ARE YOU GOOD ENOUGH?

OC&C
Strategy Consultants

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THE WORLD RETAIL STANDARD

OC&C Strategy Consultants bring clear thinking to the most complex issues facing top management. We work side by side with ambitious clients seeking market leadership.

Retail is one of OC&C's longest-standing strengths. We have developed special expertise, breaking new ground as the sector has evolved worldwide. Issues include internationalisation and growth strategies; management of brands, categories, channels and formats; operational efficiency and organisation; and mergers and acquisitions.

Our work with leading retail and distribution companies has often seen us in the vanguard of sector developments, with many of our creative and innovative solutions becoming standard industry practice.

You will find OC&C across Europe, North America and Asia and at www.occstrategy.com.

BEING GOOD ENOUGH IS NO LONGER GOOD ENOUGH

RISING EXPECTATIONS ARE CHALLENGING RETAILERS TO OBSESS ABOUT WEAKNESSES

Retailers have traditionally thrived by making choices. Some retailers would offer low prices, others great service, others huge range. Successful retailers made trade-offs in a way that both delivered great customer satisfaction and created successful businesses. No-one going to Aldi expected choice or service; but they did expect the lowest possible prices. By contrast, shoppers at Albert Heijn were willing to pay a little extra in order to have a pleasant store environment and access to products and expertise not available elsewhere. But shoppers are changing, and the winning retailers are recognising this. Increasingly shoppers want it all.

In the 'mature markets' of Western Europe and North America, shoppers are refusing to accept the traditional trade-offs and are increasingly expecting retailers to deliver on every dimension of the shopping experience. Partly this has been driven by the growth of online retailing. Led by Amazon (the global winner in OC&C's 2010 Proposition Index) online retail has been able to re-define shopper expectations. It has shown that it isn't necessary to drive to the edge of town and shop in a low service environment to get great prices – you can get great prices in your own living room, with helpful advice (from 1000s of other users just like you). And the product will appear on your doorstep the very next day.

Likewise in emerging markets a generation is growing up who are increasingly familiar with modern shopping centres and supermarkets (and well known Western brands). Even in tier 3 cities they are finding that as more retail space is opened they too have choices about where to spend – retailers cannot rely on getting customers because they are the only store in town. Retailers are having to raise their game to maintain their share.

The challenge is working out how to manage all this.

For most retailers this means taking a long hard look at the preconceptions they have about how they do business. This isn't easy – it requires an objective understanding of current strengths, and finding ways to build on them. And – often even harder – really getting under the skin of and then addressing key weaknesses. And if change is needed retailers then need to explain and deliver on a new approach, changing the behaviour and attitudes of thousands of colleagues, both in head office and across the network.

For example, we have been working with a European supermarket chain that has traditionally been well known for offering great products and having high levels of in-store service. But at a price. As their competitors began to close the gap on service and product, they were left increasingly exposed. However, it was a deeply ingrained belief that their business model would not allow them to close the gap on price. Ultimately customers started to drift. So in parallel to augmenting their points of differentiation they attacked price perception with a revised private label strategy and introduced targeted price matching on known value items. And to ensure the overall economics stacked up, they introduced higher margin products that tempted customers to increase basket size. They have been rewarded with some of the strongest like-for-like growth figures in the market.

Sometimes there are hidden strengths within the business that can be rediscovered to provide a new source of competitive advantage and meet rising shopper expectations. Morrisons, the UK supermarket, which already had a strong price perception, uses its integrated supply chain (developed as a driver of cost advantage) to burnish its food quality credentials. Best Buy, the US electronics retailer, uses its strong relationship with manufacturers to get early access to technology not available in general merchandisers, minimising the scope for direct price comparison. Decathalon has used its capability to build trust in entry level private label to build a set of margin-enhancing market-leading brands at multiple price points, challenging the category leaders.

Sometimes the moves can feel even more radical. Amazon is using Marketplace to allow other retailers access to its web traffic and logistics, and provide its shoppers with greater choice and even lower prices – Amazon stipulates that whilst retailers using Marketplace are free to undercut Amazon prices they must always offer their best online price on Marketplace. Or Germany's hard discounters who have thrived for years on a model offering very limited fresh food and no brands, gradually relaxing constraints on these business norms as they seek to meet the demands of customers for both choice and low prices. Their reward has been increased basket size and frequency, offsetting the cost of increased complexity.

Of course not all retailers are able to make this change. Despite clear evidence that they are failing to meet customers' rising expectations they are too trapped in their own histories to adapt. Mervyns or Karstadt are examples of Department Stores which failed to evolve. Others like John Lewis continue to change (only last month offering an innovative price match guarantee for online and offline retailing that has redefined the UK industry standard).

All retailers need to ask themselves – Am I good enough? And where is being good enough no longer enough?

This means having clear answers to five questions:

- What is it that currently makes our shoppers prefer us to the competition? Are we doing enough to stay ahead of the pack?
- What are the major reasons people don't shop with us? What would we have to change to capture those shoppers?
- Do we understand the gold standard in our category for each element of our proposition? What would it take to get there?
- What changes to our business model could we make to better meet the needs of our customers and deliver an acceptable or enhanced return?
- Do colleagues understand how our customers are changing and are they enthused, incentivised and supported in adjusting their behaviour as needed?

It is the retailers who can answer these questions who will thrive in a world of rising expectations.

YOU DON'T ALWAYS GET WHAT YOU PAY FOR

Pricing optimisation in a value-conscious world

In the current environment, managing pricing is more important than ever. The global recession has increased the importance of price in the purchasing criteria of many customers – some of whom have traded down or trialled value propositions. At the same time, retailers face another burst of inflation – with raw material increases on items such as cotton and wage inflation in China putting upward pressure on input prices. Managing these competing pressures, in a world where like-for-like sales growth is difficult to come by, creates a major challenge for retailers.

Pricing strategy is a key element in addressing this challenge. And central to successful management of pricing is realising that customers' perception of price is as important as, if not more important than, actual prices. There are many retailers that are currently underexploiting their price position, with customers not realising the value that they are actually offering. Conversely, a number of retailers have managed to convince customers they are cheaper than they actually are – and are reaping significant rewards as a consequence.

The OC&C Price Perception Index, published annually and now in its fourth year, highlights the opportunity for retailers to better manage customer price perception. The index is based on an international survey of customers who are asked their view of the price positioning of leading retailers – which is then compared to their actual price positioning.

One interesting theme from this research is how ability to accurately judge price varies across markets. In our most recent research, French customers are the best at accurately knowing prices – and British and American customers are the poorest. Across most countries, customers have become better judges of prices over the last couple of years – as the recession has driven many customers to become more price and value focused in their shopping behaviour.

The research also identifies individual retailers who customers perceive to offer prices that are substantially better or worse than reality – ie, those that are succeeding in driving value perception and those that are currently underexploiting their price position.

An interesting example of the former is Iceland, the UK frozen food specialist retailer, which customers consistently believe is much cheaper than is really the case. Iceland has a very clear understanding of who its customer is and what missions it is trying to serve – and has executed a pricing strategy that resonates strongly with this cash-strapped customer stocking up on frozen products. An example of this is Iceland's widespread use of the 'round pound' policy - where prices are set at multiples of £1 and product is engineered to deliver that price point. This gives customers low entry price points into many categories while also enabling customers to easily add up what they can purchase for a limited amount of cash.

It is our belief that through pricing strategies and tactics such as these, all retailers have the ability to manage their price image, no matter what channel or sector they operate in.

So how can you best drive shopper perception of price and get maximum 'bang for buck' through pricing strategy?

Firstly, you need to understand what the right levers are to drive shopper perception and optimise pricing for your business. There are many levers you can choose from. While base prices may be the most obvious lever there are many others that can play just as big a role in influencing price perception. Promotions, range architecture (eg level of entry pricing) and communication (eg advertising and signage) are all key drivers. Pricing winners focus their efforts on delivering value through a few pricing levers that resonate with their shopper set and by excellence in execution.

Secondly, you should treat pricing as investment – and invest where it makes a difference. To maximise your bang for buck you need to ensure pricing investment is focused where it will have the maximum impact on customer behaviour. This could be ensuring that prices are matched with competitors on the most price sensitive products – but could equally be targeting the products or baskets bought by more price sensitive shoppers or identifying 'anchor' products that are key reasons to visit for a particular mission. In our experience, detailed customer research can give invaluable insight into where price investment is best focused – and where there are opportunities to drive margin.

Finally, you need to set a strategy, think long term and be consistent. Customer perceptions of pricing are built (or eroded) slowly – and don't change overnight. It is critical to think strategically, and once a course is set stick to it.

This year's OC&C Price Perception Index will be published in November

Perception Better Than Reality
Most Overrated Retailers

Clothing	Beyond Clothing
1. Esprit	1. Empire Direct
2. Macy's	2. Focus DIY
3. Next	3. Whole Foods
4. House of Fraser	4. Best Buy
5. S.Oliver	5. cdiscount.com

More Expensive Than Customers Realise
Most Underrated Retailers

Clothing	Beyond Clothing
1. H&M	1. Ikea
2. Kik	2. Wickes
3. C&A	3. Walmart
4. Debenhams	4. dabs.com
5. Primark	5. amazon.com

PROPOSITION INDEX: GIVE ME STRENGTH

Do you have a truly objective view of what customers think of you – and do you know who is really setting the benchmark?

Without comparative figures, how can you tell how well you are really doing? And who says all the lessons come from your peers? What can grocery retailers learn from fashion? Are there ideas developed by the entertainment sector that the electronics sector should take up?

It's easy to survey your own customers, much harder to look at your competitors'. Now a new survey tool developed by OC&C offers the in-depth information you need to make these comparisons.

The OC&C Proposition Index has built a detailed picture of how customers rate a whole range of retail businesses. It enables you not only to compare customer views by sector, but also across different sectors and internationally. Crucially, it not only tells you how well customers rate your proposition overall – but also tells you how customers perceive different elements of your proposition such as price, service or product range – giving you the opportunity to identify which part of your own proposition you may need to develop.

The Index is founded on a simple principle. Thanks to their experience of internet sites such as Trip Advisor and iTunes, customers are used to rating price, service, quality and other areas through a five star system. As a means of assessment, it is quick and convenient. Customers understand it immediately.

OC&C has asked nearly 14,000 consumers in six countries to use the star system to rate nearly 300 retailers on price, quality, look and feel, choice of products, value for money, service and trust.

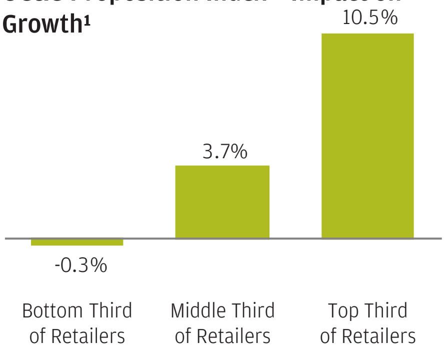
The ratings offered by consumers allow us to analyse not only which retailers shoppers see as offering the leading propositions, but also the markets and retailer sectors that are rated highly. Furthermore, scoring highly in the index is not just a measure of customer satisfaction, but also an indicator of potential for long term revenue growth. On average, retailers ranked in the top third of the OC&C Proposition Index delivered average annual growth over the last 3 years that was over 10% higher than those in the bottom third.

Overall Amazon was the proposition that customers rated most highly in this year's index. Not only did Amazon top the overall ratings in three of the six countries covered, but customers recognised the strength of its offer across many different elements of its proposition including leading product breadth and trust. Generally though, shoppers were not constrained in

The International Champions

Ranking		Category
1	Amazon	Entertainment
2	DM	Health & Beauty
3	M&S	Clothing
4	Boots	Health & Beauty
5	Play.com	Entertainment
6	Picard	Grocery
7	Barnes & Noble	Entertainment
8	Asda	Grocery
9	Bol.com	Entertainment
10	Waitrose	Grocery

OC&C Proposition Index – Impact on Growth[1]



[1] 3 year revenue growth rate

recognising excellence – the Top 10 international retailers in the index cover a diverse of mix of countries, retail sectors and channels.

Stepping back from how individual retailers fared, some significant broader trends have emerged from this research:

- **Online is redefining the standard**
  In categories such as entertainment and electrical, it's clear from the OC&C Proposition Index that customers see online not just delivering superior price and range authority, but also offering great service and customer experience. For retailers with store portfolios in these categories this raises serious questions on how their stores are best used, how you nail the customer experience proposition and how you best create a true multi-channel offer.

- **International 'Hero and Villain' categories exposed**
  The UK, for example, leads the way in grocery, department stores and health and beauty while the US leads in DIY and electricals. Entertainment is particularly strong in Germany. The Index also identifies a number of Villain categories, for example Electricals in the UK and Clothing in the Netherlands.

- **Trust is paramount**
  Building customer trust is a pre-requisite for success; 8 out of the 10 most trusted retailers are in the overall top 10. Traditionally trust takes time to build and is easily lost but many of the online players have established a high level of trust in a remarkably short period of time.

- **The importance of price varies substantially**
  In more commoditised categories such as Sports and Entertainment price is the critical driver of customer ratings. Categories such as Clothing, Grocery and Department Stores demonstrate that the customers are looking for much more than just price however.

The OC&C Proposition Index shines a 'forensic' light on how retailers are meeting customer needs. In a world too often characterised by poor customer insight where the benchmarks are being raised (good enough?) this is valuable and powerful insight.

We are actively working with clients to turn this insight into clear action and long term competitive advantage.

Find the full results at www.occstrategy.com/psi

International Benchmarks

SHOP 'TIL YOU DROP?

Groceries online in Germany

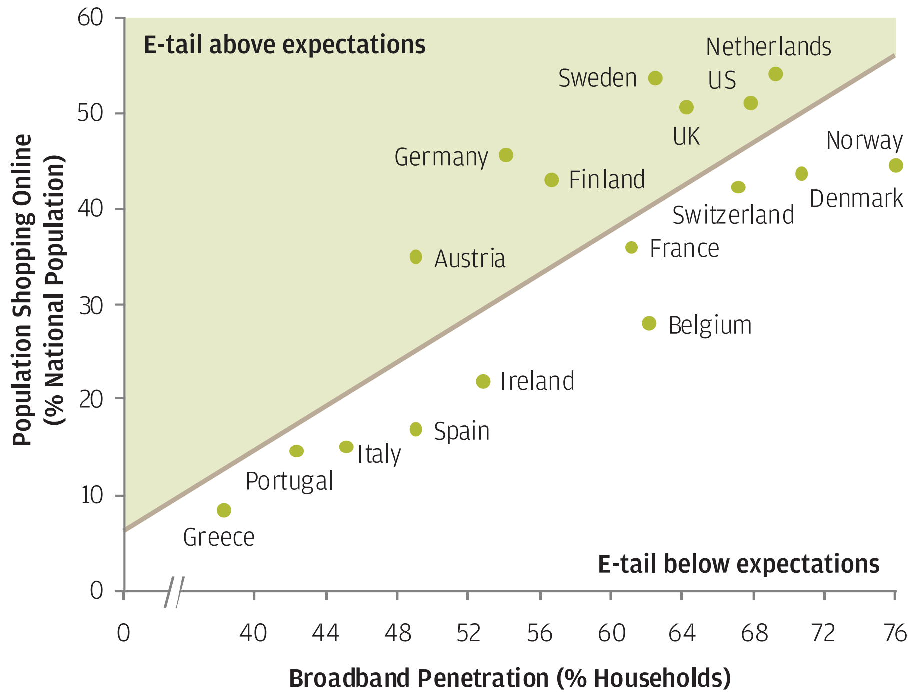
THE GERMAN QUESTION

Grocery shoppers in Germany are different from grocery shoppers in other European countries. Or, at least, that has often been the received wisdom. Obviously the supermarket landscape in Germany is different – discounters have a very high share of sales and online grocery is nascent. But in online at least, things might be about to change.

In many ways Germany should be a great market for online groceries. Germans have taken to online shopping enthusiastically, happily transferring their familiarity with catalogues into the online space. Indeed, recent OC&C research shows that Germany is one of the countries which most over-indexes on online sales relative to broadband penetration. And as broadband penetration increases, there should be further growth to come.

Until recently however online grocery was a category in which Germany lagged far behind the rest of Europe. Why?

Broadband Penetration vs Online Shopping by Country, 2009



IT'S THE ECONOMICS, STUPID!

The true economics of selling groceries online are far from clear. Many CEOs have held back investing in it because they assume that no-one really makes money.

Even those retailers that have relatively extensive online grocery businesses aren't able to be completely sure that they really are making money – or how much they are losing. Sales revenues need to be adjusted for cannibalisation (perhaps those shoppers would have come to the store anyway) and the lost sales caused by stock-outs driven by online customers. Costs need to be revised reflecting the opportunity cost of promoting online, incremental stockholding costs etc consequently sophisticated algorithms are needed to correctly allocate the end-to-end supply chain costs.

Our work with UK grocers has suggested that you can make money, if you have the right sales and drop densities. The fully loaded costs of delivery, although they vary between the players, average at least £25 per order; and they can be higher depending on the exact approach taken, and maturity of the network. In practical terms this means that online grocers need to ensure average baskets of at least £80 in order to make money.

Of course there are lots of ways of managing this number up or down, with incentives for larger baskets or adjustments to delivery fees to drive route efficiency and the like. Store based collection (or even drive though) can make the numbers look different again. But the fundamental economic truth remains: online grocery adds costs into the system and for an incumbent player with a large store network can be a significantly less efficient way of doing business. And break-even requires baskets that are 2-3 times higher than those seen in store.

That does not mean that grocers should not seek to develop an online food business. Indeed the competitive dynamics may demand it. One supermarket chain we worked with was a late entrant into the online market. They allowed customers to pre-register interest in shopping online, ahead of their national rollout. They found, however, that by the time they re-contacted customers with the news that online sales were now available in their area more than half were no longer interested as they were doing their online shopping with a competitor. What was worse, the majority of those customers had since transferred their offline shopping allegiance to that competitor too.

WHO DARES WINS

In countries where online grocery is established the question for retailers is not shall I play, but how to play? Will Germany be any different? Currently none of the major supermarket chains have fully entered the online grocery businesses, and the market is dominated by specialists and independents. Amazon's entry into the category might be the catalyst to change this. Over the next five years, we believe, the market could grow from less than 0.2% of the German grocery to close to 2%, a compound annual growth rate of over 50%.

In many ways the market should be ripe for explosive growth. There are very large customer groups (together representing almost 15% of the market or over 8m shoppers) who could have a strong affinity with the online grocery offer: young professionals, busy mums, and silver surfers. Furthermore, many of these customers are already using online in other categories – and now that amazon.de is offering dry groceries will have more immediate access to some of the core grocery categories.

But success in German online grocery is far from guaranteed. Our research suggests there are four key drivers of success:

1. A loyal customer base
Whilst retailers in Germany, like Amazon, have both traffic and loyalty it does not (yet) have grocery traffic. No-one has yet got customers reaching for their keyboards regularly when they are looking to buy food.

2. Online shop usability
Amazon's website is in many ways the model of simplicity. But it is optimised for selling branded products on a relatively infrequent basis. It cannot offer the full functionality of a dedicated multichannel grocer (turning offline shopping lists into online lists, integrating with recipes and in-store promotions through a single basket).

3. Range
Ultimately Amazon and other non-grocers can never be more than a 'top up' or 'stock up' grocery site. They lack the access to fresh products and private label that are such a key part of grocery economics.

4. Fulfilment
This is the big challenge in grocery and whilst using third party distribution systems may be low-cost, delivering a full grocery offer requires a fleet of multi-temperature vans, whether operating out of central or local/store based warehouses.

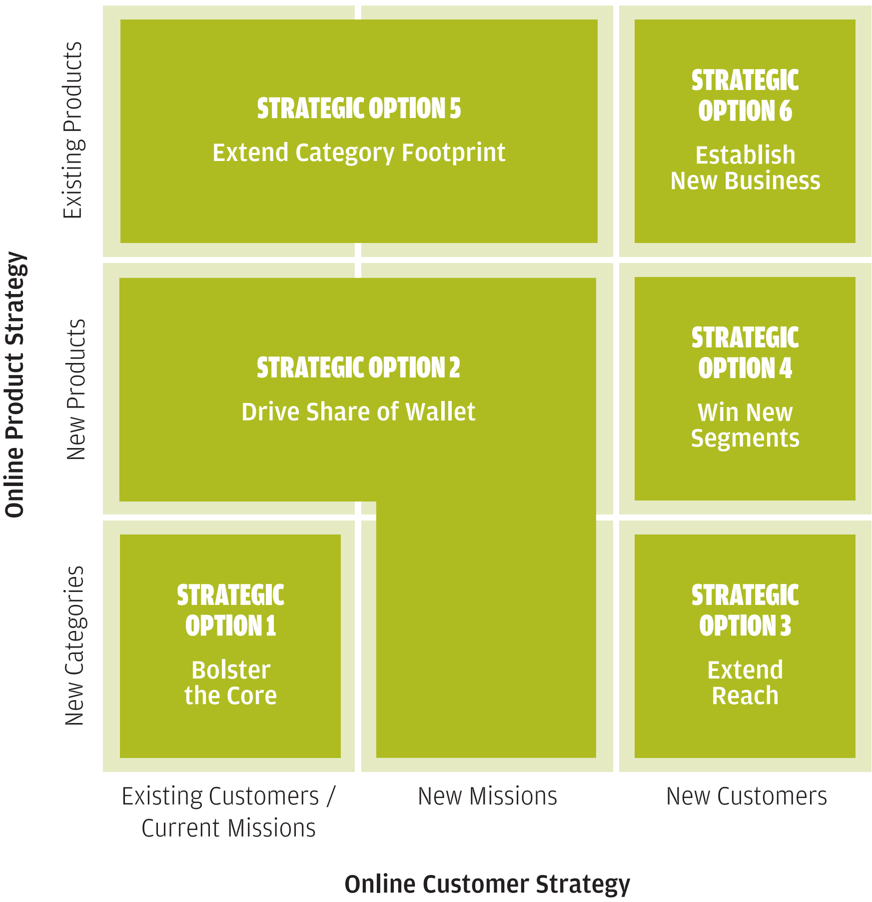
Whilst Amazon may not by itself change the game in Germany. But it will cause – indeed is causing – the mainstream grocers to think again about whether they should take the plunge and lead the market. The retailer who gets there first may gain a significant first mover advantage (Tesco's share of online grocery is double its share of store based grocery in the UK) capturing new customers and shaping the market in an advantageous way.

This may be one of those strategic issues where 'who dares, wins'.

CUT TO THE CHASE

Now that online has become the only source of growth for many retailers, the debate about the need for an online strategy is over. The big question is what that strategy should be.

"The Battlefield"

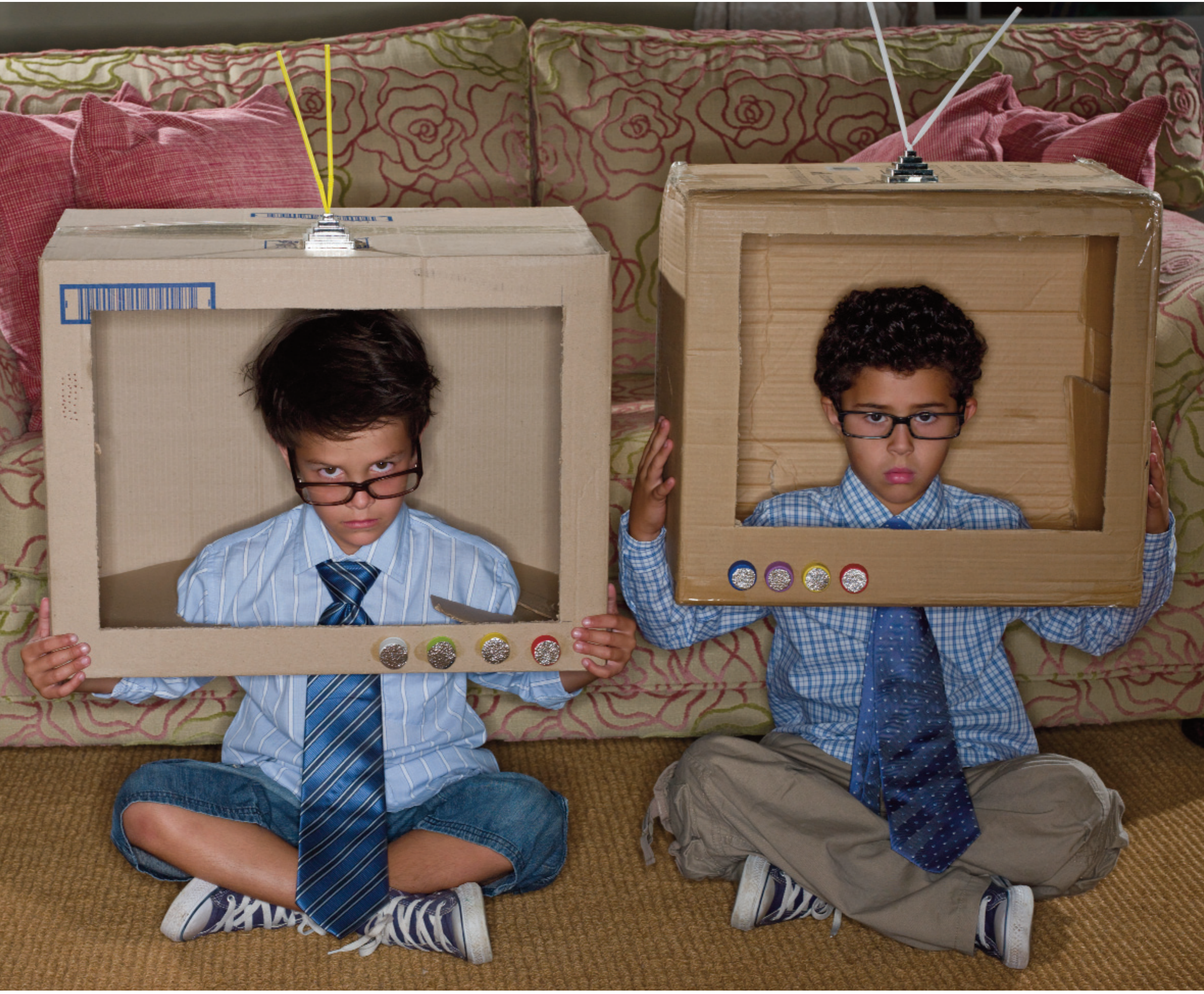


This is a world where shoppers are more fickle, transparency is greater, and yet the opportunities seem boundless. It is no surprise that retailers who have grown up in a world of steady, like-for-like growth and measured store rollouts can find it hard to adjust to the multichannel world.

Our experience is that the adjustment is made harder because CEOs do not understand what they want their online businesses to do. Too many measure success simply by looking at an accelerating top line, without understanding who the website is for and how its role compares with that of the store network. They are unclear where online growth is coming from and whether it is truly profitable.

We saw an example of this failure in a leading UK department store that became narrowly fixated on achieving an aggressive revenue target online without addressing these fundamental questions. It did not pause to consider whether its online aspiration was realistic and in line with its overall brand strategy. As a consequence, the online business retreated to a 'scattergun approach' of trying to sell multiple categories to a broad array of existing and new customer segments. This required high investment in both the web platform and marketing. Ultimately, this resulted in a confused online proposition that jarred with the stores, failed to appeal significantly to any specific customer segments and lost money.

The key to success is to be clear on the choices being made and the strategic options available. In our experience, six potential options are typically available to retailers. We identify them in the matrix on the left.



Some retailers should regard online as a means of buttressing the core business and providing a seamless multichannel experience. Many shoppers like to browse online but ultimately complete their purchases in store. Research by OC&C suggests, for example, that nearly 40 per cent of UK customers looking for clothing have completed some form of research online before buying in-store. So whilst a website may have transaction capabilities, this may not be its primary function and the head of ecommerce should not be incentivised solely on this basis.

In other categories the push to multichannel is more defensive. We worked with a specialist electronics retailer for whom the switch to online represented a great customer challenge. It became clear that systematic investment in the online platform, integration with the store network and development of a loyalty database were critical to the retailer's future survival. As they moved sales online, they needed to develop a more detailed understanding of their customers and to leverage that understanding across their different channels in order to retain as many customers as possible.

But for most retailers the online strategy need not be about serving or defending the core customer base but about reaching out to new customers or capturing greater share of wallet from existing ones. These are very different aims that require a very different supporting strategy. For example a UK clothing retailer decided to focus its website on a younger, more fashionable customer segment than its stores. In doing this, it switched from having the website look like an extension of the store to one that offered an edited range of more fashionable product, emphasised its 'fashion' credentials and shifted the product mix towards higher-priced items.

The lesson of these case studies is that there is no one recipe for success. The vital thing is for retailers to be specific about who they are trying to serve in this future multichannel world and have clarity on how those customers will shop across channels and what they will use them for. Only then will they be in a position to design a business model and proposition that is aligned to the behaviour and needs of their customers and differentiated from competitors.

In summary, retailers should retreat to first principles and ask themselves five simple questions:

- Am I using online to reach new customers or better serve existing customers?
- Do I know how these customers shop across different channels and why?
- Can I use online to sell stuff I could never sell in-store?
- Am I using online to better defend missions served today in-store or appeal to new shopping missions?
- Can I use online to position my brand in a new and exciting way?

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OC&C INTERNATIONAL RETAIL PARTNERS

Name	Country	email
Alastair Adam	USA	alastair.adam@occstrategy.com
Alex Birch	UK	alex.birch@occstrategy.com
Chehab Wahby	Germany	chehab.wahby@occstrategy.com
Christian Ziegfeld	Germany	christian.ziegfeld@occstrategy.com
Chris Outram	UK	chris.outram@occstrategy.com
David Krucik	UK	david.krucik@occstrategy.com
David Sinclair	UK	david.sinclair@occstrategy.com
Dirk Rens	Netherlands	dirk.rens@occstrategy.com
Guy-Noël Chatelin	France	guynoel.chatelin@occstrategy.com
Jacques Penhirin	China	jacques.penhirin@occstrategy.com
James George	UK	james.george@occstrategy.com

"WHILE THE CHALLENGES OUR CLIENTS FACE ARE CHANGING FAST, THE BASIC TOOLS OF SOUND ANALYSIS, CLEAR THINKING AND AN OPEN ADVISORY RELATIONSHIP CONTINUE TO PROVE EFFECTIVE"

Name	Country	email
Jean-Daniel Pick	France	jeandaniel.pick@occstrategy.com
Keri Aivazis	USA	keri.aivazis@occstrategy.com
Kerstin Lehmann	Germany	kerstin.lehmann@occstrategy.com
Marc van der Goot	Netherlands	marc.van.der.goot@occstrategy.com
Michael Jary	UK	michael.jary@occstrategy.com
Naimish Dave	India	naimish.dave@occstrategy.com
Richard McKenzie	China	richard.mckenzie@occstrategy.com
Tim Cook	UK	tim.cook@occstrategy.com
Wai-Chan Chan	China	waichan.chan@occstrategy.com
Will Hayllar	UK	will.hayllar@occstrategy.com

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Offices

Boston
T +1 617 896 9900

Düsseldorf
T +49 211 86 07 0

Hamburg
T +49 40 40 17 56 0

Hong Kong
T +852 2201 1700

London
T +44 20 7010 8000

Mumbai
T +91 22 6619 1166

New Delhi
T +91 11 4051 6666

New York
T +1 212 803 7280

Paris
T +33 1 58 56 18 00

Rotterdam
T +31 10 217 5555

Shanghai
T +86 21 6115 0310

www.occstrategy.com

OC&C Strategy Consultants