in individual stores, must evolve as the network evolves. Retailers should ask themselves: Does the organizational structure support the new network size and role? What would it take to shift the mind-sets of the property team away from a focus on opening new stores and toward making better use of existing space, introducing and refreshing store concepts quickly, and even scaling back on real estate? How can the online team—which, at some retailers, still has a cottage-industry status—become fully integrated with the stores? This integration is crucial: the store of the future should allow shoppers to move seamlessly across channels. Store staff should be well trained and comfortable in directing customers to the right products, both offline and online. The technology and systems staff members use should be connected to or aligned with the retailer's website, so that they won't have to spend precious time trying to reconcile different information. The web can support the stores as well—for example, by showing inventory levels for nearby stores.

The logistics and store teams should work hand in glove with the online team to ensure that orders are fulfilled efficiently and to get products to consumers quickly. Amazon already offers same-day delivery in more than a dozen cities and guarantees one- to two-day ground delivery across the continental United States; we believe consumers will soon expect comparable shipping speeds from all retailers.

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Even as retailers reassess and revamp their store networks, they shouldn't focus exclusively on the stores. A store-network transformation will have the desired impact only if the online channel is at fighting strength. For retailers whose online presence is already robust, it is simply a matter of ensuring a dual focus on both channels. For other retailers, getting the requisite multichannel capabilities and mind-sets in place will require a full transformation. Either way, the online channel must not be neglected in the face of the daunting changes required in the physical-store network. The future of retail will belong to retailers that can satisfy the customer, wherever he or she decides to shop. □

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