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Business Model Adaptation in Retail

A Growing Need

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Change in retail markets comes slowly and almost silently, so it is not always easy to gauge its impact. For example, on the demand side, the mass movement of women into the workforce has been responsible for a drop in store visits of as much as 35 percent in some countries and—with many of these women now shopping weekly instead of daily—a parallel 20 percent increase in the average ticket amount. But because this shift has taken place over a 25-year period, it has gone mostly unnoticed. On the supply side, regulatory barriers, real estate constraints, and economies of scale in purchasing and warehousing have given incumbents a strong advantage but also a false sense of security. As a result, companies have missed opportunities to make the progressive adjustments necessary to retain customers in an evolving market.

Yet a small group of retailers have managed to steadily and forcefully improve their performance over time, gaining market share from competitors and delivering above-average financial results, despite constantly shifting economic conditions, regulations, and consumer demographics. In the past five years, retailers like Esselunga in Italy and Mercadona in Spain have consistently created two to four times more value for their shareholders than their competitors while continuing to gain market share—even in a recessionary environment.

What these champions have in common is an ability to adapt purposefully and continuously to change in their markets and competitive environments. Their fine-tuned radar can pick up early signs of shopping-pattern shifts, while their competitors continue to see the same market, day in and day out. As a result, they are always first to market with innovative value propositions. Their outstanding success has resulted in a widening gap between them and their competitors.

In this paper, we discuss how other retailers can emulate these winners in adapting their business models to today's complex and dynamic environment, and so renew their competitive advantage and reignite growth.

Why Adaptability Is More Important Than Ever

Despite a market that has undergone considerable change over the past couple of decades, many retailers still give low priority to a regular reexamination of their customer-value propositions and underlying operating models. Lulled by scale economies that confer cost advantages, by regulatory barriers, and by seemingly closed real-estate markets that can dampen competition, they have become complacent in the face of almost imperceptible but still significant shifts in shopper expectations and needs.

These companies are not only missing out on opportunities to develop new and more relevant formats, they are also in danger of losing the economic advantages that have enabled them to offer consumers superior value. Before they realize it, they could find themselves unable to maintain the level of price investment needed to differentiate themselves. Meanwhile, more adaptive competitors continue to enter the market with new concepts that are more responsive to consumers' changing lives.

The ability to perceive the drivers of change in the industry early is particularly important for large retailers competing against smaller, more nimble counterparts. Their infrastructures and processes may have responded like well-oiled machines to the market of the past, but that market has evolved, and these retailers lack the flexibility and maneuverability to evolve with it. Like an ocean liner sailing through iceberg-clogged waters, they need technology to track the obstacles in their way and expert helmsmen to steer a safe course.

Consider how Esselunga became one of the best-performing retailers in Italy. The company started out in Milan in 1957 and has been able to alter its business model year after year, thanks to its ability to perceive changes in its market early on and respond to them quickly. For instance, Esselunga was one of the first retailers to understand the time constraints that a growing segment of working women were beginning to experience. In the ensuing years, it responded directly to these women's needs. To facilitate product selection, the retailer offers 70 percent fewer SKUs than its competitors do. Its stores also have wider aisles that are easier to navigate and more check-out clerks to reduce the time spent in queues.

As a result of these innovations, Esselunga's customers spend up to 40 percent less time shopping than they would at competing retailers. In addition, its rigorous attention to the location of new stores—mostly on high-traffic outbound routes—cuts down on shoppers' driving time. Altogether, these improvements give the company a differentiated offering for growing numbers of time-starved Italians. And this is just one of many reasons why Esselunga has grown at twice the rate of its main competitors over the past decade, while earning profits that are 50 percent higher than those of similar retailers.

To succeed like Esselunga, retailers must know which elements in their value proposition and operating model to monitor and how often. And they must be able to reconfigure those elements in response to changes in the market. (See the sidebar "Elements of a Retail Business Model.")

When Major Change Is Called For

Retailers like Esselunga usually have to make only small adjustments to their business model and operations because they are constantly monitoring the environment and adapting as they go along. But lagging retailers that fail to notice the changes going on around them are often forced to reinvent significant parts of their businesses in order to catch up. This can also happen when the pace of change accelerates as a consequence of economic instability or rapid demographic shifts. In these situations, the need for business model transformation is made all the more urgent by the unexpected challenges and opportunities that rapidly arise.

Consider Whole Foods, a U.S. retailer that built a preeminent position in the early 1990s as a purveyor of fresh produce and organic products. After years of nonstop growth, it experienced its first drop in sales and a significant erosion in profitability in 2008 and 2009, when the economy changed abruptly. Suddenly, consumers were actively seeking lower prices, shopping closer to home, and eliminating discretionary expenses. Whole Foods' business, built on selling premium products to U.S. consumers who had become accustomed to continually rising disposable incomes, was suddenly vulnerable. Management was caught off-guard and had to adapt its business model quickly or risk losing its position in the market. So the company initiated a program called Whole Deals, which used coupons and low-cost recipes to educate customers about how Whole Foods could help them stick to a tighter budget in tough times. It boosted the promotion of its private-label 365 brand and offered more discounts on products bought in bulk. Rather than just lower prices, Whole Foods took the bolder approach of redefining the value it offered its customers.

Business model transformation may also be needed when a company creates a new format or enters a new market, particularly if the market is already saturated. In these cases, when established retailers enjoy first-mover and scale advantages, the new entrant must develop a clearly differentiated offering. Frequently, such an offering can result from taking apart an incumbent's business model and putting it back together with superior innovations.

That was the source of the spectacular development of Trader Joe's after the family that owns Germany's Aldi discount chain decided to enter the U.S. market. Rather than just copy what other retailers were doing, the German company decided to create a "unique grocery store" out of the fledgling Trader Joe's. Today the store has only 10 to 15 percent of the SKUs of other stores of similar size. It carries many items that cannot be found elsewhere, but it does not sell cigarettes, Coca-Cola, or anything widely advertised or available everywhere else. Eighty-five percent of the products on sale at Trader Joe's bear the company's own label—that's three to four times the proportion of private-label products offered at most U.S. grocers. Its stores are one-third the size of its competitors', and its off-beat, no-frills shopping environment is truly unique within the U.S. market.

The Elements of a Retail Business Model

Some retailers assume that a little tinkering with the value proposition is all it takes to adapt to changes in the marketplace. Although it is almost always necessary to keep the value proposition aligned with shifts in the market, the most successful retailers make significant improvements in their operating model as well, because the value proposition and operating model together are responsible for the entire business model's success. (See the exhibit below.)

The value proposition is the differentiating offer the company makes to its customers. It includes the following elements:

- The product or service, including the depth and breadth of assortment, private-label options, and product quality
- The customer's shopping experience, including the physical layout of the store and the arrangement of merchandise
- The pricing and revenue model, including the pricing strategy (such as high-low or everyday low prices) and value-added services, such as free delivery

The operating model supports the value proposition by enabling the retailer to fulfill its pledge to its customers. It includes the cost model (sourcing and store operations), the value chain structure (degree of integration with suppliers and logistics, for example), and the organizational processes.

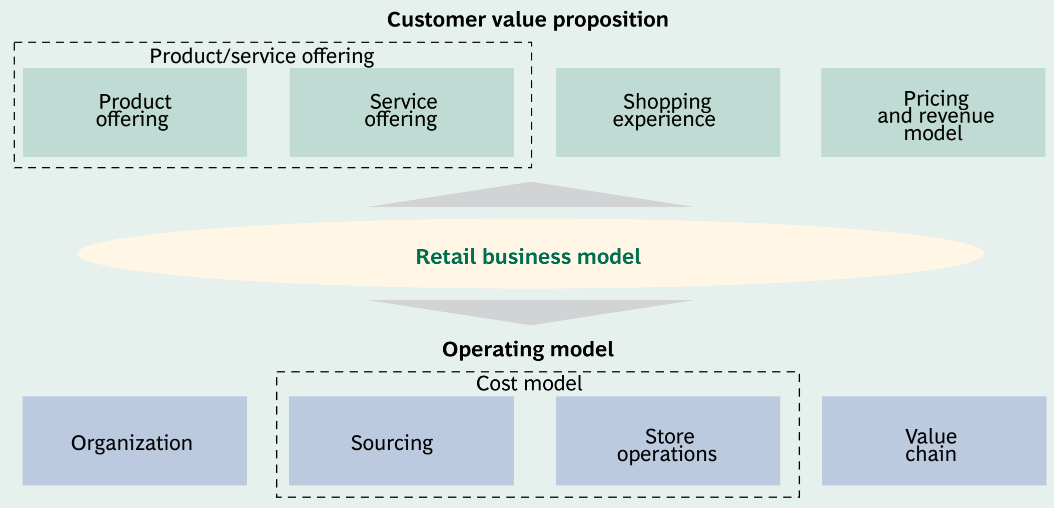
Most managers' time and resources tend to be focused on changes to only one or two elements of the business model. Few companies think about changing it entirely.

We recommend that a retailer begin optimizing its business model by using deep "customer discovery" techniques to identify what its target customers like and dislike in the product and shopping experience, as well as their shopping patterns. It can then develop a value proposition that serves those target customers and an operating model that enables the company to effectively deliver it.

A business model developed in this way evolves with changes in the environment, and the value proposition continues to be aligned with the needs of consumers. The retailer should also leverage opportunities that the operating model provides to create differentiating features in its value proposition.

Consider Grand Frais, a growing French retailer specializing in ultrafresh fruits, vegetables, fish, cheese, and meat. It leveraged the abilities and know-how of its owners—most of which are wholesalers specializing in specific categories, such as fish (Zeus Faber) and fruits and vegetables (Prosol Gestion)—to create a competitive offering in each category combining optimized product assortment and very attractive prices. The result was a new business model that has succeeded in capturing a growing share of the highly competitive French market.

Retail Business Models Integrate Two Distinct yet Intertwined Dimensions



Source: BCG analysis.

Trader Joe's was quick to understand the growing importance of a segment of consumers interested in inexpensive and convenient access to healthy and specialty products. Sometimes referred to as "low-income Ph.D.s," Trader Joe's customers can find products from Europe and elsewhere at prices that accommodate tight budgets. Supported by an extremely efficient operating model, Trader Joe's has experienced double-digit growth for the past 15 years, and its sales productivity is among the best in the industry for a retailer of its size.

Given the energy and resources required to initiate and manage a major change process and the uncertainty of success, retailers understandably want to know whether such an effort is absolutely necessary or whether a few minor adjustments might suffice instead. To find out, they must have a thorough understanding of how shifts in the competitive environment and market are affecting the business.

Over many years of working with retail clients, we have perfected a standard health-check tool that enables us to rapidly evaluate the need for major change and identifies the levers to be employed. (See the sidebar "A Business Model Health Check.") In general, a major transformation is necessary in the following situations:

- When both the value proposition and the operating model put the company at a disadvantage with key competitors
- When the gap in performance between the company and key competitors is growing rapidly

The first step in assessing the need for change is to identify key competitors in the market and evaluate the performance gap. The analysis should include both financial and operational metrics, such as sales

A Business Model Health Check

The first question retail managers ask when they notice signs of trouble in their business is whether the problem will require a Band-Aid or major surgery. If they diagnose the trouble as minor, they can fix it quickly and maintain their competitive position. If they conclude that the problem is serious, they could be embarking on a very expensive course of treatment that puts the health of the organization at greater risk. Therefore it is critical to correctly assess the urgency of the need for change as well as the elements of the business model that require attention.

The Boston Consulting Group's business model health-check tool consists of several high-level analyses that use publicly available data to benchmark key elements of a retailer's business model against those of its major competitors.

The first step is to identify the competitors that are drawing customers away. This requires detailed and up-to-date market-share data. The next step is to compare the retailer's basic operating data with comparable data from competing companies. This comparison should address the following:

- The attractiveness of different value propositions with target customers, as measured by same-store sales, household penetration, market share evolution, and price points
- The efficiency of different operating models, as measured by sourcing scale, gross margin adjusted by price positioning, store operating expenses, and corporate overhead costs

Potential threats that could arise from such environmental factors as sociodemographic trends, an economic crisis, regulatory changes, or disruptive new technologies should also be examined. Finally, it is important to assess the urgency of the need for change and the company's willingness and ability to change, which can be a function of financial restrictions, regulatory constraints, stakeholder pressure, and the owners' vision.

The results of this fact-based diagnosis will indicate whether the company can fine-tune specific aspects of the value proposition or operating model, or whether it needs to make major renovations to the business model. It might also suggest the need for retrenchment, particularly when change is necessary but the ability or willingness to undertake a major transformation is lacking. Even a retailer as large and successful as Walmart finally decided to exit the German market when it realized it was not capable of making the changes to its business model that would have been necessary to succeed there.

growth, profit margins, market share gain, relative sales density, and like-for-like growth.

The next step is to assess the difference in relative competitive advantage between the company and these winning competitors, the speed at which the performance gap is growing, the sources of the gap, and the structural sustainability of the company's current business model. These variables will determine how the retailer should respond to its competitors' market position. The assessment might require analysis of the following:

- Changes in demographics, such as population growth, average age, household size, proportion of women in the workforce, urban and suburban population percentages, and penetration of ethnic minorities or immigrant groups
- Changes in the regulatory framework, such as modifications to regulations governing new-store openings, laws on pricing, and health standards
- Real-estate space constraints, such as limits on footprint expansion in a given area
- Disruptive new technologies (past examples include radio-frequency identification systems, self-checkout systems, electronic data interchange, and customer relationship management)

It is also important to perform a qualitative review of potential threats and opportunities. When assessing their own business models, truly innovative retailers look not just at their direct competitors but also at winning retailers in other regions or categories in order to identify best practices that could be adapted.

For instance, a few years ago we worked with a very successful U.S. apparel retailer that sent a manager to Europe and Asia every year to spend a few weeks looking for nascent trends across a variety of categories that might give the company an innovative edge back home. One result was the introduction of a new lingerie line that enabled the retailer to increase volume sales by 60 percent; another was the company's expansion from apparel into cosmetics, which created a stream of new revenues.

Once a company understands the capabilities of its current business model, it is better positioned to brainstorm fresh opportunities. Ikea offers a good example of leveraging existing assets to experiment with new business models. Its stores are popular in many parts of the world and the company has achieved enormous success over the years. When it came to light that the value of nearby real estate increased dramatically whenever Ikea opened a store in Russia, the retailer decided to explore a new business model to complement its existing one: capturing the appreciation in real estate values resulting from its presence in malls. Ikea now earns higher profits in Russia from its new division, Mega Mall, developing and running malls, than from its original standalone retail business. In fact, the concept has been so successful that Ikea has begun exporting this business model to more mature markets.

How to Approach Major Change

When it becomes clear that major change is unavoidable if a retailer wants to remain competitive, the next question is how to approach the process. A common mistake at this stage is to underestimate the amount of change needed and the roadblocks that may be encountered.

That was the fate of Caprabo, once a true innovator in Spanish retailing. Caprabo opened one of Spain's first supermarkets in Barcelona in 1959 and went on to build a powerful network of medium-size stores in city centers across most of Catalonia. The company was very successful throughout the 1980s and '90s, and in the late 1990s and early 2000s it began to acquire retailers in other regions of Spain. But Caprabo's business model slowly grew obsolete as Spanish trade consolidated and consumers' shopping behavior changed.

In contrast, Mercadona, a regional supermarket chain founded in Valencia, understood early how the market was changing and progressively introduced a value proposition that was more aligned with consumers' needs. At 1,400 square meters, Mercadona's stores were nearly twice the size of the average

Spanish supermarket and most had free parking for customers. Mercadona also introduced "everyday low prices" and actively leveraged its own brands (Hacendado, Bosque Verde, and Deliplus) to build a significantly lower price perception. Finally, its streamlined assortment (only 8,000 SKUs compared with more than 20,000 SKUs for supermarkets of a similar size) and superb in-store service provided an easier shopping experience than the cluttered stores of other chains. Consequently, Mercadona achieved one of the highest store-productivity levels in the Spanish market. It sustained like-for-like sales growth of 7 percent for more than a decade, whereas that of many competitors remained mostly flat during the same period.

Today, Caprabo no longer exists as an independent banner, but it didn't go quickly. Over the eight years prior to its sale, the company's management launched several programs that in theory should have raised its competitive standing: one year it introduced a project to improve sourcing conditions; another year it redesigned its loyalty program. Later on, it developed a two-tier private-label strategy (which was subsequently reversed), implemented a sophisticated enterprise-resource planning (ERP) system, and hired a design agency to create a new shopping experience at its stores. Caprabo's demise did not stem from lack of action. Rather, the company failed to recognize that a string of improvements wouldn't suffice without an overall vision for the business and a plan to implement it.

U.S. retailer Circuit City found itself in a similar situation in the late 1990s. Its stores were too small to accommodate the increasing assortment that consumers were demanding, and its operating model could not compete with that of its competitors. In the ensuing years, the company tried several small-scale solutions, including eliminating white-goods appliances, closing down or renovating unprofitable stores, and changing the compensation system for its salespeople. Most of these efforts were called for, but they were insufficient to address the fundamental issues Circuit City faced, and the company filed for bankruptcy in 2008. As with Caprabo, management's attempt to fix these problems was a case of too little too late.

The two most fundamental issues that retailers confront when approaching a major transformation are how to drive business model change and how to sequence the components of the change program. Although the solution will depend on a company's individual circumstances, we have identified seven general rules that adaptive retailers should follow:

- *Put consumers at the center of all decisions.* Identify the compromises that your current business model is forcing on customers. Why are nonusers and defectors dissatisfied, and how does your value proposition compare with your competitors' offering? Finding the answers to these questions might require extensive market research, in-depth interviews and home visits, customer shop-alongs, and quantitative surveys to create a comprehensive and unbiased picture of your current business. When designing store signage and labels, for example, retailers should consider the needs of different customer segments—customers who are shorter or taller than average, or those who need reading glasses or are colorblind. It is the responsibility of everyone in the company, not just the customer research department, to consider such issues.

- *Pay attention to competitors.* Benchmark your competitors' key performance indicators and thoroughly explore the intricacies of their business models. Complement this analysis with reviews of the best practices of other companies (we call this *industry patterning*), even when they aren't direct competitors. One of our clients, a retailer of beauty products, got the idea of redesigning its supply-chain infrastructure from a flower distributor—another business that handled small and fragile items.

- *Watch out for underlying trends.* Demographic, economic, technological, and sociocultural megatrends could represent either a threat to your existing business model or an opportunity to build a differentiating advantage. The fact that a trend is not in the news every day does not mean it has lost momentum. Timing is very important: moving too early could cause a retailer to miss out on the highest returns, whereas moving too late could cause it to miss the opportunity completely.

- *Maintain a holistic approach to change.* Your new business model should be cohesive and aligned with all the levers your organization can employ. Successful models provide an integrated experience for customers, with an operating model that supports the value proposition.

- *Ensure differentiation.* To succeed, the new business model must be sufficiently differentiated from that of incumbent retailers. Be critical when assessing whether the new concept is really new or just a variation on an existing model.

- *Embrace iterative design.* Even the best design will have flaws and room for improvement. Retailers should leverage a network of outlets to test the new model extensively. Zara, for example, has built a model shopping mall in the basement of its headquarters in Arteixo, Spain, where it tests new concepts in a realistic setting. It also tests business model innovations in selected stores before approving and rolling them out. Although many retailers perform testing and pilot projects, their efforts often fall short in assimilating what they learn, modifying the concept, and testing it again.

- *Pay attention to implementation.* Many companies underestimate the importance of implementation and fail to mobilize their management teams and store personnel. Geographic complexity (for example, multiple stores dispersed over a large territory) and the large number of people involved in the change process can become major hurdles. Careful attention to progress is essential when moving from design to execution. Whereas many retailers pay attention to process management, few spend enough time tailoring the rollout program to maximize adoption by field employees and customers. Other retailers fall short in designing the scorecard for success—relying on metrics of their own creation rather than measuring actual performance and returns. As a result, they tend to spend more capital and derive less benefit than planned.

Getting the sequence of actions right can be as important as the actions themselves. We often observe that retailers start tweaking the value proposition before making any improvements in the operating model. Whether it is a revamped format or a competitive pricing strategy, a change in the value proposition usually requires short-term funding. It is not uncommon for retailers to find they have to halt or slow down the rollout of their improved value proposition owing to a lack of funds to finance it. But proper sequencing can ensure that sufficient improvements in the operating model are introduced early enough to help fund the changes in the value proposition. Such improvements might include better sourcing, streamlined logistics, or leaner store operations.

The recent economic downturn and uneven recovery have intensified the need to respond to change much faster and more dramatically than ever before. To adapt a business model to evolving market conditions, a company must be able to measure and understand subtle shifts in competitor movements and consumer behavior and respond accordingly. Retailers that have created an advantage out of their ability to adapt their business models are winning today, and they will continue winning tomorrow.

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