Customer-Centric Merchandising

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2007 Benchmark Report

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EXECUTIVE SUMMARY

Retail merchandising has survived with a product-centric focus for years. The "merchant prince" was expected to know what the consumer wanted, and the consumer was expected to respond to any merchant with a "hot hand." Merchandising was an art form. Times have changed. Consumer tastes are more fickle than ever before, and profitable lifecycles are shorter as well. Changes in the culture of some merchandising organizations have made line-of-business users more open to embracing new ways of doing business. The smartest merchants combine art and science to create a new form of merchandising. RSAG calls this technology-enabled customer-centricity in merchandising, or Customer-Centric Merchandising for short. This report will identify the business benefits achieved by retailers who adopt a customer-centric merchandising focus, and identify other retailer priorities to move in this direction.

THE BUSINESS CHALLENGE

Fractured planning processes continue to plague retailers, no matter their size or segment. Merchandise, store, financial, and expense plans have little cohesion in most retail organizations giving rise to merchandising practices that are disconnected with other critical business areas and ultimately breeding inefficiencies. Retailers recognize the need to become more efficient and effective in their merchandising practices. At the same time, they remain challenged to improve customer loyalty and acquisition in a marketplace that is seeing channel blurring (cannibalization from new consumer channels) and a lack of differentiation in product offerings on the rise.

OPPORTUNITIES

In many retail organizations, disconnected departmental planning creates uncertainty, leaving even large merchandising organizations "flying by the seat of their pants", and providing the disservice of multiple versions of the merchandising truth. It is of little surprise, then, that more than half of all respondents place a very high priority on the ability to take advantage of integrated planning with cross-functional teams. At the same time, retailers see big opportunities in localizing assortments, pricing, and promotions, as well as in integrated multi-channel business intelligence. Clearly, retailers are attempting to circumvent the commoditization of products and cannibalization from new consumer channels by fine-tuning their customer-centric merchandising efforts with these opportunities.

ORGANIZATIONAL BARRIERS

Of top concern to respondents, an aging and inflexible technology infrastructure has made it difficult to quickly adapt to changing business needs – a recurring theme in our reports. However, an even larger predicament presented itself in this study. Respondents clearly stated a need for more sophistication in merchandising tools (getting beyond the spreadsheet), while also admitting to merchandising being viewed internally as more art of than science. Adding one last ingredient – 75 percent of respondents stated the organization is resistant to change – many retailers look to be cooking from a recipe for complete paralysis. Time has come to change this mindset.

TECHNOLOGY ENABLERS

Retailers have been notorious for IT thriftiness, opting to put more budgetary might behind new and/or remodeled stores and other areas of the business. Be that what it may, a lack of merchandising sophistication is pervasive, giving rise to rogue PC-based spreadsheets providing multiple versions of the truth and aging systems lacking much useful functionality. Merchants are doing their best with the tools they've been given. Our respondent base clearly indicated the need for more sophistication and analytics in merchandising to take advantage of identified opportunities.

"BOOTSTRAP" RECOMMENDATIONS

Retailers must get beyond the fractured planning process. This change won't come easy and will entail a completely new way of thinking and interdepartmental cooperation. Once and for all, retailers must create interdependent communications in the retail planning process to succeed on a sustainable basis. Additionally, retailers must make better use of technology. RSAG recommends against a "roll your own" strategy in favor of packaged software – the functionality is there now. ROI will need to be clearly demonstrated through pilot projects and functional simplicity must be conveyed to users to get beyond spreadsheets.

SECTION I: OVERVIEW

STUDY RATIONALE

Retail merchandising survived with a product-centric focus for years. The "merchant prince" was expected to know what the consumer wanted, and the consumer was expected to respond to any merchant with a "hot hand". Merchandising was an art form. When the merchant's hand cooled, he was out.

Times have changed. Smart merchants know that today's consumer will not be dictated to. Consumer tastes are more fickle than ever before, and profitable lifecycles have shortened, requiring all-time quick turnarounds. The move of sourcing to the Orient as the primary hub and improved communications has reduced the "knock-off cycle" from years to months. Private label merchandising has commoditized everything from snow peas to snow suits.

Additionally, advances in computing power have made it possible to combine product and consumer-related information. Changes in the culture of some merchandising organizations have made line of business users more open to embracing new ways of doing business. The smartest merchants combine the art and science of merchandising to create a new form of merchandising.

In light of these facts, RSAG initiated the Customer-Centric Merchandising Benchmark Report to identify and study the business benefits achieved by retailers who adopt a customer-centric merchandising focus and the key business drivers behind the adoption of such a strategy. In addition, as enabling technology has become a key success factor to business process improvement, we looked at the level of IT adoption across various merchandising disciplines and evaluated merchants' technology approaches to support their activities. As always, we also wanted to identify missed opportunities and offer prescriptions for improvement to help take full advantage of the business possibilities around customer-centric merchandising.

METHODOLOGY

RSAG uses its own model, called the "BOOT," to analyze issues in the Extended Retail Industry. This model is built with our proprietary survey instruments. Specifically, the "BOOT" methodology is designed to reveal and prioritize the following:

- **Business Challenges** – RSAG queries enterprises to help them identify the biggest external challenges they face. These issues provide a business context for the subject being discussed.
- **Opportunities** – Every challenge brings with it a set of opportunities, or ways to change and overcome that challenge. RSAG's surveys ask respondents how they're choosing to meet their challenges. We also identify opportunities missed – and describe leading edge models we believe can drive success.
- **Organizational Inhibitors** – Even as enterprises find opportunities to overcome their external challenges, they may find internal organizational inhibitors that keep them from executing on their vision. Opportunities can be found to overcome these inhibitors as well. RSAG's surveys help respondents

determine what their organizational inhibitors are and how to conquer internal challenges.

- **Technology Enablers** – The Extended Retail Industry can no longer function without a strong technology foundation. RSAG surveys question retailers about the technologies they employ to help solve business challenges.

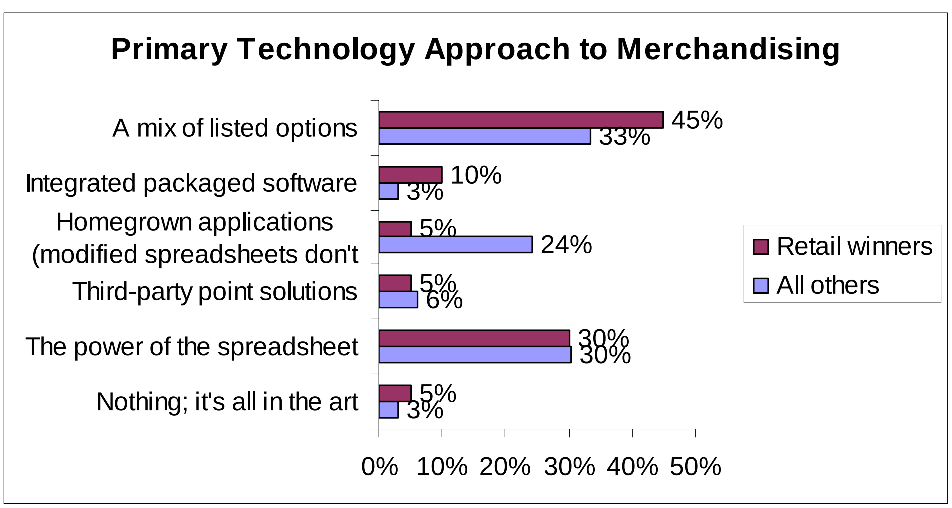
RSAG believes winning is not an accident in the Extended Retail Industry. Customers vote with their wallets. Sustainable sales improvement and successful execution of brand vision are direct results of an enterprise's recognition of external and internal business issues, its ability to take advantage of opportunities for improvement, and its use of technology enablers to simplify and rationalize business processes. Data that emerges from the BOOT model helps us understand the behavioral and technological differences between winners and their peers.

DEFINING RETAIL WINNERS

Our definition of retail winners is straightforward, following Wall Street's methods. Wall Street judges retailers by year-over-year comparable store sales improvements, and RSAG does the same. Assuming an industry average comparable store sales growth of 3 percent, we define retailers with sales above this hurdle as "winners," those at this sales growth rate as "average," and those below this sales growth rate as "laggards".

Within this context, the importance of moving from a product-centric to a technology-enabled customer-centric (TECC) merchandising model can be extracted from Figure 1. Although 30 percent of both retail winner and "all others" respondents report still using spreadsheets as the primary approach merchandise management, winners utilize advanced integrated packaged software more than the rest of the pack by a better than three-to-one margin. Winners also are far less likely to use a "roll your own" application approach to merchandising than their average and underperforming peers. The majority of all others seems bound either to building their own custom applications or to fall prey to the power and mystique of the spreadsheet.

Figure 1:
Winners Employ More Advanced Merchandising Tools than Their Peers



SURVEY RESPONDENT CHARACTERISTICS

RSAG conducted an online survey between December 2006 and February 2007 and received complete sets of answers from 55 retail respondents. Respondent demographics are as follows:

- **Functional Area**: 45 percent of respondents were from merchandise management, 22 percent from information technology, 15 percent from logistics/supply chain and procurement, and 18 percent from store operations management and other areas.
- **Job Title**: 13 percent identified themselves as senior management (C-Level) executives, 11 percent were vice presidents, 56 percent were directors or managers, with the remaining 20 percent from IT, internal consultants, support staff and other positions in their companies.
- **Revenue**: 20 percent of respondents had annual revenues of $50 million or less, 13 percent from $51 million to $249 million, 29 percent had annual revenues of $250 million to $999 million, and 38 percent had annual revenues of $1 billion or more.
- **Segments**: 74 percent of the respondents were from general merchandise and apparel (GMA), 13 percent from fast moving consumer goods (FMCG), and the remaining 13 percent from do-it-yourself (DIY) and miscellaneous other retail segments.
- **Year-Over-Year Comparable Store Sales Growth Rates**: Assuming average comparable store revenue growth of three percent, 39 percent reported better than average results, 48 percent reported average results, and 13 percent self-identified as worse than average.

In addition, interviews of four respondents from different retail segments and of various sizes have provided anonymous anecdotal information, adding more richness to the report. Interviewees include:

- Retailer 1 – This $1.1 billion enterprise operates more than 150 specialty apparel/accessory stores under multiple brands mainly in the US, but also in Canada and the UK.
- Retailer 2 – This $300 million enterprise operates hundreds of off-price women's apparel shops in the US under multiple brands.
- Retailer 3 – This Tier One retailer operates thousands of automotive supply stores in the US and other countries under multiple brand names.
- Retail 4 – This multi-billion dollar specialty retailer runs multi-channel retail operations under various brand names incorporating stores, catalog call centers, and eCommerce sites.

SECTION II: BUSINESS CHALLENGES

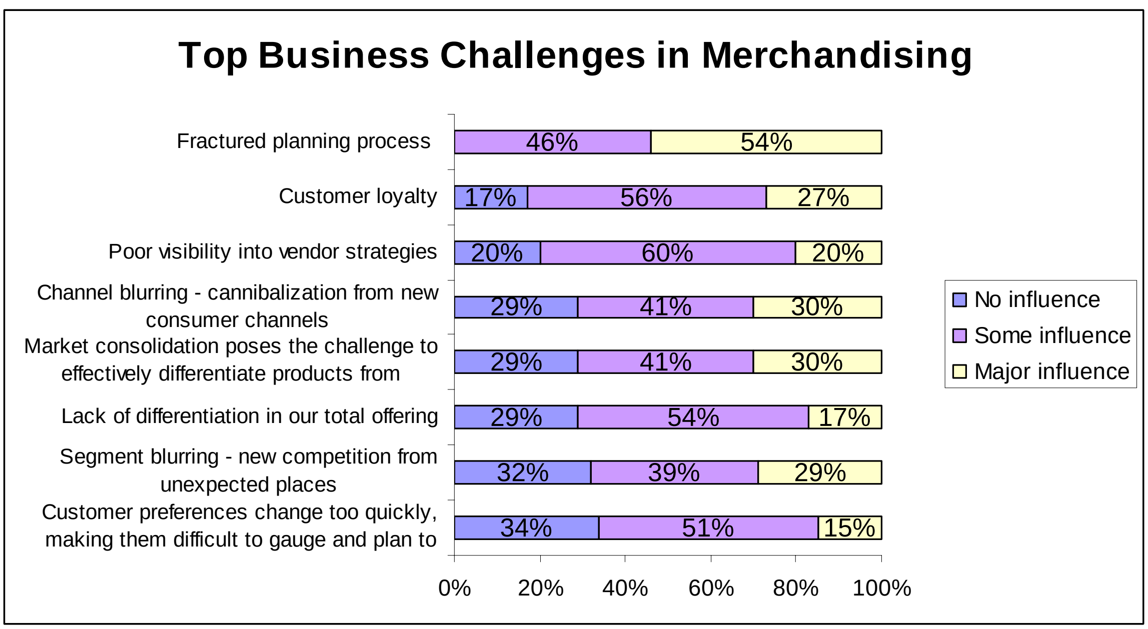
FRACTURED PLANNING PROCESSES A UNIVERSAL CHALLENGE

As shown in Figure 2, fractured planning processes (incorporating merchandise, store, finance, and expense) top the list of business challenges. Every survey respondent identified this as an issue, with a majority (54 percent) of respondents indicating it having a major influence over merchandising processes. This story is not new, but it has proven to be stunningly intractable.

The typical interdepartmental planning scenario begins with finance putting together "the plan" for the enterprise, and then each department taking responsibility for "making it happen." Merchant heads must then work out assortment, pricing, promotion and other activities to fit within the plan. This results in multiple re-forecasts and revised plans depending on how initial forecasts are matching up to sales.

A better approach begs for interdependent and continuous communication between function areas. Corporate needs can be clearly communicated from the top and individual departments then can indicate whether or not they can meet those needs. Too many "versions of planning truth" in each department creates confusion and ineffective business processes. Lack of communication creates excess inventory, or worse, an escalated out-of-stock position for the consumer.

Figure 2:
Fragmented Planning Processes Threaten Retailing Success



Retailer 1 battles a complex challenge in this regard. This organization operates its retail and direct (web and catalog) businesses separately, with different processes and systems. Merchandising in each division is run idiosyncratically. The net result: the organization by its very nature is fractured. Retailer 1 states that the business has been successful ***despite*** its disjointed business processes and poor systems adoption. The company is wholeheartedly invested in the power of the spreadsheet. It is a merchant-driven (vs. financial) organization giving much leeway to the art of merchandising. Our interviewee indicates, however, that the organization cannot operate this way for much longer and expect to grow or be as successful as in years past. The process-integration and systems gap will soon reach its limits.

For Retailer 2, the primary challenge in its planning process is technology vs. process integration. This interviewee believes retail organizations are either process rich or technology poor or visa versa. The organization employs advanced planning for merchandising and stores, including both sales and margin plans, and tied back to financial goals. However, the retailer struggles with integration due to older technology lacking advanced, much less integrated, functionality. A project is currently underway to improve inter-system communication.

Retailer 3 experiences completely siloed planning – a textbook case of fractured planning. The process begins with finance putting together "the plan" for the enterprise, and then each department is given the responsibility to "make it work". Merchants must then force assortment, pricing, promotion and markdown plans to reconcile to the financial plan. This results in quarterly re-forecasts and revised plans, called "latest estimate of plan", depending on how initial forecasts are matching up to sales.

CUSTOMERS SAY, "IF YOU DON'T MAKE IT SIMPLE, I'LL GO ELSEWHERE"

Additionally, customer loyalty has emerged as a serious pain point for a majority of merchants. While our respondents don't seem to be overtly troubled by fickle customer product preferences, 83 percent indicated customer loyalty as a primary challenge they are facing. This would indicate the challenge isn't so much about providing what consumers want but rather the ability for them to get the same thing elsewhere that may be more convenient, offer a better deal, or provide a better shopping experience.

Also, with loyalty schemes in such widespread adoption, retailers seemingly would be less concerned by this issue if these programs were living up to their name. However, no significant industry data seems to demonstrate how well or poorly they are performing.

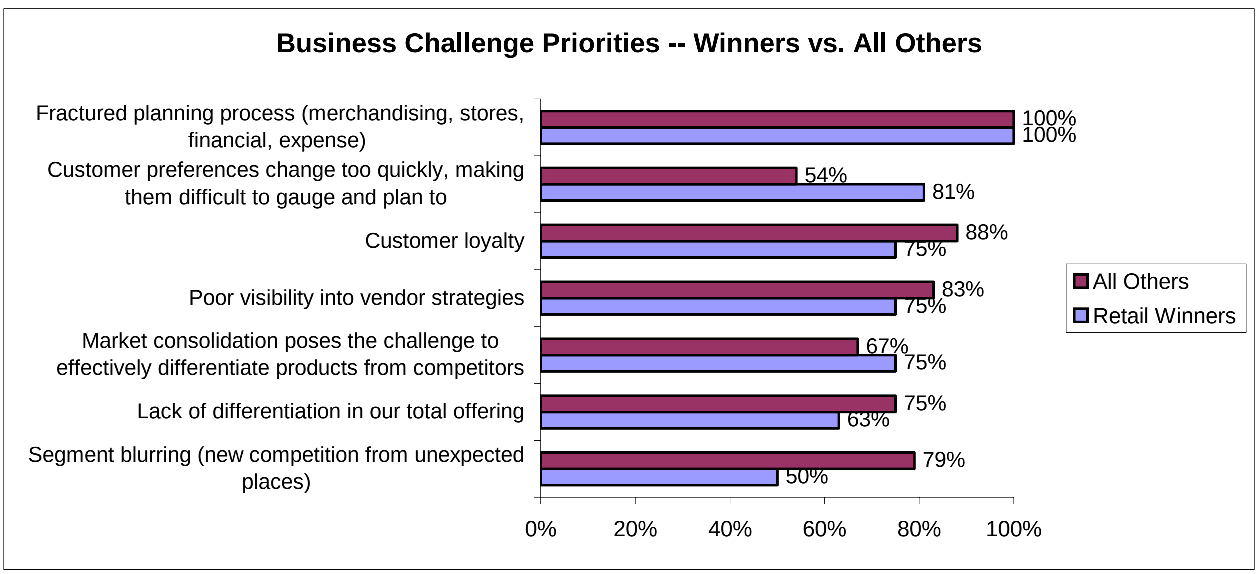
For Retailer 4, customer loyalty poses less of an issue for its largest and well known brand. The retailer has developed a fairly loyal following with unique and high-quality products. Customer loyalty has become a bigger problem for another of its large and popular brands. . Traditional competitors and a spate of unexpected companies looking to take market share by expanding offerings to similar product lines are eating into sales and margins. Seventy percent of this banner's offerings are private label merchandise which helps to differentiate it from the competition. High design standards and the promise of localized assortments are this banner's greatest hope to win back customers.

RETAIL WINNERS FOCUS ON CUSTOMER PREFERENCES

While a fractured planning process is the top concern for retail winners and "all others" alike, overall, business challenge priorities differ between the two groups (Figure 3).

For example, more retail winners find frequently changing customer preferences a pressing issue (81 percent) vs. all others (54 percent). Winning retailers proactively look to meet and beat consumer expectations, and are concerned with the ability to anticipate customer preferences in their merchandising practices. Incredibly, *46 percent of respondents in the "all others" category indicated changing customer preferences had no influence in the merchandising process.* Here is a clear case to re-examine which approach their merchandising organization is taking – product-centric or customer-centric.

Figure 3:
Winner's Priorities vs. All Others'



In addition, retail winners and all others differ significantly in concern over segment blurring (new competition from unexpected places), suggesting that winners are more focused on proactively understanding and meeting customer needs than looking over their shoulders at their competitors.

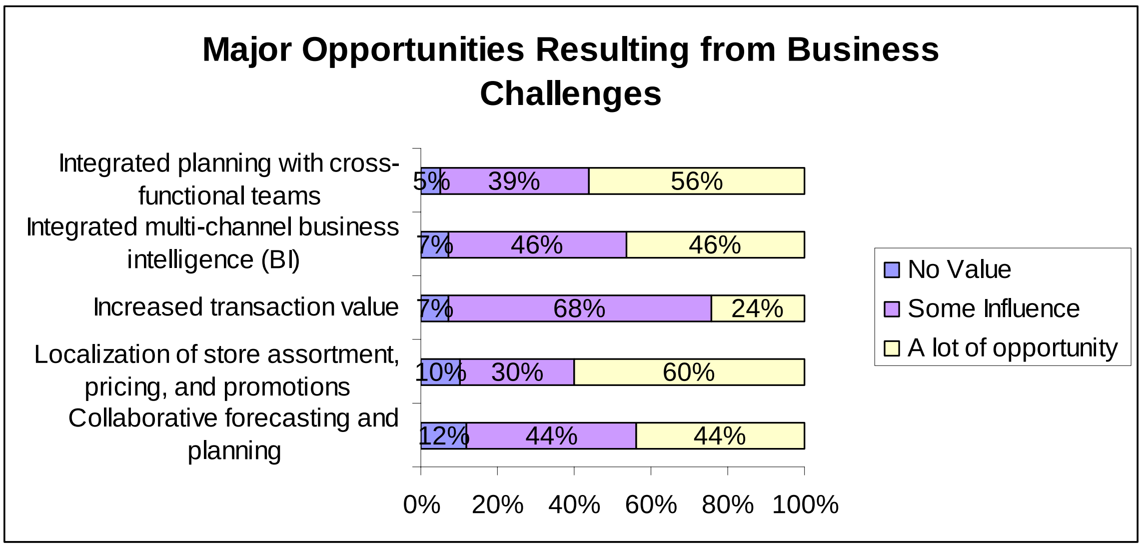
Target Stores (not interviewed for this study) is a prime example. While the mass merchandiser understands it must compete with other big discounters and wholesale clubs, it places a laser focus on understanding who its customers are and serving them accordingly. From a merchandising perspective, the retailer has placed great importance on partnering with well known designers for high-margin apparel lines and added more private label merchandise to its overall product mix. Additionally, it has guided its advertising and promotions light years ahead of any other retail firm.

The challenges faced by our respondents are felt both internally and externally. Within the organization certain hierarchical barriers make for great inefficiencies, inaccurate forecasting, and less-than-perfect planning. Externally, retailers face a multitude of challenges posed by a highly distributed environment, constant movement in consumer trends, more empowered and disloyal consumers, and a mass of competition. With all this complexity, one sometimes wonders how any retail organization can be successful. Before turning out the lights and calling it quits, however, smart organizations realize that from these challenges are presented opportunities to leverage for success.

SECTION III: OPPORTUNITIES

RSAG asked survey respondents to rate opportunities to help overcome their merchandising challenges, ultimately to ensure consumers get the products they need when and where they need them, and to increase profits. Figure 4 illustrates those opportunities respondents rated most highly in terms of value to overcoming their primary business challenges.

Figure 4:
Integrated Planning and Localization Are Most Valued Opportunities



INTEGRATED PERFORMANCE PLANNING PROCESS

Noting the primary challenge in the previous section, it is no surprise our respondent base favored integrated planning with cross-functional teams as an opportunity to once and for all have cohesion in the performance planning process. Within a typical retail organization, performance planning is either a compilation of multiple independent processes run in silos (as noted earlier in Retailer 3's example) or a string of performance processes run serially, often exceeding six months or more to complete. Either way, these planning cycles are out-of-sync, time-consuming, and error-prone, resulting in retail plans that contain multiple interpretations of the same data and that foster minimal operational buy-in. Due to the sheer magnitude of the effort involved, the budgeting and planning process in today's retail organizations tends to be an exercise in reaching an "acceptable" plan number, as opposed to attaining a detailed understanding of the data.

Store, merchandising, and expense planning must interlace with the overall financial plan, rather than operating in silos and being "shoe-horned" into compliance with projections. For example, the store plan should forecast their controllable net, or revenues minus expenses, by understanding key demand drivers from merchandising: assortment, pricing, and promotions. Ideally, retailers would implement "closed-loop" interdepartmental communication with cross-functional teams that allows merchandising, stores, central services, and finance to adopt a synchronized performance planning process that works collaboratively, rather than independently. Ultimately, this synchronization promises more accurate and efficient planning, which results in a single, yet collective, version of the planning truth in a much shorter timeframe. For merchants, this leads to proactively meeting customer needs, or "Customer-Centric Merchandising".

For Retailer 4, the planning process is only fractured technologically: systems to support a unified process end-to-end aren't there. The retailer has the business processes to bring together all groups; however, in some ways its systems dictate the planning process. The retailer is in the process of implementing integrated packaged software, which should alleviate this issue to a large degree.

RIGHT PRODUCT, RIGHT PLACE, RIGHT PRICE

Also top of mind for survey respondents, is localization of store assortment, pricing, and promotion. Sixty percent of respondents believe it provides a lot of opportunity for improving the customer experience and overcoming business challenges. .

Given the complex, distributed nature of this marketplace, a retailer's ability to understand local market demand and preferences is crucial for success. Tailoring assortments to customer preferences by region, store clusters, and individual stores requires a finely tuned understanding of consumer needs and the ability to accurately forecast the impact of such decisions. Optimizing pricing on at least a regionalized basis reduces unnecessary markdowns, while also providing better sell-through rates. Retailers also need to understand the effects of localized promotions to optimize sales lift by product.

According to Retailer 5, it's best to start localization with "low hanging fruit" – product with obviously disparate, localized demand. The retailer leverages localized assortments but only in certain merchandise groups where it makes sense to the demographics being served in a particular region or store. The retailer also believes localized pricing would be beneficial to a certain degree, but the ROI for this functionality isn't yet overwhelming. Its outdoor business, for example, requires staggered pricing based on seasonality. It would like to engage markdowns earlier in the Northeast than in say Texas, which isn't possible at this point. Instead, the retailer manages this by distribution simply by stopping replenishment of Northeast stores.

HIGH-TOUCH MARKETING FINDS LUKEWARM RECEPTION

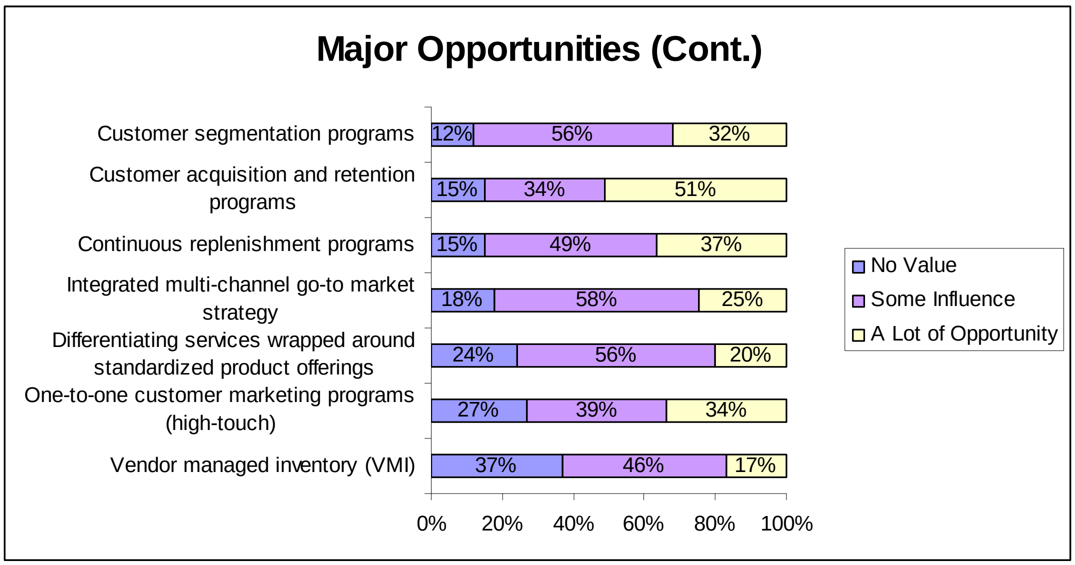
Much noise has been sounded around one-to-one marketing and mass customization as core to customer-centricity. From trade journals to tradeshows, a multitude of importance has been placed on understanding customers down to individual preferences. This detailed understanding, as advertised, would create tight customer relationships and a loyal following.

Our respondents help separate the noise from the reality. The fact is, amid all the buzz, few retailers have adopted one-to-one marketing or mass customization strategies. Retailers realize such high-touch customer programs are expensive and overall difficult to manage and execute well.

As Figure 5 illustrates, retailer response to one-to-one marketing as a business driver is lukewarm at best. A one-to-few approach proves more sensible utilizing localized store assortments, pricing, and promotions. This approach takes more process excellence than capital investment to accomplish successfully. Most of RSAG's research over the past year supports this data: retailers are far more concerned with the basic blocking and tackling of store clusters and demographic-specific assortments than they are with one-to-one marketing plans.

Figure 5:

No Ringing Endorsement for 1:1 Marketing



RETAIL WINNERS SEE ADVANTAGES OF A MULTI-CHANNEL ENTERPRISE

Our data reveals that retail winners see more opportunity from cross-channel business intelligence and a multi-channel go-to-market strategy than their average and underperforming peers. **Sixty-nine percent of retail winners indicate multi-channel business intelligence creates a lot of opportunity for the merchandising process vs. just 29 percent of all others**. In considering a multi-channel go-to-market strategy, almost 40 percent of retail winners rate it as promising a lot of opportunity. By comparison, just 18 percent of all others place the same high importance on this opportunity while nearly a quarter of these respondents believes there to be no value to multi-channel BI at all.

Most retail organizations operate more than one channel. This has become the norm since just before the turn of the millennium. Conventional wisdom and most historical survey data supported the notion that multi-channel customers were more profitable than their single-channel counterparts. However, times are changing.

According to a recent RSAG study on multi-channel retailing, even as the number of multi-channel shoppers continues to grow, relative profitability of this shopping segment has decreased. A comparison of 2006's retail respondent base with our 2005 report shows that while many retailers still find multi-channel customers to be more profitable, the trend is moving downward toward a more equal footing with single-channel customers. Simply speaking, multi-channel retailing is becoming a cost of doing business. For further information on multi-channel retailing strategies, see the RSAG report, "*Searching for the True Multi-Channel Retailer*".

Winners realize that while multi-channel retailing may now be commonplace, success relies on strong cross-channel consistency in merchandise offerings, pricing, and promotions. Business intelligence enables quicker, more accurate decision making regarding these actions. In addition, success starts with a strong multi-channel go-to-market strategy that focuses on cross-channel operational consistency and efficiency.

Retailer 4, for example, opted to implement an integrated package solution to provide the infrastructure for its growing multi-channel business model. Lacking operational consistency, the retailer's prior infrastructure was inflexible and unable to scale to business demands.

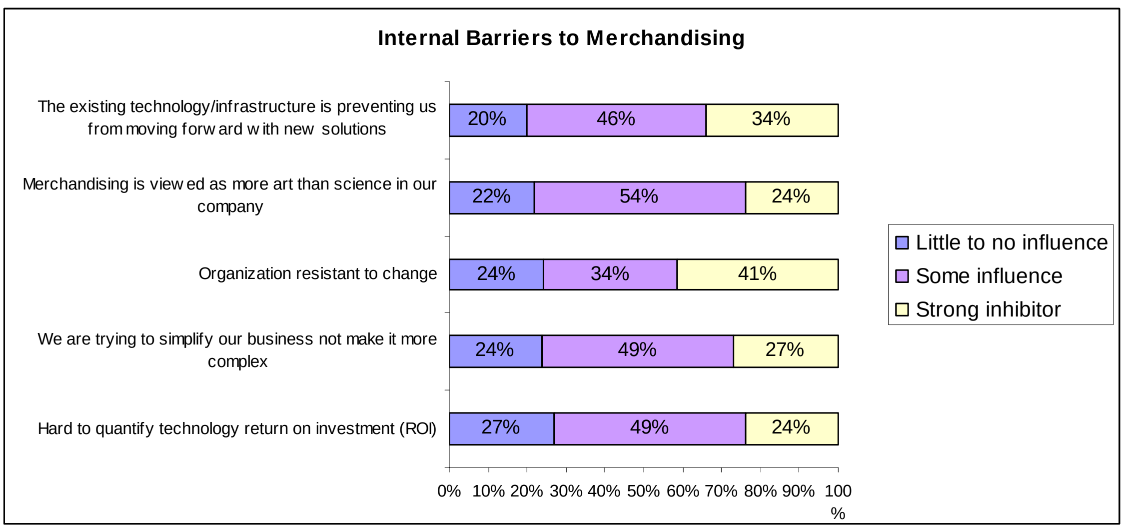
SECTION IV: ORGANIZATIONAL BARRIERS

INTERNAL INHIBITORS – A RESISTANT ORGANIZATION AND INFLEXIBLE INFRASTRUCTURE

RSAG asked survey respondents to identify the top organizational barriers keeping them from implementing new merchandising systems to help take advantage of the opportunities they believe exist.

We've grown accustomed to seeing the need to define clear Return on Investment (ROI) at the top the list of organizational inhibitors, but this survey brought different results, primarily due to the age of the problem. Our retailer respondents are most concerned about inflexibility in both business process change and technology. While the top five listed were fairly even in recognition as having some influence, Figure 6 illustrates a change-resistant organization (41 percent) and an inflexible technology infrastructure (34 percent) as major internal obstacles.

Figure 6:
Organizational Inhibitors Focus on Process and Technical Inflexibility



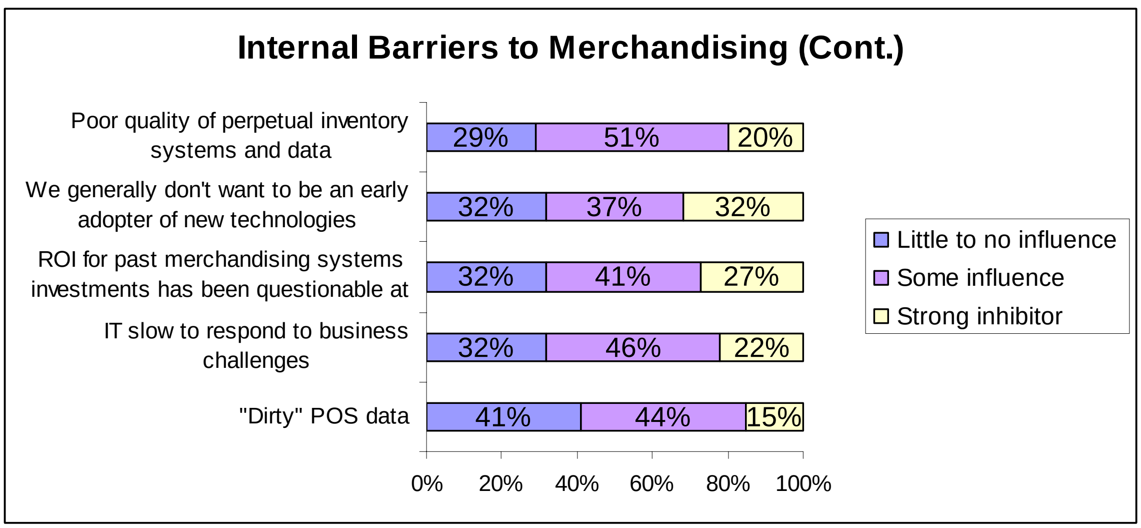
Aging, inflexible infrastructure has consistently presented itself in numerous RSAG reports as a strong internal inhibitor. As retailers gradually recognize how these infrastructures are holding them back, we expect a further move to more integrated solutions. Retail may never be a single solution business, but we expect retailers to demand their applications work better together.

Merchandising, of course, presents its own unique set of circumstances. Respondents clearly indicate a need for more sophistication in merchandising (getting beyond the spreadsheet) while also admitting to merchandising being viewed internally as more art of than science. Adding one last ingredient, 75 percent of respondents agree their organizations are resistant to change, and we find a recipe for complete organizational paralysis.

THE DATA DISCONNECT – DIRTY DATA AND PERPETUAL INVENTORY

Despite the many conversations in the industry around the problem of "dirty data" and the need for "cleansing", our respondents revealed "dirty" data from POS systems has little effect as an internal inhibitor; they rate it at the bottom of all organizational inhibitors (Figure 7). On the other hand, these respondents indicate poor quality of perpetual inventory data as having at least come influence (51 percent) if not being a major inhibitor (20 percent), with just 29 percent deeming it a non-issue.

Figure 7:
Dirty Data Less of an Issue than Perpetual Inventory



How do we explain this seeming conundrum between accurately scanned POS data and inaccurate or poor perpetual inventory? Three issues emerge: 1) poor receiving count accuracy, 2) poor physical inventory count preparation and accuracy, and 3) a high shrink rate, particularly in fast moving consumer goods. The fascination with RFID in the supply chain was, in no small part, related to the difficulty in obtaining accurate receiving counts from bar-code scanners

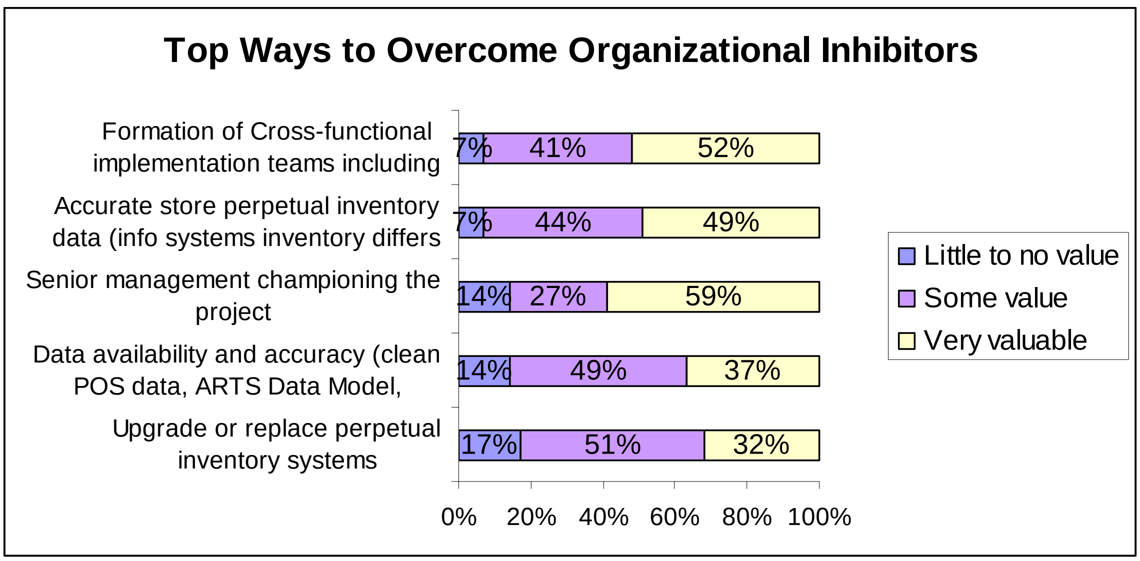
Retailer 3 explains it has worked diligently on arriving at clean data from the point of sale, and has cleansed historical data as well. This provides merchants with one source of the truth for all key planning metrics. However, perpetual inventory still poses a challenge, as the retailer finds difficulty in reconciling physical inventory with what is in the system. Planned new systems will have the capability to handle this issue with inventory adjustment balance functionality. RSAG discourages simply adjusting inventory counts without a deep analysis of the cause of inaccuracies. Inventory adjustments are really just another form of "gut feel merchandising" if they don't identify the causes of errors, and solve problems at their roots.

THE NEED FOR INTERNAL COOPERATION AND GOOD DATA

Internal cooperation and accurate information top the list when we asked respondents how they could overcome their organizational issues (Figure 8).

Support for internal alignment comes from the overall respondent base, as 52 percent indicate cross-functional implementation teams including business users are a very valuable means to overcoming organizational barriers for implementing new merchandising systems. Slightly more (59 percent) see senior management championing projects as very important as well. While senior management may open doors for systems budgeting, it takes cross-functional teams to help you walk through them.

Figure 8:
Need for Internal Alignment and Accurate Information



Three of the top five selections to overcoming inhibitors incorporate various aspects of data accuracy. Just 29 percent of respondents, however, place a high value on cleansing POS data (not listed in Figure 8), further illustrating disconnects between these two issues.

Managed or hosted services receive little support as an option to breaking internal barriers to new merchandising systems implementations. Our respondents rate managed services for packaged merchandising systems, advanced merchandising analytical tools, roll-out and/or maintenance, and hardware at the bottom of the list respectively in terms of value. Although business users have their differences with the IT organization (68 percent indicate IT being slow to respond to business needs poses some issue if not being a strong inhibitor), they still believe keeping control over merchandising systems internal provides them their best option.

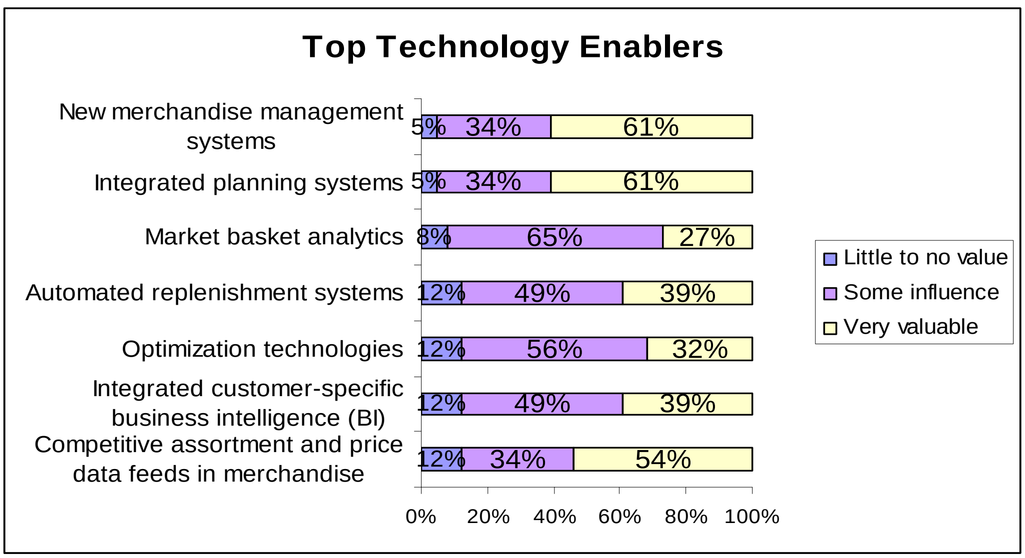
SECTION V: TECHNOLOGY ENABLERS

TECHNOLOGY ENABLERS TO DRIVE EFFICIENCIES

Retailers are notorious for thriftiness when it comes to IT expenditures, opting to put more budget dollars behind new stores and/or remodels or as seen in some recent cases (and much to the dismay of shareholders) into CEO compensation packages. Whatever the reason, a lack of merchandising sophistication is pervasive, giving rise to rogue PC-based spreadsheets and databases, which allow for multiple versions of the truth, and aging systems infrastructures that are lacking the functionality and flexibility needed to keep up with fast changing business demands. In many respects, merchants are doing their best with the tools they've been given.

So what sits at the top of retailers' merchandising technology wish lists? Figure 9 clearly illustrates the need for more merchandising sophistication and analytics.

Figure 9:
Seeking More Sophisticated Tools and Analytics



NEW MERCHANDISE MANAGEMENT SYSTEMS

Incorporating integrated or stand-alone modules, the merchandise management system serves as the backbone of a retailer's systems infrastructure, enabling core retail business processes such as purchase order management, SKU creation and maintenance, receiving, allocation, replenishment, and store inventory control, to name a few. It is therefore not surprising to see it as the most important technology enabler identified by respondents.

Given the importance of such systems to the retail business, we expected no differences in value rankings between retail winners and their peers. But the data shows a better than modest difference. ***Sixty-three percent of retail winners believe merchandise management systems to be very valuable, compared to 46 percent of all others.***

At the beginning of this report (see Figure 1) we saw that winners use advanced packaged software more frequently than average performers and laggards. This is not atypical. Data from our benchmark reports generally illustrate that retail winners take better advantage of new systems and advanced technology to support the success of their organizations.
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INTEGRATED PLANNING SYSTEMS

This technology enabler, while of top importance to a majority all respondents, is most important to our largest retailers answering the survey. Their sheer size and volume makes it problematic to deal with planning in silos and effectively manage their business. Seventy-one percent of retailers with annual revenues of $1 billion or greater feel this was a very valuable enabler to help them merchandise effectively. Mid-market retailers ($250 million - $999 million) express a high interest in integrated planning systems as well, with NO respondents expressing this tool as unimportant to their business. A rapid growth curve predominant with this tier requires similar efficiencies sought from their Tier One counterparts.

Of course, no discussion of integrated planning systems is complete without mentioning difficulties in adoption. Retailers have chased the holy grail of integrated plans for well over twenty years. While it is facile to presume that a new and improved technology will solve the planning conundrum, history has proven (and our respondents agree) that processes must change FIRST. History has also proven that the willingness to change business processes must come from within. It has also proven that riding the pendulum between merchandising as art and science is counter-productive to the retailing organization and satisfies neither customers nor Wall Street. The BEST merchandising organizations use art to determine the WHAT of merchandising, and science to determine the WHERE, HOW MUCH, and WHEN.

MARKET BASKET ANALYTICS

The largest Tier One retailers (>$5 billion) highlight the importance of these advanced tools with 67 percent indicating a very high value to their enterprises. Since 81 percent of all Tier One respondents (>$1 billion) use "gross margin" as a key performance indicator (KPI) to measure the value of their merchandising technology investments, taking advantage of market basket analytics becomes more important to influence buying behavior and maximize sales and profits from promotions, the conversion of non-buyers, and in-store product mix and placement.

Tier Three and Four retailers, however, place just moderate importance on this merchandising technology with 72 percent indicating it having some value to the organization. Our KPI data reveals these retailers are more concerned with same store sales increases and customer retention to measure technology investments.

AUTOMATED REPLENISHMENT SYSTEMS (CAO, CONTINUOUS REPLENISHMENT)

Our retail winners place much more importance on automated replenishment than their peers. Fifty percent find automated replenishment very valuable while just 36 percent of all others view this enabling technology important.

Automated replenishment requires a certain level of sophistication across the supply chain, although the details vary by segment.

- For merchandise purchased locally, or "landed", partnerships between distribution channel members are critical to rapid replenishment response. Economic order quantities become secondary to actual and forecast demand. Retail winners seem more capable to handle this level of sophistication and collaboration than their peers.
- For imported merchandise, a different type of partnership emerges. It may be appropriate for the manufacturer to hold raw materials until clear demand signals are received, than it is to ship in larger quantities early in the product's lifecycle. It may also be appropriate to use different modes of transportation once the goods arrive in the country where the goods will be sold, to reduce time to shelf. This is more complex than the purchase of landed merchandise. Even retail winners are challenged to balance the trade-offs between transportation costs associated with small lots of merchandise, and lost gross margin associated with bringing in fixed, or large lots of product.

OPTIMIZATION TECHNOLOGIES

With the exception of those retailers under $50 million, **all respondents find merchandise optimization technologies valuable to the enterprise**. In addition, those self-identified as retail winners place a higher value on these technologies than their average and under performing peers in a better than two-to-one margin (44 percent and 21 percent respectively).

Optimizing pricing, promotions, and markdowns has achieved meteoric adoption since the turn of the millennium, utilizing advanced algorithms, historical data, and company rules to control margins on a wide range of products. CFOs in particular have been enamored with these tools to protect against unnecessary margin erosion and regain dollars that drop directly to the bottom line.

INTEGRATED CUSTOMER-SPECIFIC BUSINESS INTELLIGENCE

Although most respondents find at least some value in customer-specific BI tools, they are most valuable to Tier 1 retailers: 50 percent find them very valuable to the merchandising process, and the other 50 percent believe them to add some value. Retailers of this magnitude and size capture an extraordinary amount of customer data and require analytical engines to understand and optimize the value of their customers throughout the customer lifecycle. Customer analytics serve retailers in analyzing buying behaviors, in segments or individually across time. This allows business users to take action accordingly.

Oddly, Tier Three and Four retailer respondents, who measure the success of systems investments predominantly by customer retention and percentage change in same store sales, are lukewarm to the value of this enabling technology.

COMPETITIVE ASSORTMENT AND PRICE DATA FEEDS IN MERCHADISE MANAGEMENT SYSTEMS

Most every retailer does it, and for good reason; 88 percent of all respondents find value in competitive assortment and price data. Big retailers, small retailers, winners and all others, they all shop the competition. Whether the information comes from an IRI or a Nielsen, or from internal competitive shops, this data allows retailers to calculate demographic market share by region and store location. This added data dimension aids in market basket analysis and localization of assortments and pricing. It is a valued component to the merchandising process across the board.

SECTION VI: "BOOTSTRAP" RECOMMENDATIONS

RECOMMENDATIONS FOR ALL RETAILERS

Retailers must get beyond the fractured planning process, and leave this huge cultural issue behind them once and for all. The change won't come easily and will entail, in many cases, a completely new way of thinking and interdepartmental cooperation. To win and achieve sustainable growth, retailers must create interdependent and continuous communications in the performance planning process to succeed on a sustainable basis.

Additionally, retailers must make better use of technology and update to advanced merchandising solutions. We recommend against a "roll your own" strategy in favor of packaged software – the functionality is there now and some providers have integrated spreadsheet user interfaces to keep familiarity for business users. ROI must be clearly demonstrated through smaller pilot projects and functional simplicity must be conveyed to end users to get them over spreadsheet barrier.

Explore a Services Oriented Architecture (SOA) approach to mitigate integration costs vs. "rip and replace." Pressure vendors to bear part of the cost of integration and simplify integration in future revisions of their offerings. Look for those vendors who, at minimum, have a clear roadmap to an integrated offering.

Finally, keep in mind that while senior executive project champions open doors to funding new systems projects, cross-functional teams with business users help you walk through them. End users will define the ultimate success or failure of your merchandising system implementation.

FOLLOW THE LEADERS: EMULATE RETAIL WINNERS

For retailers interested in improving their performance, look to see what the winners are doing.

Specifically:

- **Place high importance on understanding changing customer preferences.** Retail winners value knowledge of frequently changing customer preferences far more than their peers. Winning retailers proactively look to meet and beat consumer expectations, and strive to anticipate customer preferences in their merchandising practices. Of course, this will entail more sophisticated merchandising systems with advanced functionality, as well as a willingness of the organization to balance art and science within merchandising. If this isn't on the radar screen, it may be time to re-examine which approach the merchandising organization is taking – product-centric or customer-centric.

- **Stop rolling your own**: While it is easier, on the surface, to get an in-house developed project onto the docket than it is to get a capital request through the steering committee, over the long haul, this is incredibly counter-productive. There are numerous retailers with long-since customized versions of packaged software bought in the early to mid 1990's. These retailers are stuck in time: they have all the business intelligence the market had to offer a decade ago in their applications, surrounded by codification of their organizational idiosyncrasies. Business logic has improved and the state of the application union is far better than it was before - but the retailer is stuck.

- **Create a step-wise plan for modernization**: While we know rip and replace is, to some extent, a thing of the past, a plan must be put in place to reduce dependency on out-dated infrastructures. Even though each application must justify its place with direct return on investment, attempt to define your integration strategy early, and then put pieces in place step-by-step, in accordance with the plan.

The subject of merchandising has been discussed for years, but the tenor of the subject has changed. While supply chain execution remains important, the supply chain exists for the purpose of satisfying the customer, not just reducing costs. In the age of geographically disbursed retail enterprises, customer-centric merchandising can only be accomplished with the assistance of technology to create localized assortments, space, and product plans.

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