Joachim Zentes | Dirk Morschett |
Hanna Schramm-Klein

Strategic Retail Management

Text and International Cases

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Preface

Retailing is becoming consistently more important in economic terms. This becomes evident when looking at the development of many individual countries, in Europe, America and Asia. In highly developed countries, retailing is assuming more and more of a leadership role in the distribution channel. The expansion strategies, retail branding strategies, innovative solutions for supply chain management etc., all reflect this trend. In transformation countries, such as in Central and Eastern Europe, as well as in emerging countries, such as China and India, fundamental changes in retailing structures become apparent and may lead to comparable developments. In view of internationalisation, a further profound change can be noticed. Retailing companies that were formerly characterised by a local or national orientation are increasingly developing into global players with worldwide operations.

Book Concept and Overview

The present book is devoted to the dynamic development of retailing. The various strategy concepts adopted by retailing companies and their implementation in practice are at the core of the book. This is not a traditional textbook or collection of case studies, but is intended to demonstrate the complex and manifold questions of retail management in the form of 15 lessons that provide a thematic overview of key issues and to illustrate them with the help of comprehensive case studies. Internationally known retail companies are used as examples to facilitate an understanding of what is involved in strategic retail management and to present some best practices.

The book is divided into four main parts. Part I introduces "Formats and Players in Retailing" and comprises Chapters 1 to 3. In Part II, growth, internationalisation and positioning strategies, as fundamental aspects of "Strategic Marketing in Retailing" are dealt with (Chapter 4 to Chapter 6). Part III focuses on the "Marketing Mix in Retailing". Store location, merchandise and category management, pricing, instore marketing and customer relationship management are discussed in Chapters 7 to 11. The final Part IV "Buying, Logistics and Performance Measurement" deals with retail purchasing strategies and concepts, modern concepts of physical distribution and IT-based supply chain management, as well as methods of performance and financial controlling (Chapters 12 to 15).

Teaching and Learning

The book is targeted primarily at students in their third and fourth academic year (undergraduate and graduate level) in the field of Business Administration/Marketing/Management at different institutions, such as universities, academies and business schools. In addition, practitioners in the consumer goods industry and in retailing companies, who wish to obtain compact and practice-oriented information on current retail concepts, will also benefit from reading this book.

Furthermore, the book can be used in education as a basis for working with case studies. For this purpose, the case studies are integrated into the lessons in such a way that they provide additional content and a specific application of the individual lessons. That is, they form part of the main topic, but also lead to suggested discussion subjects and questions in order to deepen the understanding of the topic. Instructors are provided with additional resources. For each case study, a suggested solution can be requested from the H.I.MA. (Institute for Commerce & International Marketing, Saarland University, Germany, e-mail: hima@mx.uni-saarland.de).

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At the H.I.MA., where the three authors teach and research retail management, we would particularly like to thank Juliane Krebs for preparing a number of case studies in cooperation with the retail companies, as well as for the layout design and final editing. Case studies were also prepared by Markus Lehnert, Sandra Pocsay and Lambert Scheer.

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Saarbrücken, January 2007

JOACHIM ZENTES DIRK MORSCHETT HANNA SCHRAMM-KLEIN

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Introduction

Evolution of Retail Management

Retailing is one of the world's largest industries. It is in a permanent state of change, and the pace of this change has been accelerating over the last decade. From the marketing perspective, retailers are, by definition, closer to the consumer than manufacturing companies (Reynolds 2004b, p. 3). Retailers represent the culmination of the marketing process and the contact point between consumers and manufactured products. While retailing has long set buying decisions as its highest priority and was very focussed on the product assortment, it now follows a more holistic approach to management and marketing and is seizing the opportunity to be consumer-oriented, engage in the personal contact with customers, gather information on consumer behaviour and exploit insights into consumer behaviour and preferences. What was once a simple way of doing business is transforming into a highly sophisticated form of management and marketing. Retail marketing consistently features more efficient, more meaningful and more profitable marketing practices (Mulhern 1997, p. 103).

Definition of Retailing

Retailing involves those companies that are engaged primarily in the activity of purchasing products from other organisations with the intent to resell those goods to the final customer, generally without transformation, and rendering services incidental to the sale of merchandise. The retailing process is the final step in the distribution of merchandise; retailers are therefore organised to sell merchandise in small quantities to the general public. The services added to the products commonly include transportation and stock-keeping to ensure that the products are available at the point-of-sale. However, the process also encompasses the selection of products for a retail assortment, the provision of sales advice, after-sales-service and many other functions.

Emergence of Large-Scale Retail Chains

A number of developments are responsible for the dynamic change in modern retail management. In most developed countries, retailing has experienced a dramatic increase in the scale of operations and in market concentration. This is due partly to the appearance of *large-scale retail chains* that have taken over market share from independently owned small shops. These retail chains first developed into regional groups and then into nationally and even internationally active retail operations. In the last decade, mergers and acquisitions between already large players have intensified this development. Many retailers now have massive turnover, very large numbers of employees and extensive store networks. The world's largest retailer, *Wal-*

Mart, achieves a turnover of 312 billion USD which exceeds the gross domestic product of many smaller countries and employs 1.8 million people. *Carrefour*, the largest European retailer and the no. 2 in the world, operates more than 12,000 stores worldwide.

International Multi-Channel Retailers

At the same time, many retailers have developed into international multi-channel retailers, that is, they operate in many countries and offer different retail formats for their customers. For example, the French *Carrefour* is now a multi-format group that uses hypermarkets, supermarkets, convenience stores, hard discounters and other formats to sell its assortment to customers in over 30 countries. More than half of its turnover is earned outside the home market. The German *Metro Group* employs food superstores (*Real*), food supermarkets (*extra*), consumer electronics category killers (*Media Markt and Saturn*), cash & carry wholesale stores (*Metro C&C*), and other formats and earns more than 50 % of its turnover in 29 markets outside Germany. *Tesco* is expanding rapidly into Eastern European and Asian markets and, in addition to several store-based formats, very successfully operates an e-commerce channel, *Tesco.com*. While the rise of e-commerce in retailing was initially over-estimated in the days of Internet hype, it has nonetheless developed slowly but surely and *Tesco* now achieves sales of over 1 billion EUR with its online-channel.

High Levels of Concentration

In most country markets, retailing is also a very concentrated industry. According to the market research company *Planet Retail*, the top 5 food retailers account for more than 55 % of the market in the UK In Germany and in France, it is even above 70 %. Consequently, a *shift in power* within the distribution channel is one of the most influential developments over the last decades. The power of individual retail organisations is growing; they are now comparable to and, in many cases, even larger than many manufacturers, even for global brand manufacturers such as *Procter & Gamble*, *Sony* or *Nestlé*. Thus, manufacturers now depend on a few large retailers for a substantial share of their turnover. Hand in hand with the increasing size, retail marketing budgets, IT budgets, and budgets for top managers, have been increasing. Not only the growing size and concentration, but also the increased sophistication of retail management, combined with the better availability of customer data, contributed to the power shift. Retailing is currently one of the leading industries in the application of new technologies. Retailer *PoS data* has became more valuable as IT systems have facilitated the collection of data at the checkout. Furthermore, as retailers have grown from regional to national chains, they have been able to accumulate knowledge about consumer trends, the development of product sales, etc., that has enhanced their relevance as gatekeepers for products on their route to the customer. Customer-specific data that is now increasingly being gathered via *loyalty cards*, adds to this knowledge. Where manufacturer brands once used

Power Shift towards Retailers

to be all important, the last few years have witnessed the power of *retail brands* challenging the position of suppliers (Gilbert 2003, p. 1). Retailers have started to embrace the concept of *strategic marketing*, they use strategic planning and position themselves relative to their competitors. Thus, the enormous buying volume of retailers is only one source of its power base, certainly the most important, but other developments add to their power.

Marketing and Logistics Leadership

Retailers are *intermediaries* in the distribution channel. However, while retailing has long been considered a somewhat passive link in the value chain between manufacturer and consumer, retailers now use their position to become the *dominant player in the distribution channel*. They develop their own marketing concepts and assume *marketing leadership* in the vertical relationship with manufacturers. Retailers have also developed their own logistics concepts. Accordingly, while it was the manufacturers who traditionally fulfilled large parts of the logistics function, retailers today also strive towards *logistics leadership* in the distribution channel.

With this book, our objective is to cover the most important aspects of retail management with a comprehensive, yet brief, and innovative approach. We discuss 15 different topics in retail management by first giving a thematic overview of the topic which covers the key issues and explains the most important concepts and then illustrating them with the help of extended case studies. For the case studies, internationally known companies were chosen that can be considered best practice cases in the respective strategy fields.

Formats and Players in Retailing

In Part I, formats and players in retailing are discussed. A *retail format* represents a specific configuration of the retail marketing mix (e.g. store size, typical location, merchandise, price and service offered) and it often forms the core of the retail strategy. Different formats are described and there is a discussion of those that are currently gaining market share and those formats that are on the decline. For example, category killers such as *IKEA, Media Markt* and *Leroy Merlin* have been growing tremendously over the last few decades. Hard discounters, such as *Aldi*, are certainly one of the most aggressively growing retail formats in food retailing worldwide, and e-commerce is growing constantly from a still rather small base. Some pure Internet players, such as *Amazon* and *Dell*, have reached a very considerable scale, but Internet shopping is offered more and more often as part of a multichannel approach (Chapters 1 and 2). At the same time, not only new formats, but also new players are competing with existing retailers. The most important trend explained in this book is the emergence of manufacturers as competitors. To an increasing extent, manufacturers operate in vertical marketing systems, trying to control the distribution of their products to the consumer, either through contractual or even by means of equity-based vertical strategies (Chapter 3).

Strategic Marketing in Retailing

In Part II, the most important aspects of strategic retail marketing are discussed. Very dynamic growth is one of the most important developments in retailing over the past decades, and forms the foundation for many other subsequent changes. This growth is being achieved through various different *growth strategies*, such as outlet multiplication, acquisitions, and franchising (Chapter 4). In addition, since many industrial countries are characterised by stagnating retail markets, this growth is more and more often achieved by entering foreign markets. The process of *internationalisation* poses a complex task, since the local environments in host countries often differ considerably from the home market (Chapter 5). Growth, whether nationally or internationally, can only be achieved with a sustainable competitive advantage and retailers are now increasingly trying to develop a clear *positioning* for their companies relative to that of their competitors. One important component of this marketing strategy is to create a strong *retail brand*, with clear and distinct associations in the consumers' mind which support the development of customer loyalty to the company (Chapter 6).

Marketing Mix in Retailing

Within the framework of strategic retail marketing, retailers have more options available in their *marketing mix* than manufacturers, because they are in direct contact with the final consumers, who visit their stores and interact directly with them. Part III of the book examines the marketing mix and takes an in-depth look at a number of retail marketing mix instruments. The *location of the store* is considered a dominant determinant of retailing success, because in store-based retailing, good locations are key elements for attracting customers to the outlets. Also, because of its intrinsically fixed nature, location cannot be changed in the short-term (Chapter 7). Within the store, the retailer offers a *merchandise* assortment to its customers and one of the primary functions of the retailer is to select the appropriate breadth and depth of the assortment and the specific products, e.g. manufacturer brands or store brands, and to tailor the offer to the target customers. A new concept is *category management* that aims at implementing a more strategic and holistic approach to merchandising (Chapter 8). Closely related to the assortment itself is the *pricing policy*. Since consumers spend a large share of their income in retailing, pricing is considered highly relevant for retail patronage decisions and, within pricing processes, retailers have many strategic and tactical options available to influence purchasing behaviour (Chapter 9). As already mentioned, the customer is also influenced by the store environment. Many buying decisions are made at the point-of-sale, so that professional *instore marketing* can increase sales very substantially. Store layout and store design can support the customer orientation in the store and create a positive store atmosphere (Chapter 10). *Customer relationship management* (CRM) is a relatively new element in the retail marketing mix. A key objective of CRM is to establish enduring relationships with customers and loyalty programmes are manifestations of CRM in retailing. However, behind

the loyalty cards that most consumers now carry, are very different methods and concepts with which the retailers intend to collect data and to tailor their marketing to the individual customer (Chapter 11).

Buying, Logistics and Performance Measurement

While Parts I through III focus on aspects of retailing that are at least partly visible to the customer, Part IV deals with back-end and internal processes that are necessary to create the offer to the consumer. Retailers need to buy the merchandise they offer to their customers, and they use various, very heterogeneous supply sources, ranging from global manufacturers of branded goods to external buying organisations in foreign markets and store brand manufacturers. Relationships with suppliers and new concepts such as *efficient consumer response* have emerged, but the *buying concepts* employed must be closely adapted to the specific supply situation (Chapter 12). The products must be transported along the supply chain – from the factory to the store shelf. More and more frequently, *physical logistics* is considered a core competency of retailers who need to establish the necessary infrastructure and coordinate the *product flows* (Chapter 13). Those product flows within the *supply chain* are dependent on *information flows*. It is necessary to establish when a product is sold in a certain store, so as to trigger an order to a warehouse, and subsequently to a supplier. The exact process depends on information on the available products in stock at the various stages in the supply chain, forecasted consumer demand, etc. To enhance the efficiency of the supply chain, different *collaborative concepts* for achieving efficient replenishment have been developed, and these are based on new enabling technologies (Chapter 14). Finally, the intensive competition in retailing, combined with the price pressure to which most retailers are exposed, make it necessary both to perform well and constantly improve the effectiveness and efficiency of all applied strategies and processes. Adequate controlling is thus necessary and retailers have developed sophisticated systems for evaluating the profitability of their store network, supply chain efficiency and financial performance. New concepts, such as value-based management, have also been quickly embraced by retailers (Chapter 15).

This short overview of different fields of strategic management in retailing shows that the world of retailing has become very complex and challenging. In the following 15 chapters, we cover the most important aspects and give the reader an insight into the main developments and concepts. Based on the case studies, the reader will also gain an understanding of how the concepts are implemented by successful retail companies around the world.

Part I

Formats and Players in Retailing

Chapter 1

Retail Formats - Food

Retailers have various ways of meeting customer needs through organising and designing their retail outlets. The objective of this Chapter is to describe the different types of food-oriented retail institutions which represent different types of retailer strategies in selling their goods and services.

Types of Retail Institutions

From a managerial point of view, understanding the different types of *retail institutions* is important because they have a competitive impact on the retail business. There are several types of retail institutions which mirror retailer business operations. Thus, each type represents a specific retailing strategy.

NACE Codes - Examples

Figure 1.1

Section G : Wholesale and retail trade; repair of motor vehicles, motorcycles and personal and household goods

52 : Retail trade, except of motor vehicles and motorcycles; repair of personal and household goods

52.1 : Retail sale in non-specialized stores
52.11 : Retail sale in non-specialized stores with food, beverages or tobacco predominating
52.12 : Other retail sale in non-specialized stores
52.2 : Retail sale of food, beverages and tobacco in specialized stores
52.21 : Retail sale of fruit and vegetables
52.22 : Retail sale of meat and meat products
52.23 : Retail sale of fish, crustaceans and molluscs
52.24 : Retail sale of bread, cakes, flour confectionery and sugar confectionery
52.25 : Retail sale of alcoholic and other beverages
52.26 : Retail sale of tobacco products
52.27 : Other retail sale of food, beverages and tobacco in specialized stores
52.3 : Retail sale of pharmaceutical and medical goods, cosmetic and toilet articles
52.31 : Dispensing chemists
52.32 : Retail sale of medical and orthopaedic goods
52.33 : Retail sale of cosmetic and toilet articles
52.4 : Other retail sale of new goods in specialized stores
52.41 : Retail sale of textiles
52.42 : Retail sale of clothing
52.43 : Retail sale of footwear and leather goods
52.44 : Retail sale of furniture, lighting equipment and household articles n.e.c.
52.45 : Retail sale of electrical household appliances and radio and television goods
52.46 : Retail sale of hardware, paints and glass
52.47 : Retail sale of books, newspapers and stationery
52.48 : Other retail sale in specialized stores
52.5 : Retail sale of second-hand goods in stores
52.50 : Retail sale of second-hand goods in stores
52.6 : Retail sale not in stores
52.61 : Retail sale via mail order houses
52.62 : Retail sale via stalls and markets
52.63 : Other non-store retail sale
52.7 : Repair of personal and household goods

Source: European Union.

Classification Schemes

Several systems of retail classification have been developed by governmental institutions in order to collect and analyse business data more effectively. One of the first classification systems is the *Standard Industrial Classification* (SIC) code, a classification system that was developed for the *US Census*

Bureau in 1930 and uses special codes (special sets of numbers) to identify types of retailers (Ogden/Ogden 2005, pp. 88-89). It served as the basis for further development of classification systems that are also applied on an international basis such as the *International Standard Industrial Classification of all Economic Activities* (ISIC) of the United Nations, the NAICS (*North American Industrial Classification System*) or the NACE (*Nomenclature statistique des Activités économiques dans la Communauté Européenne*) of the European Union (see Figure 1.1).

However, these classification schemes are used for data collection and statistical analysis to provide insight into the development of the various retail institutions at a national or international level. For retail managers, on the other hand, the more strategic aspects of the different types of retail institutions are of primary importance. Therefore, for *strategy development* and competitive analysis, the classification of retail institutions in terms of the characteristics of the strategies that retailers employ in selling goods and services, is important. Such types of retail institutions are referred to as *retail formats*. A retail format represents a specific configuration of the retail marketing mix (e.g. nature of merchandise and service offered, pricing policy, advertising and promotion programme, approach to store design and visual merchandising, typical location, etc.) which is maintained consistently over time (Fox/Sethuraman 2006, p. 193).

Retail Formats

Theories of Retail Evolution

A number of theories explain the present structure of the retail industry and predict the future development of current and new retail formats. The *wheel of retailing* and the *retail life cycle* are two particularly important theories.

The Wheel of Retailing

Cyclical Theories

The *wheel of retailing* (McNair 1931) is a well-established framework for explaining developments in retail institutions. The theory suggests that retail institutions go through cycles (see Figure 1.2). The rationale is that, as low-end retailers upgrade their strategies to increase sales and profit margins, new forms of low-price (discount) retailers take their place in the market.

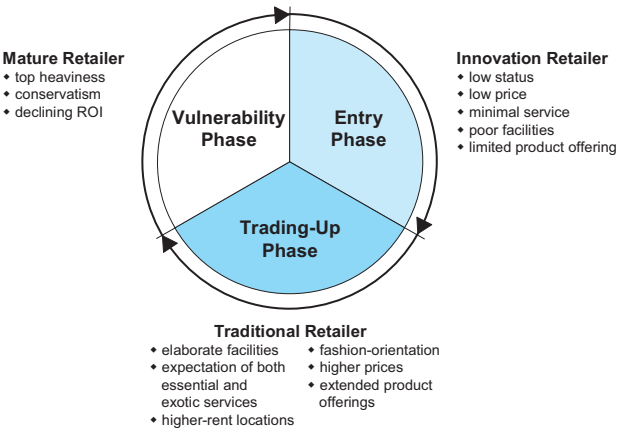
The *wheel of retailing* consists of three stages (McNair/May 1978; Berman/Evans 2007, pp. 129-131):

- According to the wheel theory, retail innovators often appear as low-price operators. Thus, the cycle begins with retail institutions starting off with *low prices* and *low service levels*.

- The second phase is called *"trading up"*. Retailers wishing to expand their business and attract more customers, enhance the quantity and quality of merchandise handled, provide more services, and open outlets in more convenient locations. This leads to an increase in operating costs and prices and thus offers opportunities for new competitors to enter the market with low-price strategies.
- The third phase is characterised by an *increase in competition* in services of all kinds and by a convergence in terms of the marketing mix of retailers as they mature. They become vulnerable to new competitors that enter the market with low prices.

The Wheel of Retailing

Figure 1.2



Source: Adapted from Brown 1988.

The Retail Life Cycle

The concept of the retail life cycle refers to the succession of identifiable stages a retail format goes through over time (Berman/Evans 2007, pp. 132-134; McGoldrick 2002, pp. 21-23):

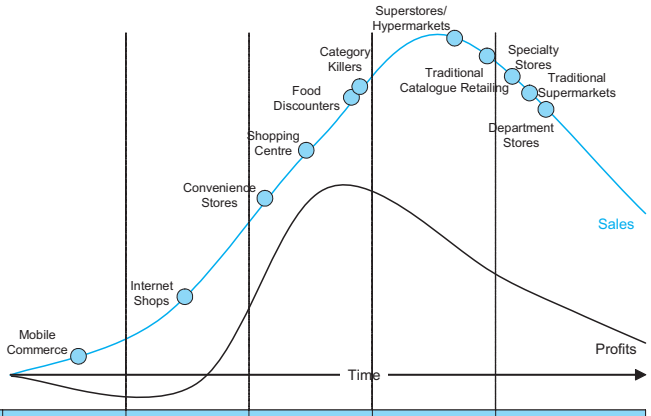
Stages in Format Development

- In the *development stage*, the new format is introduced to the market. There is departure from the strategy mix of existing retail institutions, as at least one element of the marketing mix is altered in the new format.
- In the *introduction phase*, sales and profits are low, but growing. Costs and risks are high because long-run success is not assured at this stage.

- The *growth phase* is characterised by rapid growth of both sales and profits. Existing companies expand their markets and new competitors with the same retail format enter the market. Towards the end of this stage, growth acceleration begins to decline and cost pressure may emerge.
- The next stage is characterised by *maturity* of the retail format which is brought on by market saturation, in turn caused by a high number of firms in this retail format and competition from new formats. Sales growth declines and profit margins may have to be reduced in order to stimulate purchases. Once maturity is reached, the main goal is to prevent the business from declining and to sustain profit as long as possible.
- In the final stage (*decline*), sales volume declines and prices and profitability diminish. Companies can try to avoid decline, for example, by *repositioning* the retail format, but many companies abandon the format altogether and start introducing new formats to keep their customers or attract new ones.

Figure 1.3 illustrates the characteristics of these five stages and indicates the stages in which present retail formats operate.

Figure 1.3 *The Retail Life Cycle*



	Development	Introduction	Growth	Maturity	Decline
Sales	low/growing		rapid acceleration	high, levelling off	dropping
Profitability	negative to break even		high yield	high/declining	low to break even
Positioning	concept innovation		special needs	broad market	niche
Competition	none		limited	extensive/ saturation	intensive/ consolidated

Source: Adapted from Berman/Evans 2007, p. 132; Zentes/Schramm-Klein/ Neidhart 2005, p. 34.

Store Erosion

In the context of the retail life cycle, the phenomenon of *store erosion* (Berger 1977) is important. It is defined as a diminution in the appeal and ability of a retailing company to attract customers over time, due to changes in the company's internal and external conditions. As a selection process in a *dynamic environment*, new retailing formats which meet new customer needs, render existing retail formats obsolete. In order to avoid decline and survive, retail companies must adapt to the changing conditions in the marketplace and *reposition* their retailing concept.

Formats in Food Retailing

Format (R)Evolution

Over the last few decades, food retailing has undergone substantial changes. *New non-food competitors* have entered the market by expanding their assortment and selling food. But traditional food retailers (in most cases) also carry merchandise outside their traditional lines, i.e. non-food items, and offer other kinds of services. These developments indicate that it is difficult to clearly allocate retail institutions precisely to either food or non-food formats. In this section of the book, conventional supermarkets, superstores, combination stores, hypermarkets and supercentres, convenience stores, food discounters, warehouse clubs and several non-store formats are presented. Table 1.1 provides an overview of the characteristics of the most important retail formats.

Conventional Supermarkets

Supermarket Strategy Mix

Conventional supermarkets are self-service stores that carry a wide range of *food items* (mainly groceries, meat and produce) and related items. The share of non-food items offered in this retail format is limited to between 10 % and 25 %. The format covers, for example, health and beauty aids and products (Berman/Evans 2007, p. 139; Ogden/Ogden 2005, p. 102).

Supermarkets are usually located in city or neighbourhood locations with sizes between approximately 400 m² to 800 m² and 1,000 m². Important players that utilise supermarkets in Europe are, for example, *Sainsbury's*, *Edeka*, *Rewe*, *Ahold's* supermarket "*ah*" or *Intermarché* as well as *Kroger* and *Albertson's* in the USA.

This retail format has been the main format for grocery shopping and accounted for the majority of sales in food retailing for several decades. Yet, it currently faces intense *competition* from new formats that offer, for example, more convenient shopping facilities, more product lines, and more variety in the assortment, or lower prices as a result of lower operating costs (Weitz/Whitfield 2006).

Companies like *Edeka*, for example, try to *reposition* their supermarkets and thus to improve their competitive position emphasising freshness and high quality in the assortment, introducing medium- to higher-level store brands and improving store atmosphere and thus providing a better *instore shopping experience*.

Table 1.1 *Selected Characteristics of Store-Based Retail Formats in Food Retailing*

	Conventional Supermarket	Superstore	Hypermarket	Convenience Store	Hard Discounter
Size (m²)	400-1,000	1,000-5,000	5,000-30,000	200-400	500-1,500
SKUs	20,000-30,000	30,000-40,000	40,000-150,000	1,000-3,000	700-1,500
Merchandise	extensive width and depth of assortment; average quality; manufacturer and store brands	full assortment of supermarket items, plus health and beauty aids and general merchandise	full selection of supermarket and drugstore items, and general merchandise; extensive width, and depth	medium width and low depth of assortment, average quality	medium width and low depth, heavy use of store brands (up to 90 %)
Percentage Food	75-90 %	60-80 %	60-70 %	90 %	80-90 %
Prices	average/ competitive	competitive	competitive	average to above average/high	very low
Atmosphere and Services	average/good	average	average	average	low
Location	city or neighbourhood	community shopping centre or isolated sites	community shopping centre or isolated sites	neighbourhood, city or highly frequented sites	neighbourhood, traffic-oriented
Promotion	use of newspapers, flyers, coupons	heavy use of newspapers, flyers, coupons	heavy use of newspapers, flyers, coupons	little to moderate	heavy use of newspapers and flyers

Source: Adapted from Berman/Evans 2007, p. 137; Levy/Weitz 2007, p. 40.

Superstores

Food-based *superstores* are larger and more diversified than conventional supermarkets. Their size varies between 1,000 m² or 1,500 m² and 5,000 m² with expanded service deli, bakery, seafood and non-food sections (Berman/Evans 2007, pp. 139-140). They are *"true" food stores* with a share of non-food items ranging from approximately 20 % to 40 %, but offer expanded *one-stop-shopping* possibilities to consumers.

Combination Stores

A similar store concept that tends to be larger than superstores (up to 9,500 m²) and offers a higher share of non-food items (from 25 % to 50 % of sales) is sometimes referred to as *combination stores*. They combine food and non-food items, thus offering a higher level of one-stop-shopping for consumers than superstores (Berman/Evans 2007, pp. 140-141).

This combination of food and non-food items in superstores and combination stores yields operating efficiencies and cost savings. The main reason for this is that non-food items tend to have higher margins. Superstores and combination stores usually follow either a *high-low pricing strategy* (HiLo), which means that they are very promotion-oriented (e.g. intensive advertising or distribution of flyers), or an *every-day-low-price strategy* (EDLP), using very few promotions and selling their merchandise permanently at the same – low – price (see Chapter 9). Superstores and combination stores can be located in city or neighbourhood locations, but also on isolated sites or in shopping centres oriented towards customers who drive to the store by car. Important players that operate superstores or combination stores are, for example, *Metro* with its *extra* format, *Intermarché, Rewe, Tesco* or *Albertson's*.

Large Retail Formats

"Big Box Retailing"

Over the past few decades, large retail formats have gained market share in grocery retailing. These larger-scale retail formats are also referred to as "big box retailers" (Levy/Weitz 2007, p. 43).

International Differences

Whereas the trend towards such *large retail formats* has developed more or less similarly in the international context, specific types of formats have nonetheless been developed in the various different countries. Of these, *hypermarkets*, which originated in France, are the largest. Their size ranges from 9,000 m² to 30,000 m² (e.g. *Carrefour* and *Auchan*). The German "*SB-Warenhäuser*" (e.g. *Metro's* format *real*, or *Kaufland*) tend to be smaller with sizes from 5,000 m². Whereas these European formats have a larger share of food items ranging from 60 % to 70 %, in the USA, the "*supercenters*" format (e.g. *Wal-Mart, Kmart, Target*) ranging from 14,000 m² to 21,000 m² carries a broader assortment of general merchandise. Thus, the share of non-food items is higher, ranging between 60 % and 70 % (Levy/Weitz 2007, pp. 43-44).

"Big Box" Strategy Mix

These large retail formats usually follow an aggressive, promotion-oriented *low-price strategy*. The stores are generally located at isolated sites or integrated in or close to shopping centres. The architecture is usually cost-oriented with a very simple store design and a *functional-oriented* store atmosphere. As these large retail formats offer a broad assortment of food and general merchandise and thus provide *one-stop-shopping* opportunities, customers usually shop bigger shopping baskets. These store formats have a greater market area than the smaller store formats (e.g. supermarkets), i.e. customers are willing to drive longer distances to visit these types of retail outlets. These stores therefore offer substantial parking facilities. Because of their low operating costs and the combination of food with higher margin non-food merchandise which allow for an often *aggressive pricing strategy*

and shopping convenience (e.g. in terms of the broad and deep assortment), during the past few decades, large retail formats have gained market share mainly at the expense of conventional supermarkets.

Convenience Stores

Convenience Shopping

Convenience stores ("c-stores") are usually situated in locations that are easy to access, such as in heavily-frequented areas or in urban neighbourhood locations. They open long hours (up to 24 hours, depending on local or national legislation). The stores are small and facilities are limited, with an average atmosphere and average service level. Convenience stores can be operated as stand-alone units (e.g. *Tesco Express*, *Seven-Eleven*, *Auchan, Coop Pronto*), but are often associated with petrol stations (e.g. *Shell Shop*s, *BP* or *Aral Stores, Esso Shops*).

The *very limited assortment* of these stores is food-oriented. A high proportion of sales consist of impulse purchases, with most in areas such as snack foods, soft drinks, beer and wine, tobacco products or newspapers and magazines. The average transaction in convenience stores is small and the prices are usually above average.

Ease of Shopping

Convenience stores focus on ease of shopping. They offer fast shopping, thus enabling customers to purchase *quickly*, picking merchandise in a *short time* without having to search through a large store or wait in long check-out lines. They also offer "mental convenience", as the assortment is limited, which enables customers to make their choice fast (Berry/Seiders/Grewal 2002).

Hard Discounters

Food hard discounters usually follow a very aggressive *every-day-low-price strategy* with prices up to 20 % to 30 % below those of conventional supermarkets. They offer a small selection of items and therefore are also referred to as *"limited-line stores"* or *"limited-assortment stores"* (e.g. Ogden/Ogden 2005, p. 106). The basic assortment consists of food items with a high rate of turnover and few sizes and brands are offered per product category. Prominent examples of internationally successful hard discounters are the German *Aldi* or *Lidl* chains (see case study *Aldi* in Chapter 5) and *Carrefour's Dia*.

"No-Frills"

The stores are characterised by a "no-frills" setting, which means that, for example, there are almost no services available (no helpdesk, no sales staff in attendance, etc.) and store design and atmosphere are *very simple* and *cost-oriented*. Often, products are sold out of boxes (*"box stores"*) or cut cases and are presented on pallets. Food hard discounters often carry only a limited

range of manufacturer brands and rely heavily on *low-price store brands*. Thus, prices are less comparable between different retailers.

Non-Food Promotions

Food-based hard discounters often complement their assortment by a weekly or semi-weekly changing selection of *non-food items* which are sold at very low prices and heavily promoted by newspaper advertising or the distribution of flyers to households. These items come from a variety of product categories (ranging from personal computers and furniture to home accessories) and often do not have any association with the regular merchandise carried by the retailer. Such items are offered in order to increase *store traffic*, and these non-food items that, in some cases, are produced exclusively for this purpose, usually have a *higher margin* than food items.

Hard discounters are usually located in easily accessible *traffic-oriented and cost-oriented locations* with a focus on low occupancy costs, e.g. neighbourhood locations or periphery sites with adequate parking facilities. Because of their aggressive pricing strategy, the convenience dimensions (e.g. "mental convenience" because of the limited assortment and quick shopping due to the small store size) and location strategy, hard discounters have grown consistently over the past decades. They often play an important role in *proximity retailing*.

Warehouse Clubs

Warehouse clubs are a food retail format which is specific to the USA and not prevalent worldwide. Warehouse clubs sell their products both to end users and to small to medium-sized companies. Business members typically represent less than 30 % of the customer base, but account for approximately 70 % of sales (Weitz/Whitfield 2006, p. 66). *Membership* is required and customers are charged an annual fee. The largest warehouse clubs in the USA are *Costco* and *SAM'S CLUB* (*Wal-Mart*).

Membership

This type of store is characterised by *low prices* for a *limited assortment* comprising half food and half general merchandise. The stores are very large (9,000 m² or larger) and are located in secondary sites, i.e. in low-rent districts. Store architecture and design are very simple and cost-oriented, characterised by a simple interior, concrete floors, and wide aisles (Ogden/Ogden 2005, p. 104).

Items are usually presented on pallets. In this type of store, fast moving, high-turnover merchandise is offered, thus, minimising holding costs. Warehouse clubs concentrate on special purchases from popular brands. Products are often sold that are available on special promotion from the manufacturers (e.g. overruns, returns, etc.) (Berman/Evans 2007, p. 141).

The concept of warehouse clubs resembles *cash & carry wholesalers* (e.g. *Metro*) that also require membership. Even though membership is restricted to companies and these outlets focus on business-to-business trade, end users also frequently purchase at these stores.

Non-Store Formats in Food Retailing

The dominant share of food retailing is generated by store formats. Nonetheless, there are several *non-store formats* at which groceries and related products can be purchased by consumers. For example, *remote ordering* channels, such as traditional catalogues or Internet shops can be used to distribute merchandise. While these formats are generally gaining importance, the share of groceries offered through mail-order channels remains rather limited (see Chapter 2).

Remote Ordering

Traditional Non-Store Formats

For fresh merchandise, e.g. farm produce, bakery products, meat or fish, the use of *market stands* or *truck and van sales* is a traditional mode of distribution that, for example, small producers use to reach their customers as a specific form of direct selling. Because of the close and personal contact with their customers, these vendors often have high retention rates among their customer base, but the costs associated with direct selling are very high and therefore, so are the prices.

Vending Machines

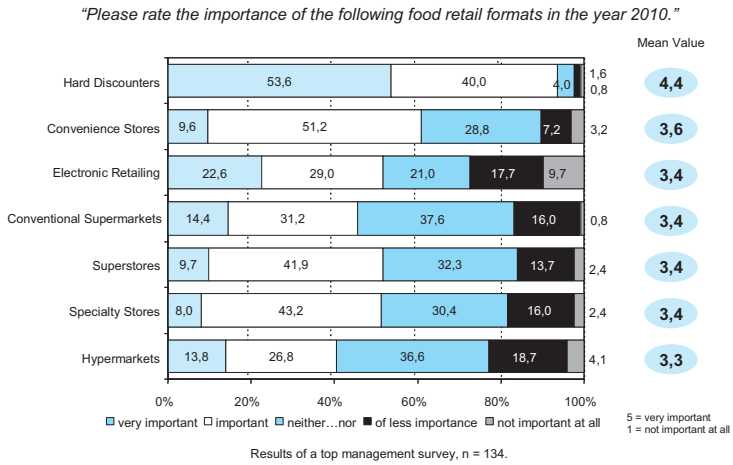
Vending machine retailing constitutes yet another alternative. Merchandise such as snacks and soft drinks are stored in a machine and dispensed to customers when they deposit cash or use a credit card. Vending machines are usually placed at convenient locations with high traffic (Levy/Weitz 2007, pp. 56-57). Developments in the field of vending machines are quite innovative. For example, new types of kiosk vending machines provide customers with product displays and information on the merchandise or electronic systems track inventory and cash, thus reducing out-of-stocks or malfunctions.

Conclusion and Outlook

The food retailing landscape has changed dramatically over the past few decades. *Competition* has increased because of, various factors including, mergers & acquisitions and the internationalisation of retail companies (Fox/Sethuraman 2006; Dawson 2006). In addition the main retail formats in this sector have also changed as a result of these developments, *technological progress* and responses to changes in customer behaviour (Weitz/Whitfield 2006).

Relevance of Food Retail Formats in 2010

Figure 1.4



Source: Adapted from Zentes/Schramm-Klein/Neidhart 2005, p. 42.

Interformat Competition

Even though new non-store retail channels have been developed, because, for example, of new developments in information and communication technology, *bricks-and-mortar store formats* remain the most important channels for selling groceries. Important developments result from new store formats that have been developed and gained market share. Most important in this context is the increase of *discount*-oriented retail formats such as large retail formats (e.g. hypermarkets) and small food-based hard discounters. *Convenience stores* are also becoming progressively more important. The future trends with respect to the relevance of the different retail formats in food retailing are illustrated in Figure 1.4.

In order to remain competitive in the mature business of food retailing, more and more retailers carry merchandise outside their traditional business. This phenomenon is referred to as "*category migration*" (Zentes/Schramm-Klein/Neidhart 2005, pp. 52-55) or as the "blurring" of retail formats (Fox/Sethuraman 2006, p. 200; see Chapter 8). For example, food discounters offer non-food items as special offers in weekly or semi-weekly promotions, so as to generate store traffic and improve profit margins. Another important trend is that food retailers are extending their regular assortment to increase sales and margins. For instance, hard discounters have extended their basic assortment in recent years by adding fresh meat or frozen food (Zentes/Schramm-Klein/Neidhart 2005, pp. 54-55).

Further Reading

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Case Study: Carrefour[1]

Profile, History, and Status Quo

The origins of *Carrefour* date back to 1959 when the company was established in France by the Fournier and Defforey families. The shops were all located on thoroughfares; hence the name "*Carrefour*". In other words, the name signifies that it is convenient to shop there (Lhermie 2001).

Openings of the First Stores

Carrefour opened its first supermarket in Annecy, Haute-Savoie, and at the same time, the *LLC Promodis*, the forerunner of *Promodès*, was created. The company was formed through a merger of two wholesaler families from Normandy, managed by Paul-Auguste Halley and Leonor Duval-Lemonnier. In 1962, *Promodès* opened its first supermarket in Mantes-la-Ville (Yvelines) and in 1963, *Carrefour* invented a new store concept: the hypermarket. The first *Carrefour* hypermarket opened in Sainte-Geneviève-des-Bois, with a sales area of 2,500 m², twelve check-outs and 400 parking spaces.

Retail Brands

Fournier Badin and Defforey attended Bernardo Trujillo's seminars in Dayton (Ohio) at the end of the 1950s, and were much influenced by what they heard. Just a few years later, the *Promodès* supermarkets adopted the *Champion* retail brand name. *Carrefour* opened its first hypermarket outside France, in Belgium, and the first outside Europe, in Brazil (Sternquist 1998). In 1972, *Promodès* hypermarkets adopted the *Continent* retail brand and con-

1 Sources used for this case study include the web sites http://www.carrefour.fr and http://www.carrefour.com, and various annual and interim reports, investor-relations presentations as well as explicitly cited sources.

venience stores operated under the *Shopi* brand. In the 1970s, *Carrefour* introduced "produits libres" (generics as an early type of store brand), which are unbranded products but "just as good and cheaper" and started the development of hard discounting. The company created the *Ed* chain in France, and *Promodès* in Spain. Meanwhile, *Promodès* branched out into franchising with *Champion* supermarkets. In the 1980s, *Carrefour* store brand products were introduced. In the 1990s, the internationalisation of the company started to increase and new stores were opened all over the word (Reynolds/Cuthbertson/Bell 2004).

Carrefour and the Multi-Format Approach – Status Quo and Forecast

Table 1.2

Store Format	Number of Stores (2005)	% of Sales (2005)	Number of Stores (2010)	% of Sales (2010)
Hypermarkets & Superstores	935	58.10	1,401	60.96
Supermarkets & Neighbourhood Stores	2,780	25.33	3,485	22.30
Convenience & Forecourt Stores	2,764	5.55	3,243	5.24
Discount Stores	5,502	8.63	7,302	9.30
Other Non-Food Formats	N/A	0.47	N/A	0.59
Internet Shops	N/A	0.08	N/A	0.10
Cash & Carries & Wholesale Clubs	179	1.84	166	1.51
Total	12,160	100.00	15,597	100.00

Source: Planet Retail 2006b.

International Growth Strategy

Carrefour is the currently leading retailer in Europe and second in the world. With a presence in about 30 countries, more than half of its sales are generated outside France. This makes it one of the most international of all food retailers (McGoldrick 1995). The group is concentrated mainly on three continents: Europe, Latin America and Asia. The group started this worldwide expansion more than 40 years ago, from which it has gained considerable experience. With the strength of this expertise, *Carrefour* pursues a growth strategy that is based increasingly on its international business (McGoldrick 1995). Thus, over the last few years, about 80 % of the new points-of-sale

were created outside France. Growth has been achieved with an increase of sales outside France of 8.3 % at constant exchange rates.

This international growth strategy is based on three axes (Cliquet 2006):

- the multi-format approach for flexibility and responsiveness
- the adoption of a common global strategy
- the achievement of strict profitability targets.

Development of Carrefour Through the Multi-Format Approach

Overview

Variety of Retail Formats

The worldwide expansion of *Carrefour* is the result of a structured approach. Since 1999, the group has drawn on its developments and acquisitions in its various businesses to implement a specific strategy, the so-called "*multi-format approach*". Over and above the synergies between the formats, this process creates an impetus for international expansion (Bose 2005). The establishment of hypermarkets in a particular country makes it possible to put in place the tools and processes necessary for further development (relationships with suppliers, logistics, marketing, etc.). The offer can then be extended progressively by setting up supermarkets and hard discount stores and, when the country is sufficiently mature, convenience stores. The multi-format strategy thus leads to growth in global sales, improved purchasing conditions and, of course, an increased market share in the countries concerned (Datamonitor 2005b).

Complementarity of Store Formats

The multi-format approach is an essential means of securing market share in the various countries. *Carrefour* tries to respond to the specific needs and shopping habits of local customers. The multi-format approach contributes to the rapid expansion of the group (Shiue/Horng/Yeh 2006). It enables *Carrefour* to transfer retail brands, while respecting the development of the trading structure of a town, region or – even more common – an entire country. This was the case in 2004 in Greece, at Ioannina, for example. In 2004, a supermarket was opened south of this town of 90,000 inhabitants, and a hypermarket to the north was enlarged under the *Carrefour* retail brand. The result – with two stores, total sales in the Ioannina region almost tripled. The development potential of this approach is considerable and three other operations of this type are planned in the country over the next few years.

The Formats

Hypermarkets

Carrefour hypermarkets offer a large choice under one roof – between 40,000 and 60,000 items – of food (60-70 %) and non-food (30-40 %) products, mostly at low prices (Levy/Weitz 2007). Being part of a shopping mall or retail park, hypermarkets attract good traffic. In the last few years, *Carrefour* decided to capitalise on the attraction of its hypermarkets by:

- strengthening its position and price image
- adjusting the business model to meet customer expectations
- making shopping easier so that it can be a pleasure: simplification of messages, introduction of shorter paths around the store, adaptation of the product mix to changing customer requirements
- "connecting" with customers to serve them better.

Price Leadership

The essence of a hypermarket is offering a very large range of products at low prices (Datamonitor 2005d). In phases of the business cycle marked by low consumer confidence, the hypermarkets have seized the occasion to strengthen their price image. This is particularly the case in France. For example, the mass consumer product panel of November 2004 ranked 125 French *Carrefour* hypermarkets amongst the 179 price leaders in their customer catchment areas. This number has more than doubled compared with the beginning of the year when only 30 % of stores were first or second in their catchment areas. This also applies to the hypermarkets in Belgium, the price position and image of which have considerably improved.

Electronic Tagging System

The price strategy is accompanied by a new system of assisted pricing. The electronic tagging system enables the company to change prices remotely. It also eases stock management through a rapid indication, at the shelves, of the exact stock level. Accordingly, it is easier to respond to local competition quickly and flexibly. This is carried out site by site, by monitoring the competition in the surrounding region and within the customer catchment area.

The *Carrefour* hypermarkets stand out not only for their low prices and the high quality of their product mix, but also for their variety, which has been strengthened by the company over the last few years through several different measures.

"Departments"

For example, several areas dedicated to non-food products were created. These include the "*Techno*" concept for new technologies, sound and vision. The areas set aside for this purpose in the hypermarkets have been redefined and are now run by specialised sales staff. Information panels have also been

installed at the entries to these areas in order to improve the visibility and offer customers a more personalised and friendly reception. Another example of development can be seen in the textiles area: modernisation of the relevant areas and a restructuring of the collections, the *Tex* store brand in particular. Household equipment (crockery, furniture, decorative items, etc.) and general equipment (bin bags, bulbs, batteries, ink cartridges, etc.) also represent solid product lines.

To persuade customers to visit the hypermarkets more often, it is necessary that they differentiate themselves from their competitors, not only in price, quality and adaptation to local context, but also in their product mix. To be visible and useful, this differentiation requires a richer and more clearly visible product mix.

The hypermarkets try to offer the best price on the 20 % of mass consumption products that account for 80 % of sales. Furthermore, they give access to an additional product mix. This richness was recently enhanced with a rebalancing of food against non-food which will continue on an ongoing basis. The hypermarkets are paying particular attention to fresh produce, a major factor in differentiation and customer loyalty. To keep the teams ahead of the game and maintain their professionalism, a major training programme is due to be rolled out in the near future. This will affect all employees, from members of the executive committees to sales department managers.

Non-Food Products

In the non-food area, the product mix is adjusted according to several criteria including the customer requirements and macro-economic conditions in the various countries, as well as local competition from specialist retailers. The hypermarkets adapt the aggressiveness of their pricing to the reality of local specialist competition. Thus, in France, *Carrefour* offers a greater permanent range of textile products than seasonal ones. The Spanish model, on the other hand, offers a more seasonal textile range.

Space (Re-)Allocation

In France, *Carrefour* has chosen to emphasise certain non-food product categories: For example, cultural media is going through major changes with a structurally regressive compact disc market. *Carrefour* has anticipated this fall and reduced the space in its hypermarkets given to CDs but increased the space allocated to books. Technology sales that were divided into telephony, computers, audio and photography sections have now been integrated into the "*Techno*" concept. This greatly simplifies the access to technology, and the result is clearer and more precise advice. Textiles combine the strength of the permanent *Tex* collection with the progressive implementation of the Spanish collections.

Price Image

After an appropriate adjustment of the price position, attention must also be focused on the price image in order to gain market share. The modernisation of the stores is supported by an expansion of the fresh produce range.

Thanks to the launch of the *No. 1* brand and despite the hard discount competition, *Carrefour* remains one of the leaders in terms of price image. In a very competitive environment, the Spanish hypermarkets have been engaged in an intense price battle for two years. This investment is now paying off. In the recent past, *Carrefour* hypermarkets again improved their price image and increased their market share. More generally, the group has consolidated its leading position as an international retailer. A similar upward spiral has been set in motion with the suppliers. This can be seen in the success of large-scale, innovative operations, as exemplified by the "*Codico Magico*" interactive game which is broadcast on television. The group and, more particularly, its hypermarkets are thus well-placed to continue their growth in the Spanish market, one of the most dynamic in Europe.

In Latin America, the rise of customised hypermarkets is particularly conspicuous. *Carrefour* adapts its hypermarkets to fit the country. Thus, in order to respond to the requirements of the Latin American population, they are divided into three living-standard categories. The stores are thus differentiated according to:

- the number of employees on duty in the store
- the number of different mass-consumption products offered for sale and
- the nature of the non-food product mix.

Associated with the very aggressive offensive of lowest prices and the use of store brands, this approach has led to a steady improvement in the price image amongst the various population groups. This is the case in Colombia, where *Carrefour* has the best price image in the market. In Argentina, the hypermarkets hold second position. In 2004, a franchised hypermarket of 7,700 m^2 was taken on and eleven existing stores were enlarged, making a total additional sales area of 41,000 m^2. These enlargements are very profitable and make it possible to:

- markedly increase shopping convenience for the customers, giving them more space and more accessible display shelves
- offer a wider product range and thus offer all of *Carrefour's* regular food and non-food product mix.

This organisational renewal is accompanied by a modernisation plan for all the stores, including those that are not enlarged. In the forthcoming years, *Carrefour* plans to return to a hypermarket expansion in Latin America.

Supermarkets

With its adaptability and integration into the daily life of the customers, the supermarket format is a success in all those countries in which it is established. The format offers several advantages: convenient services and a quality and freshness of products which enable it to establish strong links with its customers. Operating under various retail brands, both in France and internationally (*Champion*, *Norte*, *GS*, *GB* and *Globi*), the supermarkets play one main role in all the geographical areas in which the group has a presence: complementing the hypermarket format. The adaptability of the group's supermarkets is well illustrated by the *Champion* supermarket in Paris. Its organisation responds to the requirements of the Parisian customer, who has little interest in promotions, constantly seeks low prices, is as much attracted by the manufacturer as by the store brands and is always in a hurry. A "fast lane" has been set up with suitable opening hours (the supermarket is open until 22:00), the produce is self-service to avoid waiting at peak hours and certain check-outs are reserved for baskets and small, two-basket trolleys.

Adaptation to Local Context

Generally, the supermarkets adapt to the local context by taking account of customer types, their consumption habits, the nature of the competition, etc. Their model gives the benefit of flexibility and leads to three different types of store:

- in-town stores, which offer essentially food products
- town-fringe stores, which often have a role that complements or even competes with the hypermarkets (within the group)
- rural stores, characterised by a greater development of the offer of non-food products (textiles, general, etc.).

The very construction of the stores incorporates this flexibility. Highly modular, their architecture facilitates rapid modification. The group's supermarkets are also characterised by the presentation of a wide range of products. Over the last few years, the growth of the supermarkets has been backed by franchising which favours rapid expansion and offers good development opportunities. Franchising meets the increasingly evident requirements of the independents and small chains (Bronson et al. 1999). These have a great deal to gain from the support of a group like *Carrefour*. This gives them the benefit not only of powerful central purchasing, strong and effective communication and high-performance logistics, but also of the group's commercial know-how. With a presence in France, Belgium, Italy and Norway, franchising now represents a significant growth vector for the format.

Franchising

Store Brands

In order to gain market share and strengthen links with their customers, the supermarkets have invested strongly in prices and the development of store brands. Starting in Autumn 2003, many store brand products have benefited from successive price reductions. There were also several occasions on which the prices of one thousand *Champion* products were frozen for several months. Also, the stores were substantially modernised. Helping customers make their choices and identify low prices, the new signage, distinctive in each department (butchery, bread and pastries, perfumery, etc.), contributes to strengthening their links with the format and its brands. This lies at the heart of several projects now being devised or rolled out, which aim at a greater differentiation of the *Carrefour* group supermarkets from other retailers. This detailed programme covers the launch of niche brands and new items (bio, baby and cosmetic products, etc.), and the more effective exploitation of existing product ranges, especially the *Quality Lines*, special recipes and fresh produce. This strategy is implemented through customer loyalty programmes, which facilitate communication and direct marketing actions. Each supermarket regularly measures customer satisfaction through checkout surveys and analyses changes in consumption attitudes and expectations.

Customer Loyalty Programmes

Hard Discount

Combining simplicity, modernity and functionality, the *Carrefour* hard discount stores try to meet the needs of customers who want food products at the lowest price (Bruce/Moore/Birtwistle 2005). The third largest hard discounter in the world, *Dia*, is one of the driving forces of the group's expansion. Backed by *Carrefour's* purchasing power and capabilities, *Dia* offers its customers a hard discount. *Dia* has a presence in eight countries in Europe, Latin America and Asia. The store network comprises nearly 5,500 points-of-sale under the *Dia*, *Ed* and *Minipreço* retail brands. The hard discount format is a model that complements the hypermarkets and supermarkets very effectively as it can be adapted to many local conditions and constraints. In all countries, the hard discount retail brands benefit from the power and expertise of the *Carrefour* group in terms of prices, brands, quality, logistics and IT systems. Like the other formats, the hard discount stores commenced in 2003 and continued in the following years to incorporate international products that were developed at the group level (*Produits Carrefour Internationaux* (PCI)), in their product range. At the end of 2004, *Dia* stores were already offering their customers over 200 PCI items. This not only helps the hard discount stores to establish their particularly aggressive position in their markets, but also contributes to maintaining the high level of quality offered to their customers. The company itself considers the hard discount concept as a very flexible model. The small floor area makes hard discount stores

International Store Brand Concept

easier to expand worldwide than other formats. More than half of the sales come from store brands. The key reasons for success are speed of adaptation, flexibility and decentralisation. The stores are regularly re-fitted and enlargements, changes of location, modernisation or reorganisation are very frequently carried out. Thus, the business model changes with its market.

Types of Hard Discount Stores

The hard discount store adapts to its environment and can be divided into three types:

- The town-centre *Dia* with a sales area of less than 300 m². This format offers a range of food products at minimum price. These rented stores are extremely flexible and firmly anchored in the urban environment.
- The town-fringe *Dia*, with a sales floor area of about 600 m² and a car park. Larger than the previous type, its product range is greater in most of the cases. It offers products in wholesale packaging and has a fresh produce section.
- The *MaxiDia* concept, close to a hard discount supermarket, tried out in Spain since 2004.

Dia has developed an original concept, quite different from its competitors, providing a decisive competitive advantage. For example, *Dia* excels with its fruit and vegetable know-how and choice. It offers a small range of good-quality produce at the lowest possible price. The overall product range is defined precisely to maintain a balance of store brands and manufacturer brands at low prices. It is also adjusted according to country and concept maturity. The proportion of manufacturer brands can thus vary between 40 % and 80 %. The strength of *Dia* is also based on continuing communication about quality and food safety. The accent is on the strengthening of quality controls and increasing frequency of supplier audits carried out by independent laboratories. Special attention is paid to the performance of the online traceability system. The loyalty cards are deployed in all those countries in which the retail brand has a presence and is sufficiently successful.

Convenience and Other Business

The real strength of the convenience retail brands is that they meet the daily needs of customers with a practical product mix and speedy shopping in a friendly atmosphere (Swoboda/Schwarz 2006). The *Carrefour* group implements store concepts, quality product mixes and innovative services which correspond to customer living habits. A large part of the convenience stores is managed in the form of franchise stores. Thus, it also benefits from the usual commitment of franchisees to increasing the profits of their stores. *Carrefour* intends these stores to become a part of the daily life of customers. Friendly and accessible, the convenience stores try to offer many services to

their customers (Liebmann/Zentes 2001). In addition to the quality of the welcome and products, customers appreciate the adaptation to their shopping habits and daily lives. In a continually changing world, marked by an increase in single households in search of fast and practical services, there is a "revival" of interest in convenience stores, especially in highly developed regions. Established in four European countries, *Carrefour*'s convenience stores benefit from this trend. In order to make them even more attractive, they extend the very concept of convenience, from their geographical location to their friendliness and advice. The group's strategy in this area combines various elements, above all, pricing. The strategy consists of a pricing policy in line with customer expectations. The other main directions are:

- innovation in store brands: continuing refinement of the retailer branded product mix, which is a fundamental vehicle of brand loyalty;
- the quality of services is a key element in convenience shopping with long opening hours and home deliveries;
- the quality of the product range and continuity of availability: all this relies on the integration of logistics and mastery of purchasing, which benefits, in particular, from the group's conditions.

In 2004, two new concepts, *Shopi* and *8 à Huit*, launched in the previous years, continued to be deployed in France. Together with *Marché Plus*, *Proxi Services* and *Sherpa*, these retail brands form a complete system. This makes it possible to establish a network throughout the country and, at the same time, to adapt to the varying needs of the customers in terms of practicality, last-minute shopping, friendliness and even seasonality.

Shopi is thus positioned as a small convenience supermarket, *Marché Plus* as a town shop offering multiple services and *8 à Huit* as a retail brand that plays a role in town, but also as a small supermarket in rural areas. During the last few years, a reconsideration of these concepts was launched. One example among many is the new *Convenance* concept of *Marché Plus* and *8 à Huit*. In these urban last-minute stores, fresh produce and ready-to-eat items are offered. Because convenience trading demands continuous adaptation to customer requirements, almost all the stores are managed by franchisees. Each month, the franchisees present their results to the group for detailed, real-time monitoring of the business. Therefore, various control tools have been established, including a regional barometer and an assessment of the franchisees with regard to *Carrefour* services. The convenience store addresses various types of customers. *Carrefour* knows these customer types and can share this knowledge with manufacturers.

C-Store Franchise Concept

In convenience stores, customer loyalty depends on friendliness, the development of services and enlargement of the range of fresh produce. Their

Product and Service Range

location in the heart of the districts or villages where their customers live makes convenience stores visible, and they can make themselves more attractive by developing their communication. This attractiveness is increased by the offer of a wider range of additional services. Thus, the *Marché Plus* stores offer home delivery, dry-cleaning, photo development, the sale of stamps and telephone cards, photocopying, a fax service, automatic ticket machines, etc. Located mainly in the mountains, *Sherpa's* range of services is particularly well adapted to its customers, especially the seasonal trade: return of unused products, hire of raclette and fondue appliances, etc. In addition, the allocation of appropriate display shelves and the quality of the product range and supply now represent a major investment in store modernisation and the development of new concepts.

Cash & Carry

The cash & carry business continues to develop as well. To serve restaurateurs and food trade professionals, *Carrefour* is developing the cash & carry business in France (*Promocash*), in Spain (*Puntocash*) and in Italy (*Docks Market*).

Internet Shop

The e-commerce web site *Ooshop* continues to satisfy many customers, offering home deliveries of products at the same prices as the hypermarkets. The concept is available in France and Spain.

Questions

1. Is it possible for *Carrefour* to extend the success of its multi-format concept worldwide? Discuss critically and give examples.
2. Since 2004, *Carrefour* has been in a relaunching process, because of a growing competition both on a world-wide level and in many specific country markets. Conduct a SWOT analysis for the group and discuss critically the multi-format approach in this context.
3. In some country markets, *Carrefour* is pushing its expansion through convenience stores. Discuss the general characteristics of convenience stores, analyse the development of convenience stores of other retail companies and explain the advantages of adding a convenience store retail format to the existing portfolio.

Hints

1. See annual reports as well as the current press for an analysis of divestments and problems encountered in the internationalisation process of *Carrefour*.
2. See, for example, Kotler/Bliemel 2001 for a SWOT analysis.
3. Consider, among others, the various theories of retail evolution.

Chapter 2

Retail Formats – Non-Food

In this Chapter, the main characteristics and empirical relevance of a variety of store and non-store retail formats applied in non-food retailing are discussed. Many retailers sell to their consumers through multiple retail formats. This phenomenon, which is referred to as multi-channel retailing, is also discussed in this Chapter.

Diversity of Retail Formats in Non-Food Retailing

General Merchandise Retailing

In non-food retailing, a variety of retail formats are used to sell merchandise to consumers. This *diversity* results from the *plurality* of product groups that are characterised as non-food items. Even though product groups also vary within the food sector, with regard to consumer shopping behaviour, there are major differences, particularly between non-food and food items. These differences relate to product characteristics such as perishability, specific demand patterns, product value (e.g. in relation to product size or volume), or turnover rate. For example, while food is usually purchased daily or several times per week, non-food items usually are purchased infrequently. Some categories such as cosmetics or household articles are bought more frequently than others, for instance, TV-sets or computers that usually are purchased only every few years.

Retail Innovations

While in non-food retailing, substantial sales are generated by traditional store-based retail formats, non-store formats such as catalogue retailing or electronic channels are also vitally important. New developments in *technology* and customer behaviour in the past decades have led to a change in the relevance of different retail channels and to the evolution of *new retail formats* mainly in the field of non-store retailing (see Chapter 1). Another important trend is that many traditional store-based or catalogue retailers have started to sell their merchandise through several retail formats. By adding additional retail channels, they are evolving into *multi-channel retailers*.

Store-Based Retail Formats

The major types of store-based retail formats in non-food retailing that will be discussed in this Chapter are specialty stores, drugstores, category killers, department stores, full-line discount stores, variety stores and off price retail formats.

Specialty Stores

Specialty Store Strategy Mix

Specialty stores specialise in one or very few product types and consequently carry a limited number of products within one or few lines of products (and services). Usually, the merchandise is of average to good or *high quality*. While the width in the assortment is narrow, the depth is usually extensive and specialty stores thus provide a *better selection* in terms of a higher choice variety than competitors from other retail formats such as department stores (Ogden/Ogden 2005, p. 99). Specialty stores additionally offer a high level of *services* and knowledgeable sales personnel. Typically, the stores are located in city locations or in shopping centres, are small and the *instore atmosphere* is very pronounced so as to create a pleasant shopping experience. *Limited-line specialty stores* are a specific type of specialty store that carry only a very narrow assortment, but offer pronounced depth in this limited sector. Often, these stores offer (very) high quality merchandise and a high-level of customer service and instore design, while prices are above average.

This store format, traditionally chosen by retailers that sell merchandise such as clothes (e.g. *Gap* or *Benetton*), footwear (e.g. *Footlocker*), cosmetics (e.g. *Douglas, The Body Shop* or *Sephora*), books (e.g. *Barnes & Nobles*, *WH Smith* or *Thalia*) or jewellery (e.g. *Christ*). In many cases, however, specialty stores are run by *independent local retailers*.

Market Segment Focus

The main element of specialty stores' strategy is that they focus on a specific market segment. While this offers many opportunities in terms of tailoring their stores to their *target groups*, the strategy makes them vulnerable to changes in consumer tastes and preferences. They also suffer from the high costs that result from the *quality-oriented strategy* in terms of store environment, merchandise and service offered to the consumers (Levy/Weitz 2007, pp. 48-49). This often results in higher than average prices.

While specialty stores have been the traditional format for non-food shopping, in recent years, they have been one of the weakest, slowest-growing areas in retailing and have lost market share to other store-based or non-store formats.

Drugstores

Drugstores are specific types of *specialty stores* that focus on beauty and health and personal grooming merchandise (Levy/Weitz 2007, p. 49). In addition, these stores often sell categories such as food items, magazines or newspapers, stationery, toys or gifts. Depending on governmental health care policies, in some cases, *pharmacies* are associated with drugstores and sell *prescription pharmaceuticals* in addition to ethical or over-the-counter

Pharmaceuticals

(OTC) medicine. The product categories sold in this store format are similar in some respects to food items, mainly in terms of shopping frequency and purchasing patterns ("*near-food items*"). In some statistics, drugstores are therefore classified as food store formats.

Shopping Convenience

Compared to traditional specialty stores, drugstores tend to be more aggressive on price and apply pricing strategies such as every-day-low-price (EDLP) strategies or promotion pricing. Important players include *Boots*, *Walgreens*, *Schlecker* or *dm-drogerie markt*.

Drugstores are often located in city or shopping centres, but are now found more and more at locations such as neighbourhood locations or isolated sites. Thus, they play an important role in *proximity retailing* and usually – because of their locational strategy and rather small store size with speedy check-out facilities – offer a high degree of *shopping convenience*.

Category Killers

Category Killer Strategy Mix

Category killers, also referred to as *category specialists* or *power retailers*, are discount stores that offer a broad depth of merchandise in a particular category, usually in *large stores*. They offer an almost *complete assortment* in a particular category at *low prices* and thus, can "kill" a category of merchandise for other retailers (Levy/Weitz 2007, p. 50), mainly for specialty stores. The service level offered by category killers is usually kept at a low level. Self-service approaches are generally applied to sell merchandise, but assistance is offered, if requested by the customers.

The outlets usually are located in out-of-town locations (exceptions, such as *Saturn*, a German-origin category killer in the field of consumer electronics, focus mainly on city locations). They offer extensive parking facilities to their consumers and thus draw them from a *large catchment area*. Store architecture and instore design are kept very simple and offer a shopping experience that is dominated mainly by size and pricing (Wileman/Jary 1997, p. 78).

The strategy of *low operating costs* in terms of rents, personnel costs, low cost design, etc., combined with huge buying power, usually leads to high asset productivity (e.g. space, stock turnover). This makes category killers one of the retail formats with the highest growth rates over recent years. They have gained market share mainly at the expense of specialty stores, because of advantages in terms of price and product range. Category killers are now established in many non-food categories such as consumer electronics (e.g. *Curry's*, *Darty*, *Media Markt* or *Best Buy*), DIY (e.g. *Leroy Merlin*, *B&Q* or *Home Depot*), sports (e.g. *Decathlon*), furniture (e.g. *IKEA* or *Conforama*), office products (e.g. *Staples* or *Office Depot*), pets (e.g. *PetsMart*, *Mille Amis* or *Fress-*

napf/Maxi Zoo) or toys and baby products (e.g. *Toys 'R' Us* or *Babies 'R' Us*), and the format is still expanding into new categories.

Department Stores

"All Under One Roof"

Department stores are *large retail units* that carry a broad variety of merchandise and offer a deep assortment "under one roof". The term "department store" results from the structuring into separate departments for displaying merchandise in a manner that resembles a collection of specialty stores. Each department not only has a specific selling space allocated to it, but also usually has its own point-of-sales terminals and salespersons to assist the customers (Levy/Weitz 2007, p. 46). The merchandise sold by department stores traditionally comprises a wide range of categories such as clothes, accessories, appliances, home furnishing, jewellery, cosmetics, toys, furniture, sporting goods or consumer electronics. Recently, however, most department stores have been reducing product variety and focus more and more on soft goods (e.g. clothes and footwear).

Shopping Experience

The main locations of department stores are *city centres,* or they often serve as anchor stores in *shopping centres*. Department stores a pleasant atmosphere which creates an enjoyable shopping experience. Instore design and visual merchandising are thus very important. Also, the services offered by department stores are diversified and may include, for example, a tailoring service for clothes or home deliveries.

In terms of the merchandise carried and the services offered, department stores can be categorised into three tiers (Weitz/Whitfield 2006, p. 67):

- upscale, *high-fashion* stores with exclusive designer merchandise and excellent customer service; these are often the flagship stores of department store chains (e.g. *Harrods, Selfridges, Jelmoli, Saks Fifth Avenue, KaDeWe, Galeries Lafayette Paris Haussmann*)
- modestly priced, *mid-level* merchandise with less customer service (e.g. *Macy's, Hoopers, Debenhams, John Lewis*)
- stores with *lower level* merchandise and prices (e.g. *Sears, JCPenny).*

Most department store chains such as *Galeries Lafayette, Karstadt, El Corte Inglés, House of Fraser* or *Saks* operate department stores in several of these tiers.

Interformat Competition

In recent years, the overall sales and market share of traditional department stores have declined and – internationally – they face substantial competition from other retail formats such as category killers and discount stores or non-store formats (e.g. Internet retailers). The difficulties mainly result from

the problems in retail positioning as an outcome of the "*all under one roof*" approach. Whereas first-tier department stores seem to have a clearly differentiated position and usually produce strong financial results, these difficulties relate mainly to outlets in the second and the third tiers, which lack such a clear positioning and are therefore struggling. Also, the overhead and *operating costs* associated with such large retail outlets that are oriented towards ambience, attentive services and a broad variety of products, are very high in comparison to the more cost-focused and price-aggressive retail formats. Additionally, these retail formats often have better assortments in the limited lines they carry. The departments simply cannot offer the same depth (Berman/Evans 2007, p. 144).

Repositioning

Even though department stores are trying to respond to their deteriorating position in terms of giving a *clear profile* to the stores by, for example, tightening up their assortment, increasing the amount of exclusive merchandise or brands offered, introducing store brand programmes, improving customer relationship management and customer service systems or marketing campaigns to improve their image, this erosion of market share still seems to continue.

Full-Line Discount Stores

Discount Department Store

Full-line discount stores are a specific type of *department store* that offer a broad variety of merchandise at low prices, from such categories as electronics, furniture and appliances, household ware or gardening tools (Levy/Weitz 2007, p. 48). This store format has its origins in the USA, with *Wal-Mart*, *Kmart* and *Target* as the most important players.

Store architecture and instore design are *very simple,* so as to keep costs low. Also, the merchandise is usually less fashion-oriented than in department stores. Full-line discount stores offer both store brands, for example, non-durable goods, and manufacturer brands, such as hard goods (e.g. TVs or household appliances). Usually, customer service is very limited. Products are sold via self-service. Customers use *shopping carts* to do their purchases and pay at centralised check-out areas (Berman/Evans 2007, p. 145). Thus, operating costs are kept low. This store format struggles from the lack of a pleasant shopping experience and its similarity to hypermarkets (or supercentres) with respect to non-food items. Full-line discount stores are therefore faced with strong general competition from hypermarkets and from category killers in each specific category. Over the last few years, they have lost market share, which, for example, has led *Wal-Mart* to close some of its full-line discount stores or convert them into supercentres.

Variety Stores and Value Retailers

Variety Stores

Variety stores, such as *Woolworths* or *Ben Franklin*, offer a broad assortment of inexpensive and popularly-priced merchandise. Categories such as clothes, accessories, jewellery, candy, toys, etc., are covered. The stores offer limited services and do not carry full product lines (Berman/Evans 2007, p. 146). This store format faces strong competition from retail formats such as category specialists, discount stores and (large) food retailing formats that carry a range of non-food items of similar product lines.

Value Retailers

While this conventional form of variety store is struggling, (extreme) value retailers have evolved as a new form of variety store. They are general merchandise discount stores that target mainly low-income customers and are thus located mainly in low rent, lower-income urban or rural areas (Levy/Weitz 2007, p. 52). The merchandise sold covers similar items to those in conventional variety stores, but the prices are much lower.

Off-Price Stores

Buying Strategy

Off-price stores sell an *inconsistent assortment* of merchandise, e.g. soft goods such as clothes, accessories, cosmetics or footwear at low prices. Some off price retailers focus on fashion-oriented, brand-name or designer-labelled items. Off-price stores use a very *aggressive buying strategy* without asking the manufacturers for additional services such as return privileges, advertising allowances, markdown adjustments or delayed payments. They often negotiate with manufacturers to discount orders, e.g. for merchandise that is out of season or for *irregular items* that have minor flaws (Ogden/Ogden 2005, pp. 99-100; Berman/Evans 2007, p. 147).

Specific Types of Off-Price Stores

Specific types of off-price stores are, for example, *closeout retailers* that sell a broad assortment of merchandise that is purchased at closeout prices, *one-price stores* that offer every product at the same price (e.g. dollar stores) or *outlet stores* that are owned by department stores, specialty stores or manufacturers ("*factory outlet stores*", see Chapter 3). In these stores, for example, excess merchandise, overruns or irregulars are sold and markdown prices in the primary stores can be avoided (Levy/Weitz 2007, p. 53).

Non-Store Retail Formats

Non-store retailing comprises all retail formats that do not use bricks-and-mortar stores. The main principle is *distance retailing*, which means that customers and retailers do not have direct contact. The most important type of non-store retailing is *home delivery*, but there also are other forms. Traditional catalogues and the Internet are non-store formats of major importance in

non-food retailing. Other channels of less importance in terms of market share are, for example, direct selling, TV shopping, vending machines or new forms of mobile retailing (mobile commerce).

Catalogue Retailing

Catalogue retailing is the traditional type of non-store retailing. The merchandise offered is communicated to consumers through a *catalogue* and customers can generally order by mail, phone or fax.

Types of Catalogue Retailing

The two main types of catalogue retailers are *general merchandise catalogue* retailers and *specialty catalogue* retailers (Levy/Weitz 2007, p. 55). While the first type relates to retailers that offer a broad variety of product categories (e.g. *Otto, JCPenny, La Redoute,* or *Freemans*), the latter focus on specific categories of merchandise such as clothes (e.g. *Madeleine, Lands' End*) or sporting goods (e.g. *SportScheck*) with an extensive assortment depth. The assortment policy of general merchandise catalogue retailers is comparable to the strategy of department stores, while specialty catalogue retailers correspond to specialty stores in terms of merchandise strategy. Often, general merchandise catalogue retailers also launch several catalogues that focus on specific product groups.

Electronic Retailing

E-Commerce

In electronic retailing (or e-retailing, electronic commerce, e-commerce, Internet retailing), retailers offer their products and services over the *Internet*. Merchandise is thus presented in Internet shops. Customers usually place their orders via electronic check-outs or they can use e-mail or traditional modes of communication (e.g. mail, phone, and fax). While, in most cases, customers pay through traditional systems (e.g. credit card, purchasing on account), some Internet shops also offer *electronic payment systems*. Also in electronic retailing, according to their merchandise strategy, retailers can be divided into general merchandise and specialty retailers. Generally, all kinds of products can be sold over the Internet, but major sales are generated in such categories as books, CDs, DVDs, clothes, computer software, toys or home electronics (EIU 2005). The Internet is of specific importance for *digital products*, e.g. software, music, e-books, that – unlike physical goods – can literally be transferred through electronic channels. In such cases, the Internet offers additional shopping convenience in terms of the direct and immediate availability of the products purchased ("*transaction convenience*").

Digital Products

The most prominent example of a successful Internet retailer is *Amazon,* which started off as a specialty retailer focussing on books, but has added

more and more product categories to its portfolio since, such as music, toys, consumer electronics, pet supplies and even groceries.

The "hype" that was associated with Internet shopping as a revolutionary retail format in its beginning has receded and a *market consolidation process* has driven many Internet retailer innovators out of the market. Nonetheless, for several years, electronic retailing – internationally – has been the retail format with the fastest growth (EIU 2005). The emergence of Internet retailing has led to *new business models* and new forms of retail transactions that are mediated by the computer. In this context, for example, *Internet auctions* (e.g. *eBay*), *Internet price comparison* (e.g. *froogle*) or *"name-your-own-price"* systems (e.g. *Priceline.com*) have been developed, though not all of them are successful.

Innovative Business Models

Direct Selling

Personal Selling

Direct selling is a retail format which involves interactive *personal contact* between salespersons and customers at non-store locations. Salespersons can contact customers directly at a convenient location (e.g. customer's home or at work) or they can contact them, for example, via telephone. They demonstrate merchandise, take orders, deliver the products to the consumers or provide them with further information or services (Ogden/Ogden 2005, p. 107). Direct selling channels can be operated by retailers or manufacturers (see Chapter 3).

The strategy behind direct selling systems that operate with own salespersons who sell individually to consumers and provide them with a high level of information and, in some cases, extensive demonstrations of products, is associated with high operating costs. Therefore, specific forms of direct selling have evolved. The main forms of these are party sales and multilevel marketing systems. *Party sales* are characterised by salespersons encouraging customers to act as hosts and invite friends to a "party" at which the products are presented. In multilevel selling systems, master distributors recruit other people to become distributors in their network (Levy/Weitz 2007, p. 55). Direct selling is applied in product categories such as, e.g., housewares (e.g. *Tupperware*), cosmetics (e.g. *Avon*) or jewellery (e.g. *Pierre Lang*).

Party Selling

Multilevel Marketing

Other Non-Store Shopping Formats

In addition to these main non-store shopping formats, there are also other non-store channels, but they are of less importance in terms of market share. For example, also in non-food retailing, *vending machines* can be used for selling books, newspapers, phone cards, CDs or DVDs etc. While the operating costs are relatively low, the main drawbacks of vending machines are

logistical, such as filling processes, out-of-stocks or reverse logistics, e.g. in the case of damaged products.

TV Shopping

Additionally, several non-store retail channels have evolved that are based on specific technologies. For example, in *TV shopping* (television home shopping) products are demonstrated in infomercials and in TV channels dedicated to television shopping or in direct response advertising on TV or radio. Customers usually place their orders via telephone, but there are also new interactive forms of TV shopping where orders can, for example, be transferred online (Gilbert 2003, p. 355). TV shopping channels are, for example, operated by *QVC* or *Home Shopping Europe (HSE24)*.

M-Commerce

New developments in information and communication technology seem to lead constantly to new retail formats. For example, *mobile commerce* which comprises retail transactions (e.g. downloading of ring tones, music or games) via mobile phones is such a new format.

Multi-Channel Retailing

The term multi-channel retailing (MCR) refers to retailers using several retail channels in parallel to sell their merchandise (Schramm-Klein 2003). This strategy has been common for a long time, but has recently become more relevant and topical, because of new channels of distribution, in particular the Internet. Many retailers act as multi-channel retailers and *combine* several retail formats, such as bricks-and-mortar stores and/or traditional catalogues with Internet retailing. By doing so, companies can exploit the unique benefits of the different retail formats and thus increase customer benefits. However, they also have to deal with the specific drawbacks associated with each retail format (see Table 2.1).

Reasons for Multi-Channel Retailing

The main reasons for evolving into multi-channel retailers are (Schramm-Klein 2003, pp. 2-3; Levy/Weitz 2007, pp. 81-83; Alba et al. 1997):

- *expansion* of market presence, reaching new markets (e.g. new target groups, geographically new markets, etc.)
- *leveraging* skills and assets to increase revenues and profits (e.g. well-known retail brands, supplier relationships, buying power, customer information, supply chain systems, etc.)
- *overcoming limitations* of existing formats (e.g. store size, flexibility in pricing and merchandise provision, information-provision modes, etc.)
- *increase in customer share*/share of wallet (customers' percentage of total purchases with the retailer).

Table 2.1 *Relative Attractiveness of Alternative Retail Formats to Consumers*

Dimension	Supermarket	Department Store	Category Specialist	Catalogue	Internet Retailer
Providing Alternatives for Consideration					
Number of Categories	medium	medium	low	low	low
Alternatives per Category	medium	low	medium	medium	low
Screening Alternatives to Form Consideration Set					
Selecting Consideration Set	medium	high	medium	low	low
Providing Information for Selecting from Consideration Set					
Quantity	medium	medium	medium	medium	medium
Quality	high	high	high	medium	low
Comparing Alternatives	medium	medium	high	low	low
Ordering and Fulfilment: Transaction Costs					
Delivery Time	immediate	immediate	immediate	days	days
Supplier Delivery Cost	low	low	low	high	high
Customer Transaction Cost	high	high	high	low	high
Supplier Facility Costs	high	high	high	low	low
Locations for Placing Orders	few	few	few	everywhere	many
Other Benefits					
Entertainment	low	high	medium	low	low
Social Interaction	medium	high	medium	low	low
Personal Security	low	low	low	high	high

Source: Adapted from Alba et al. 1997, p. 38.

Channel Integration

Multi-channel retailers applying an *umbrella brand strategy,* which means that all retail formats of the company carry the same retail brand (see Chapter 6), must provide a consistent image to consumers across all channels. Thus, the integration of retail channels is one of the major issues with which most retailers are still struggling (Schramm-Klein 2003, pp. 336-339). The provision of integrated retail channels is important in MCR, as customers in many cases use several retail channels in combination in their *buying process*. For example, consumers can (1) gain initial information on brands and product types from the catalogue, (2) inspect the physical aspects (e.g. colours, materials, content) at the store, (3) check prices and (4) availability and (5) complete the transaction in the Internet shop and (6) return products to the store.

Successful multi-channel retailers include *Otto* (catalogues, stores, Internet shop, and TV shopping), *Lands' End* (catalogues, stores, and Internet shop), *Tesco* or *Carrefour* (multiple store formats and Internet shop), or *Douglas* (stores and Internet shop).

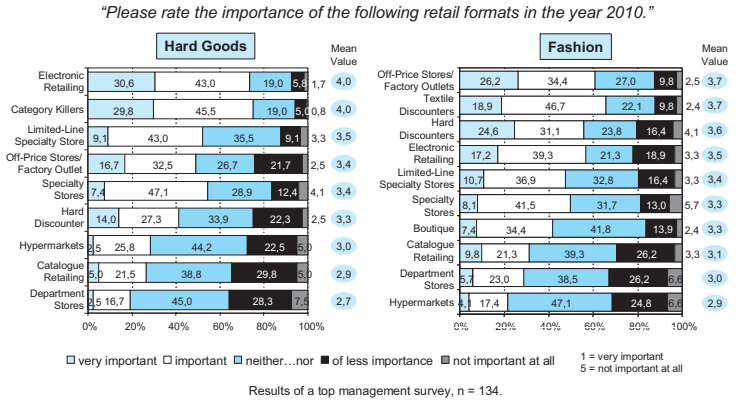
Conclusion and Outlook

New Retail Formats

In non-food retailing, traditional retail formats such as department stores, specialty stores or pure catalogue retailers are struggling with competition from new formats such as *price-aggressive store formats* (e.g. category killers, off-price stores), retailers that sell fast-moving non-food items as *special promotions* on a weekly or semi-weekly basis (e.g. *Tchibo*) or *innovative non-store formats* such as Internet shops. This trend towards more price-oriented formats is predicted to continue in the next few years (see Figure 2.1).

Anticipated Relevance of Non-Food Retail Formats in 2010

Figure 2.1



Source: Adapted from Zentes/Schramm-Klein/Neidhart 2005, p. 42.

Technological Innovation

Apart from this trend towards discount-oriented channels, the main developments in non-food retail formats result from new developments in *information and communication technologies* that not only lead to the emergence of new retail formats such as mobile commerce, but also offer potential new business models and new modes of communication to customers within the framework of existing retail formats. The new retail channels are not only important as *new competitors*, but many retailers expand their existing retail formats by adding such new channels and evolving into multi-channel retailers. These developments in retailing are accompanied by changes in consumers' *shopping motives* and behaviour, such as price or "more-for-less" orientation, convenience orientation, more sophisticated customers, etc., and can be interpreted as a response to customer needs (Uncles 2006).

Further Reading

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Case Study: Media Markt and Saturn[1]

Media Markt and Saturn as Category Killers in the Metro Group

With a turnover of 55.7 billion EUR in 2005 and about 250,000 employees, the *Metro Group* is the third largest trading group worldwide. With 30 countries and foreign sales comprising about 50 % of total group turnover, the *Metro Group* is the most internationalised of the top 30 retailers. Operative business is divided into the following four lines: wholesale (*Metro* and *Makro*), food retailing (*Real* and *Extra*), non-food specialised discounters (*Media Markt* and *Saturn*) as well as department stores (*Galeria Kaufhof*). Further detailed information is provided in the *Metro Group* case study in Chapter 12.

Consumer Electronics

Within the *Metro Group,* the sales division of "non-food specialised discounters" is represented by the *Media-Saturn-Holding GmbH,* which is based in Ingolstadt and divided in the two companies "*Media Markt*" and "*Saturn*". The *Media-Saturn-Holding GmbH* is the leading European company in the consumer electronics trade with a turnover of 13.3 billion EUR in 2005 and 37,000 employees worldwide.

With a growth in turnover of 9 % to 13.3 billion EUR in 2005 after having reached 12.2 billion EUR in 2004, the group has consequently consolidated and enlarged its operative efficiency during the last few years. In Germany,

1 Sources used for this case study include miscellaneous volumes of the Lebensmittel Zeitung, LZNet, Lebensmittelpraxis International, several German and European daily newspapers as well as explicitly cited sources.

the level of turnover associated with numerous marketing measures with the 25 years anniversary of *Media Markt*, as well as the opening of the hundredth *Saturn* market, could be increased by 100 million EUR despite unfavourable conditions within the industry. In terms of foreign business, the sales division was able to increase its turnover by 17.8 % to 6.1 billion EUR in 2005, compared with 5.1 billion EUR in 2004. All in all, the sales division disposed over a Europe-wide branch network comprising 558 stores with a sales area of 1.7 million m^2. In the financial year 2005, the *Media-Saturn-Group* increased the EBITA by 57.9 million EUR from 451.9 million EUR to 509.8 million EUR. With growth of 12.8 %, the *Media-Saturn-Group* again proved its strength in earnings power for the *Metro Group,* despite a difficult competitive environment and substantially increased expenditure on advertising and marketing at a continuously high rate both at home and abroad.

Formation and Development of Media Markt and Saturn

Saturn

The forming of *Saturn* dates back to 1961 when Anni and Fritz Waffenschmidt established the consumer electronics centre *Saturn* in Cologne and expanded it to the largest outlet for hi-fi stereo systems and records worldwide at that time. In 1984, *Kaufhof* took over the company and in 1990, *Media Markt* bought the *Saturn-Kaufhof-Group*. By 1996, *Metro* assured its leadership within the young *Media-Saturn-Holding* with 70 %. Today, the *Media-Saturn-Holding* uses the red ("Ich bin doch nicht blöd") and the blue label ("Geiz ist geil") slogans for a cleverly devised two-label strategy. The outward appearance of *Media Markt* and *Saturn* is that of two aggressive competitors. Nobody is to realise that the turnover goes into one "till". The headquarters in Ingolstadt ensure that the market leaders do not cannibalise or challenge one another in terms of market share or turnover (Lau/Kunert 2005).

Purchasing

This strategy already begins at the purchasing stage. The owners of *Media Markt* and *Saturn* outlets still order their respective computers, TVs, hi-fi stereo systems or sound storage media themselves, but outline agreements are negotiated in Ingolstadt. Key products are ordered jointly from the manufacturers for *Media Markt* and *Saturn*. The purchasing volumes are bundled – and this is reflected in the prices offered to consumers.

National and International Expansion

In addition, the headquarters arranges for national and international expansion and territory protection. In the past, *Saturn* preferred to locate in inner cities, whereas *Media Markt* typically chose out-of-town locations. This strict differentiation no longer applies. If a new outlet is planned, the site is first analysed according to the *regio cash analysis* that has been developed within the company. Among others, the following key questions are considered:

"Where do people go shopping in the region?", "Would a new outlet have negative effects on another outlet of the group (cannibalisation)?" Cashiers in existing stores provide an important data basis for the regio cash analysis, because they always ask for customers' post codes. The customer routes are then depicted in colour on a map by the headquarters. Thus, an expansion plan is generated. The colour "red" characterises a high saturation degree by *Media Markt*, "blue" by *Saturn*. The colours continuously and gradually change to "light red", "light blue" or in the ideal case "white". However, there should be no "purple" spots on the map (Stein 2005).

Sometimes, both companies are deliberately placed in the same region or city in order to keep away potential competitors, e.g. in Cologne, where about six million tourists visit the cathedral every year. Near the cathedral, both a *Saturn* store and a *Media Markt* canvass local and other customers (Peters 2005).

Characteristics of Saturn

Saturn offers a comprehensive assortment of domestic appliances, entertainment electronics, photo, computer, new media and sound storage media in large stores, the surface of which can vary considerably from 1,200 to 16,000 m^2 depending on the already-described strategic site selection. *Saturn* acts as a specialised discounter with aggressive prices and a full range of up to 100,000 articles and has thus developed – just like *Media Markt* – into a strong retail brand. Over the last few years, it has been able to increase turnover continuously – in contrast to the sector trend.

The brand-related positioning of *Saturn* is based largely on two pillars or dimensions: assortment variety and the price-performance ratio. Still mostly in inner cities, the company offers customers a comprehensive assortment at low prices. Assortment efficiency or competence is passed on to the point-of-sale (PoS) with the help of an extremely broad and deep product range and high brand availability. The excellent selection - especially of CDs and DVDs – is at the core of *Saturn's* differentiation from competitors. With up to 60,000 articles in this range, *Saturn* presents itself to the costumer as a large, competent provider. The price-performance ratio serves as an important image-related component and consequently comes to the fore at *Saturn*. The aim is to conduct bulk business by catering specifically for the masses (lowest price as the activating unique selling proposition).

Aggressiveness in particular, to suggest an extremely low price level, is a dominating and dynamic factor in *Saturn's* market image. This price aggressiveness is achieved particularly through instore communication and distance mass communication, i.e. media advertising, and thus has an important influence on *Saturn's* brand image (Zentes/Neidhart/Schramm-Klein 2005).

History of Media Markt

The following case study focuses on *Media Markt*. In 1979, Walter Gunz, Erich and Helga Kellerhals as well as Leopold Stiefel, the management CEO until the end of 2006, opened the first *Media Markt* in the Euro-Industriepark (commercial zone) in Munich. With the discount-oriented category-specialist concept "Everything under one umbrella" they were ahead of their time. At the end of the 1970s and beginning of the 1980s, consumers bought televisions from the local consumer electronics retailer, sound storage media at the music shop and washing machines from mail-order companies. The selection within each respective category was limited – and prices correspondingly high. "A limited sales area combined with a limited number of articles within the assortment as well as good margins" – is how Leopold Stiefel described the company's philosophy which paralleled that of many consumer electronics retailers at that time – until the establishment and the great success of the *Media Markt* concept: impressive outlets with a large sales area, large line extensions in all categories – and high sales figures combined with a narrowly calculated contribution margin. Additionally, current brands under one umbrella were already consistently in the focus during the start-up phase.

No. 1 in Europe

In 1988, the *Metro AG* acquired a 54 % interest in *Media Markt* with the help of the *Kaufhof AG*. Today, Stiefel still holds 5 % of the company, Kellerhals about 20 % and *Metro* about 75 %. *Media Markt* is Europe's no. 1 in the consumer electronics specialised discounter sector. With the help of constantly low prices, a unique product range of the latest brands throughout the industry and an enlarged net of specialised discounters, *Media Markt* has succeeded in achieving market leadership with a healthy margin over the competition.

Internationalisation

In recent years, *Media Markt* has been characterised by an increasing internationalisation with the aim of concentrating its market presence within a short period of time. In addition to the domestic German market, the company is currently also active in France (since 1989), Austria (since 1990), Switzerland (since 1994), Hungary (since 1997), Poland (since 1998), Italy (through the take over of *MediaWorld* in 1999), Spain (since 1999), the Netherlands (since 2000), Belgium (since 2002), Portugal (since 2004) and Greece (since 2005). It is thus further extending its leading market position in Europe. Further market entries in Russia and Sweden are planned for the near future. Foreign business currently has a 50 % share of total turnover – and this share continues to rise (Media Markt 2006b).

Positioning of Media Markt as Modern Category Specialist

Media Markt positions itself as a high-performance and price-aggressive specialised discounter through a comprehensive assortment of an average of about 45,000 articles from the following departments: telecommunication, computer, photo, hi-fi and consumer electronics. A broad service portfolio and competent and individual consulting are part of the (international) service standard (Media Markt 2006a).

Advertising Campaigns

The outward presentation of *Media Markt* in the international market (with slight country-specific modifications) is characterised by the powerful and catchy advertising campaign "Ich bin doch nicht blöd!" (I'm not stupid!) which deliberately polarises consumers. This campaign contributes to the high level of name recognition for the company. For example, 98 % of Germans are acquainted with both brands of the *Media-Saturn-Holding* and 70 % also buy there. These advertising messages were flanked in 2006 by the seasonal campaigns "Bester Media Markt aller Zeiten – Wir holen den Titel!" (The best Media Markt of all time – we earn the title!) and within the scope of *Saturn's* internationalisation "Saturn wächst nach Europa – mehr Leistung für Sie!" (Saturn expands throughout Europe – more performance for you). Since the formation of the company, the attributes "humour" and "honesty" are used to communicate the great selection of brand products at low prices. With the help of these attention-grabbing and emotive advertising campaigns, *Media Markt* has succeeded in stabilising its brand image in terms of consumer awareness and in further developing its position as a distinctive retail brand.

Organisational Structure

The decentralised organisational structure within the distribution outlets makes a considerable contribution to the continuous and profitable growth of the *Media-Saturn-Group*. As fellow partners, *Media Markt's* managers are directly integrated into and responsible for corporate success. Accordingly, the managers hold a share of 10 % in the (local) company and thus fulfil the role of a "local entrepreneur" – as the past has shown. They have essentially sole responsibility with regard to the assortment, pricing and scope of personnel and marketing and thus considerably influence the turnover and profitability of their own outlet.

Flexibility at the Local Level

Above all, the decentralised management structure allows a quick and flexible adaptation of the range of goods to specific customer expectations which differ according to the location. A reaction to the price and assortment activities of competitors in the direct local environment is possible both promptly and flexibly. Thus, the sales division as a whole benefits from managerial scope and autonomy in the single outlets on site. The respective prices are the "local best prices" offered by the respective outlet compared to direct

local competitors. Thus, standard prices at a national level are avoided deliberately in order to benefit from local price fluctuations and a varying willingness to pay. Individual stores benefit from the store network's high performance and the company relies on motivated employees satisfying the customers and their needs. Individual advice from trained employees as well as full services, correspond to the volume and quality of the assortment. This includes a professional repair service as well as delivery and installation of large items at people's homes.

Online-Shopping/E-Commerce at Media Markt

Whereas *Media Markt* is present in twelve European countries with its stores, there are only two Internet shops – in Italy and Germany. In all other country markets, the company's homepage in the respective country only gives product information and refers consumers to the local outlet. (Reference) prices are not indicated, because, as already indicated, they are calculated locally and thus are not valid nationally within the context of retail store business.

"MediaWorld" Online Shop

The entry into e-commerce was combined with the market entry in Italy in 1999. In the course of the take-over of *MediaWorld*, the online shop *MediaWorld.it* started at the beginning of 2000 with 500 articles. Logo and design were adapted to *Media Markt*, but with orange, green and yellow, they were flashier. Later on, it was adapted gradually and since January 2000, the company belongs to the *Media-Saturn-Holding*. Under company law, it had been a direct affiliate of *Metro Italia* up to that time. On the homepage of *MediaWorld.it*, the button "Compro online" (online shop) used to be somewhat hidden between job advertisements and the repair service. However, direct access is now possible on the homepage, enabling the customer to visit the online shop independently of visiting the homepage itself.

On the shop's main page, it was not very clear at the beginning how large the product assortment really was: apparently, about 500 electrical-equipment articles in twelve groups, from car radio to washing machine. By the end of 2000, the product range had been increased to 1,500 products, with the aim of ultimately having a shop with an assortment of 5,000 articles. At the beginning, the prices of the Internet shop represented an average of the prices offered at all 23 Italian outlets at that time. *MediaWorld* stores were not yet represented in the South of Italy or in Sicily. However, deliveries from the online shop were possible to all of Italy from the central warehouse in Monza. Today, prices are calculated on the basis of comparisons with those of domestic online competitors (see also the details within the context of online shops in Germany), are indicated on the homepage at the

respective product description and are communicated aggressively (Hedewig-Mohr 2000).

From the beginning, *MediaWorld* has guaranteed delivery within five working days, but freight costs depended on the weight of the goods. Up to the present, payment is mostly made with credit cards.

Online-Shopping at Media Markt in Germany

Assortment Strategy

At the end of the 1990s, *Media Markt* was a pioneer in electronic retailing. The online shop started with a limited assortment, which, since the platform launch, has gradually been extended with washing machines, digital cameras, printers, laptops and home-cinema products. Since December 2001, there has been a cooperation with the *Bundesverband der Phonographischen Wirtschaft* (German Federal Association of the Phonographic Industry) to offer digital music downloads. At first, an attempt was made to sell the music through the platform *Hotvision.de* which was to be established as an individual brand (Kapell 2002). After its failure, the music download was integrated into the *Mediamarkt.de* platform. Thus, *Media Markt* became the first retailer in Germany to focus on this future market. The download shop has increased the number of music titles from only 4,000 titles to over 40,000 titles in 2003, and currently offers 700,000 titles. During the same period, prices had been adjusted to conditions caused by increasing competition in the market for music downloads. In order to develop the image of a price-aggressive online supplier, the company successfully reduced the prices for music titles from 1.79 EUR to a competitive 0.99 EUR. About 2 % of all Internet users in Germany download their music online from *Media Markt*.

Online vs. Offline Pricing

The online shop concept has been relaunched several times (Kapell 2005a; Kapell 2005b). In 2004, for example, *Media Markt* competed with a new homepage and a separate online shop accessible through the normal homepage. The idea was to separate the core store retailing business from the defined non-store retailing. This was to be done more strictly than in the past, because many online suppliers performed better in price comparisons.

This again resulted in opposition within the company, because, before visiting the outlet, consumers often check online shop prices which are in general lower than store prices. The company found itself in a dilemma. When prices in the Internet shop were high, potential customers decided to buy from other online suppliers, but low Internet prices had negative effects on the store-based retail image (Ottmann 2004a, Ottmann 2004b, Wirtschaftswoche 2004). Thus, the company felt impelled to separate online and store sales more clearly in order to maintain its image as a price leader (Hanke 2004).

Since October 2005, this clearer separation between store and online business can be seen in the online shop *Mediaonline.de,* which now carries a separate retail brand and offers about 25 categories with 6,000 different articles. Therefore, the outward presentation of *Media Markt* and *MediaOnline* is completely separate, with no combined references.

Separation of Online and Offline Business

The company registers about 1.5 million online shop visitors every month and thus ranks among the top ten most frequently visited online shops in Germany. According to estimates, a turnover of about 50 million EUR is generated. In this context, *MediaOnline* is an electronic shopping platform with a comprehensive product range which can be delivered promptly and is extended continuously on the basis of consumers needs. *MediaOnline* comprises four main fields: product shop, music download, mobiles with a contract and DSL/web services. A search function implemented in the course of the relaunch, new solutions for advising customers and an active and constantly updated top-seller display in all categories, help consumers find the right product.

An expanded product comparison, for which *MediaOnline* relies on manufacturers' information, helps customers select similar products by means of checking specific features. Thus, similar articles within one product category can be compared on the basis of detailed product information – among others, also in terms of prices (MediaOnline 2006).

Through the strict separation of online and offline business, the online branch has autonomy in choosing its product assortment. That is, the online shop is not regarded as yet "another outlet", so that the online assortment is not the same as the store assortment. In addition, prices can vary considerably compared with those of the stores.

"BestPrice"-Strategy

Based on consistent price surveillance of all relevant price-comparison homepages and search engines, the company tries to guarantee the "*MediaOnline BestPrice*" (product price, ability to supply and transport costs). In this context, the pricing policy is oriented locally towards the relevant online competitors and is valid throughout Germany. Within the pricing framework, *MediaOnline* focuses less on pure online retailers such as *Amazon* for example. Instead, the company categorises competitors outside the core industry, but which sell some similar products, as direct competitors, such as *Tchibo*, *Lidl*, *Plus* or *Aldi*. It tries to perform better and more favourably than the above competitors by means of price comparisons and test evaluations, in order to create an image as the "mother of all bargains" (Trenz 2004). Here, the Internet shop works on "terms which are usual in the market". If an online product needs repair, the customer cannot use the service centres at the retail outlets, but has to process the return consignment via the button "returns processing" on the homepage (Trenz/Vogel 2004; Trenz 2005).

Within the scope of positioning, on the one hand, *MediaOnline* places high value on quick and smooth page switching in order to avoid long waiting periods and complicated clicking. The objective is to achieve a simple, clear and concise presentation based on the latest server technology and online shop software.

Logistics

On the other hand, short lead times according to the motto "What you see is what you get" are guaranteed. In principle, all products are in stock and can be delivered after payment. By means of tracking and tracing, customers can constantly follow the delivery process. In this context, logistics and back-office business have been assigned to *Dohmen Solutions*, a logistics services provider in Munich, which has a storage and fulfilment centre in Garching. Thus, *MediaOnline* can concentrate on the core competences of purchasing, efficient product-range planning and business coordination. The company does not have aggressive advertising, compared to the specialised discounter concept, because it hopes for a degree of spillover effect through *MediaOnline,* despite the strict separation of both channels.

Customers have the choice between advance payment and cash on delivery. Thus a pick up at the post office as well as financing the purchase price by *MediaOnline* are possible. For security reasons, credit card payment is not (yet) possible.

Summary and Outlook

In conformity with the concept of category killers, *Media Markt* positions itself as a price-aggressive specialised discounter – and presents this image to the customer with emotive and polarising advertising which costs the company tens of millions each year. Together with *Saturn*, *Media Markt* is "the measure of all things" for consumer electronics in the European market, in defiance of specialty stores competitors.

Multi-Channel Strategy

Recently, *Media Markt* has been confronted with a new opponent; a virtual one belonging to its own group: *MediaOnline*. Over the years, the company in Ingolstadt completely refused to offer online trading. The reason is the decentralised business model that grants the local outlet managers a maximum of autonomy, ranging from assortment decisions to pricing, according to the rule: one *Media Markt* – one price, a system that has proven to be very lucrative for the company. However, *MediaOnline* competes against regional pricing and thus store-based business. In the online shop, national prices are offered, geared to online competitors and thus often lower than those of *Media Markt* stores. It is not the local *Media Markt* which represents the price-value of the company, but more and more *MediaOnline*. This has consequences for the company and for *Metro*. The success story of *Media Markt* is,

among other factors, based on the model of reducing prices only up to the point required by regional competition. Price comparisons made from time to time by different institutions and in which *Media Markt* seems to be more expensive than competitors did not cause much damage (Vogel 2004). By establishing *MediaOnline,* the company provides for an ongoing price comparison – if the consumer is acquainted with the affiliation of the online retailer to *Media Markt*. This is all the more so, as the online shop offers many products – from plasma TVs to washing machines and refrigerators –, which are also available in the *Media Markt* outlets. In doing so, the intrinsic restrictions of store business are deliberately accepted – to the regret of the local store managers who have a direct holding in the company. Whether this decision has a final character or whether changes will be made within the context of a further relaunch is not yet clear. "If we want everything to remain as it is", says *Media Markt* corporate philosophy, "we have to be permanently prepared to change everything".

Questions

1. *Media Markt* operates in the market with both category killers and online shops. What are the typical characteristics and advantages of these retail formats? To what extent do these characteristics and advantages apply to the retail formats used by the *Media-Saturn-Group*?
2. The parallel use of different retail formats and/or sales formats is referred to as multi-channel retailing. What are the opportunities and risks associated with this concept in general and for *Media Markt* in particular?
3. *Media Markt* has online shops only in Italy and Germany. Assess the relevance of this retail format within the framework of the company's future internationalisation.

Hints

1. For a discussion of the advantages and disadvantages, see Chapters 1 and 2 as well as Levy/Weitz 2007.
2. See Berman/Evans 2007 and Krafft/Mantrala 2006 on the concept of multi-channel retailing. Take into account the web sites www.media-markt.com and www.mediaonline.de.
3. Check the country-specific web sites of *Media Markt* and look for existing online shops.

Chapter 3

New Competitors – Vertical Strategies

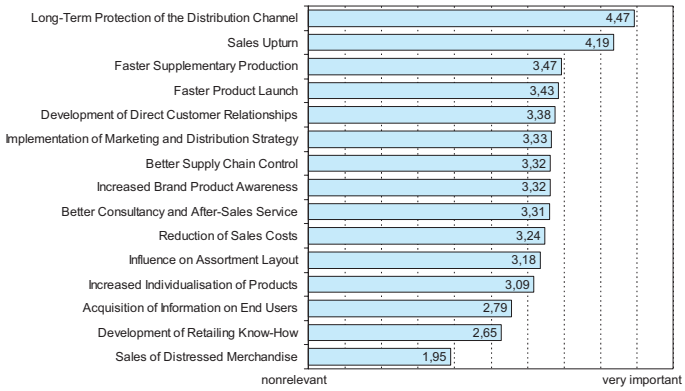
The objectives of this Chapter are to describe the role of controlled and secured distribution systems within the channel strategy of manufacturers as well as the development of the so-called verticals and to examine the impact on retail competition. Specifically, some suppliers are becoming competitors for their customers.

Channel Innovations as Driving Forces of Competition in Retailing

The retail industry is changing rapidly. Some of the most important changes involve the growing diversity of retail formats, including non-store retail formats, as discussed in Chapter 1 and Chapter 2, and new vertical marketing systems or new distribution arrangements.

Motives/Objectives of Verticalisation

Figure 3.1



Source: Zentes/Neidhart/Scheer 2005, p. 12.

New players in the world of retailing are, to an increasing extent, manufacturers operating in *secured distribution systems* (fully integrated systems) or *controlled distribution systems* (contractually-based systems). In both types of

vertical marketing systems, the manufacturer can exercise power in the distribution channel (Zentes/Neidhart/Scheer 2005). Figure 3.1 illustrates the motives or goals of manufacturers implementing vertical marketing systems. The various distribution arrangements with differing degrees of *channel control* are described in this Chapter.

In addition to this *verticalisation* tendency of manufacturers which have operated traditionally with independent wholesalers and/or retailers in *independent systems* (Berman/Evans 2007), another approach can be identified. *Verticals* are firms that perform all production and distribution functions right from their founding ("born verticals").

Secured Distribution Systems

In secured distribution systems (fully integrated systems), a manufacturer performs all distribution functions. In addition to traditional direct selling, new kinds of secured distribution systems are emerging, including electronic selling and equity stores.

Direct Selling

Fully Integrated System

Direct selling is a vertical marketing system "in which salespeople, frequently independent businesspeople, contact customers directly in a convenient location, either at the customer's home or at work; demonstrate merchandise benefits and/or explain a service; take an order; and deliver the merchandise of perform the service" (Levy/Weitz 2007, p. 55).

Table 3.1 *Importance of Direct Selling in Germany*

Direct Selling Turnover by Industries in million EUR	1994		2004
Food (sales cars, frozen food, wine, dietary supplements)	4.419	↗	5.430
Personal Care and Effects (cosmetics and body care, including watches and jewellery)	426	↗	559
Textiles (without collective buyers)	15	→	17
Home and House (windows, doors, built-in kitchens etc.)	735	↘	291
Household Articles (cooking pots, plastic containers etc., including cleaning materials)	675	↗	820
White Goods (small electronic domestic appliances)	438	→	440
Books, including Encyclopaedias	204	→	200

Source: Prognos 2005.

In such a fully integrated system a firm "has total control over its strategy, direct customer contact, and exclusivity over its offering; and it keeps all profits" (Berman/Evans 2007, p. 116). Direct selling is employed by manufacturers such as *Avon*, *Tupperware* and *Amway*.

Table 3.1 illustrates the development of direct selling in different industries in Germany between 1994 and 2004. Overall, the total turnover generated by direct selling has grown by 12 percent.

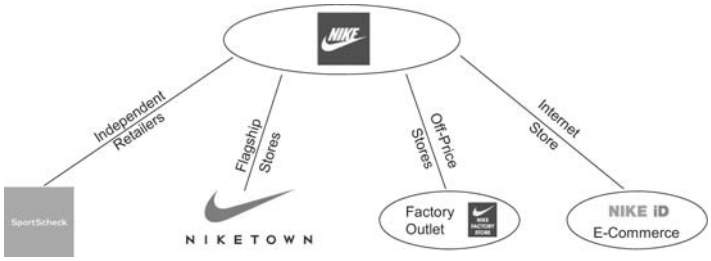
Electronic Selling

Electronic selling (by Internet or television) is a technological form of direct selling. The manufacturers communicate with customers and offer products and services for sale over the Internet, for example. The rapid diffusion of Internet access and usage has stimulated not only *bricks-and-mortar retailers* to create Internet shops, but also pure electronic retailers (*pure players*) have evolved, such as *Amazon*. Manufacturers have also discovered this distribution channel, too, within the framework of a multi-channel approach such as *Nike* (see Figure 3.2) or as pure players, which are discussed later in this Chapter.

Multi-Channel Distribution

Multi-Channel Distribution - Nike

Figure 3.2



Equity Stores

Equity stores are a bricks-and-mortar approach of secured distribution. The manufacturers operate store retail formats. The major types are specialty stores, flagship stores and factory outlets (see Figure 3.3).

Manufacturers, especially in the apparel industry, shoe industry, jewellery industry, sports equipment industry, and home equipment industry often

Monobrand Stores

operate *monobrand specialty stores*. Under the ownership of the manufacturer multiple store units are managed as a *retail chain*. The manufacturers exert strong control, decision-making is centralised.

In *flagship stores* manufacturers offer their total production programme in a high-quality presentation (lifestyle presentation) in top locations of large metropolitan markets.

Figure 3.3 *Equity Stores of Gucci*

Factory Outlets

Factory outlets, operated as isolated stores (free standing retail outlet) or integrated in factory outlet centres (FOC), are viewed by manufacturers "as an opportunity to improve their revenues from irregulars, production overruns, and merchandise returned by retailers. Outlet stores also allow manufacturers some control over where their branded merchandise is sold at discount prices" (Levy/Weitz 2007, p. 53).

As an example of a multi-channel distribution system, Figure 3.3 shows the different types of channels through which *Nike* sells its products: independent retailers or retail chains, like *SportScheck* in Germany or *Sport 2000* in France, flagship stores, as in New York, Miami, San Francisco, London or Berlin, factory outlets, for example in FOCs in Zweibrücken, Herzogenaurach, Metzingen (Germany) or Oregon (USA), Queensland (Australia), Alicante (Spain) and an Internet store.

Controlled Distribution Systems

The structure of controlled distribution systems is extremely diverse and varies from industry to industry. In general, these so-called contractual concepts can be broken down into *dealer partnership programmes* and *franchise systems*.

Contractual Arrangements

Dealer partnership programmes are (long-term) partnership contracts in which the manufacturer offers a limited support package, including, for example, marketing, advertising, training and IT to the participating dealers. "In most of the programmes the dealer also benefits from a common branding. In return, the dealer predominantly markets the brands of the manufacturer. The concepts are often viewed as customer loyalty programmes for independent dealers through which the company can rapidly increase its retail presence" (Uellendahl 2002, p. 208). There are dealer partnership programmes, for example, in the apparel industry as shop-in-shop concepts, corner concepts and concession shops (Zentes/Neidhart/Scheer 2005), or in the tyre business (replacement business) as dealer partner concepts. As an example, the *Goodyear Dunlop Company* runs outlets in Germany through the retail concepts *HMI* and *HMI plus*, in the United Kingdom by *Hi-Q*, in France by *Vulco*.

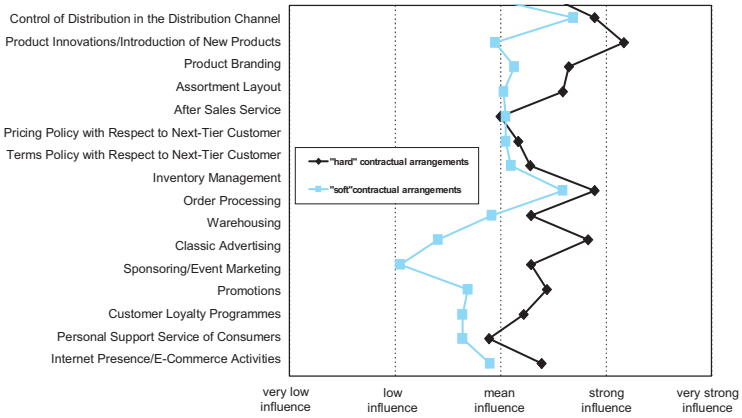
Franchising (see also Chapter 4) involves a contractual arrangement between a franchisor (e.g. a manufacturer) and a (retail) franchisee, "which allows the franchisee to conduct business under an established name and according to a given pattern of business" (Berman/Evans 2007, p. 110). Linked by a common business interest, each partner makes his contribution to the cooperation. Thus, both partners (franchisor and franchisees) benefit from the strength of the other. Uellendahl (2002, p. 208) describes the structure of the *Goodyear Dunlop* franchise systems ("*Premio*", "*Quick*"), operating in the German replacement market:

- The franchisor contributes the complete business know-how and organisation (e.g. full support package including marketing, sales promotion, training, IT, auto service, CRM, national advertising, business counselling, business planning, common branding, financial support, etc.).
- The franchisee contributes his individual effort as an independent businessman in the local market.

As controlled distribution systems, franchise systems are operated in many industries, for example by car manufacturers (auto/truck dealers), by auto accessory manufacturers (auto accessories stores), by consumer electronics manufacturers (consumer electronic stores), hardware manufacturers (hardware stores) and by apparel manufacturers (specialty stores). Examples in the apparel industry are *Palmers*, *Rodier*, *Benetton*, *Boss*, *Marc'O Polo*.

Figure 3.4 illustrates the differences concerning the influence of manufacturers on distribution channels in "hard" contractual arrangements (e.g. franchising) vs. "soft" contractual arrangements (e.g. dealer partnership programmes).

Figure 3.4 *Influences of Manufacturers on Distribution Channels in Hard and Soft Contractual Arrangements*



Source: Zentes/Swoboda/Morschett 2005, p. 683.

Secured, controlled and independent distribution systems are presented in Figure 3.5, which characterises these systems in the context of the market-hierarchy paradigm of *transaction cost economics*.

Figure 3.5 *Vertical Marketing Systems and Transaction Cost Economics*

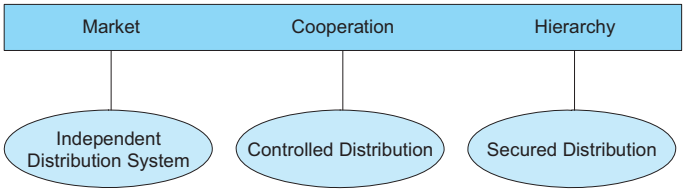


Table 3.2 provides an overview of the main advantages and disadvantages of the different concepts of controlled distribution and secured distribution. The "high degree of control" in secured distribution systems (equity stores) includes retail pricing.

Vertical price fixing in controlled distribution systems is not allowed in the European Union. When manufacturers seek to control the retail prices of their goods and services, equity stores are the best way.[1]

Advantages and Disadvantages of Secured and Controlled Distribution Concepts

Table 3.2

	Strengths	Weaknesses
Equities	• high degree of control • organisational control • brand/promotional control • guaranteed distribution	• high capital costs • huge operational costs
Franchising	• limited capital costs • less ownership risk • guaranteed distribution • low fluctuation	• limited control
Dealer Partnerships	• low-cost solution • rapid expansion	• little control • high risk of losing partners • less stability

Source: Adapted from Uellendahl 2002, p. 209.

Figure 3.6 illustrates the distribution system of the German manufacturer *MUSTANG*, which operates retail partnership concepts, franchising and equity stores.

Table 3.3 shows the development of the outlet network of *Villeroy & Boch*, tableware division, including equity stores, consignment selling and franchise stores in Germany and abroad.

[1] Another possibility is consignment selling, whereby the manufacturer owns items until they are sold by the retailer. This contractual arrangement can be combined with controlled distribution systems. Empirically, this combination is rare because of legal boundaries (in the EU).

Figure 3.6 *Controlled and Secured Distribution – MUSTANG*

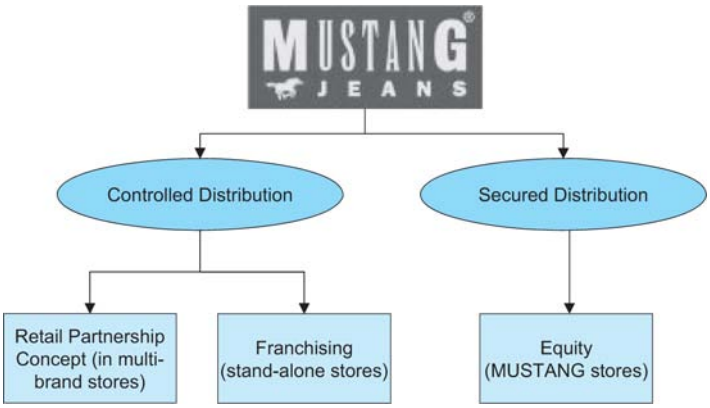


Table 3.3 *Development of the Outlet Network of Villeroy & Boch (Tableware Division)*

	2002	2003	2004	2005
Germany (domestic market)	73	76	76	76
Foreign Countries	224	290	309	322
Total	297	366	385	398

Source: Villeroy & Boch.

Verticals

The so-called verticals perform all production and distribution functions themselves right from their founding. Examples of this type can be found in the e-business (electronic retailing), but also in store formats.

Dell (www.dell.com), for example, appeals to multiple market segments – from novice to advanced computer user – by selling customised products exclusively over the Internet. *Hennes & Mauritz* (*H&M*), *Mango* and *Zara* are successful examples from the apparel industry, in which verticals are gaining market share. Table 3.4 provides an overview of the global outlet network of *H&M*.

Global Outlet Network of H&M

Table 3.4

Markets	Number of Outlets	Markets	Number of Outlets
Belgium	48	Norway	78
Denmark	56	Austria	52
Germany	288	Poland	27
Finland	27	Portugal	7
France	71	Sweden	124
Great Britain	102	Switzerland	52
Ireland	4	Slovenia	2
Italy	10	Spain	50
Canada	11	Czech Republic	12
Luxemburg	7	Hungary	1
Netherlands	73	USA	91

Source: H&M 2006.

The basic competitive advantage of verticals has its roots in controlling the total value chain, especially with regard to supply chain management and quick reactions (*quick response*) to changes in consumer behaviour. Verticals can launch new products faster and quickly produce supplementary volumes within a season. Companies such as *H&M*, *Mango* and *Zara* control the value chain "from sheep to shelf".

Conclusion and Outlook

The development of controlled and secured distribution channels – as possible sales channels for a manufacturer – is a core element in the marketing strategy of many manufacturers. While secured distribution used to involve the development of equity chains (owned by the manufacturer), the situation has changed considerably. Over the Internet, a manufacturer can sell directly to consumers without bricks-and-mortar stores and through dealer partnership programmes and franchising, manufacturers can be engaged in contractual distribution systems, which means cooperating with independent dealers. Technological developments and contractual arrangements enlarge the potential for controlling distribution channels.

The main challenge is to manage the potential conflict in multi-channel distribution systems, between independent retailers, selling products from a particular manufacturer, and retailers, cooperating in a contractual system with this manufacturer on the one hand, and equity stores from this manu-

facturer as competitors on the other hand. As "pure players", verticals are in a much better position – they do not compete with their customers.

Further Reading

COUGHLAN, A.T. et al. (2001): Marketing Channels, 6th ed., New Jersey.

KPMG (Ed.) (2001): Verticalization in the Trade: Effects in the Future Sales Channel Structure, Cologne.

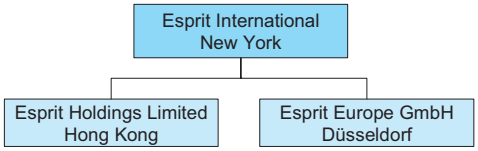
ROSENBLOOM, B. (2004): Marketing Channels: A Management View, 7th ed., Mason.

Case Study: Esprit[1]

Profile, History, and Status Quo

Esprit is an international, youthful lifestyle apparel brand "offering smart, affordable luxury and bringing newness and style to life" (Esprit 2005, p. 2). The company was founded in San Francisco in 1968 by Susie and Doug Tompkins as *Plain Jane Dress Co.* and has since been transformed into the Hong Kong-based *Esprit Holdings Limited* in 1993, with a second listing on the London Stock Exchange since December 1998. The group's current basic organisational chart is represented in Figure 3.7.

Figure 3.7 *Esprit's Basic Organisational Chart*



Esprit Holdings Limited (EHL) and *Esprit Europe GmbH* are both affiliates of *Esprit International*, a private limited partnership whose financial information

1 Sources used for this case study include the web sites http://www.esprit.com and http://www.esprit-intl.com, various annual reports, the interim report 2005/2006, investor relations presentations and services as well as explicitly cited sources.

is not available to the public. While the financial office as well as sourcing activities are situated in Hong Kong, the group is strategically and operationally led from its headquarters in Düsseldorf, Germany, where it started as a distribution facility in 1975 and developed into the headquarters, due to the enormous success in Europe and especially Germany.

Around 100 designers in Düsseldorf are also responsible for the approximately 16,000 annual apparel designs. *Esprit International,* New York, can be regarded as the "image" headquarters of the company (Gallagher 2003, p. 24).

12 Product Segments in 3 Business Segments

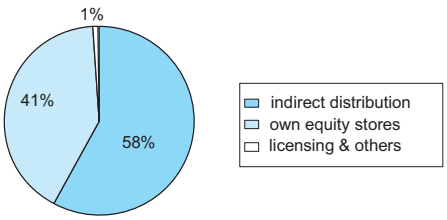
The group, with its approximately 8,000 employees, currently offers twelve product segments encompassing women's wear, men's wear, kids' & youth wear as well as shoes and accessories in three business segments: indirect distribution to department stores and major independent retailers (currently there are around 10,000 various point-of-sales worldwide, termed "wholesale" from *Esprit's* perspective) and directly-managed own equity stores (currently 670).

The *Esprit* logo is also licensed to third-party licensees who offer non-apparel products, such as jewellery, watches or umbrellas, bearing the same *Esprit* quality and image to consumers.

Figure 3.8 gives an overview of the extent of indirect distribution ("wholesale"), own equity stores and licensing in the group's total turnover for the year 2005/2006.

Group Turnover by Business Segment (in %)

Figure 3.8



Source: Esprit Holdings Limited 2006, p. 6.

The most important milestones in *Esprit's* history are summarised in Table 3.5. The group operates in nearly 60 countries on four continents today.

Table 3.5 *Milestones in Esprit's History*

Year	Activities
1968	Douglas and Susie Tompkins found Plain Jane Dress Co. in San Francisco
1971	The company is renamed Esprit de Corp.
1974	The Tompkins form a partnership with Michael Ying to set up a company as the principal sourcing agent for Esprit de Corp. in Hong Kong
1978	Start of international expansion in Europe
1979	The stencil effect logo is created
1986	European design office established in Düsseldorf
1988	Esprit International is created to manage and develop the Esprit brand worldwide
1997	Esprit Asia Holdings Ltd acquires Esprit Europe and Esprit Sourcing and is renamed Esprit Holdings Ltd to reflect the company's global vision
1998	Red Earth, a cosmetic business, is acquired
2002	Esprit Holdings Ltd purchases the U.S. trademark rights and unifies the global Esprit brand

Esprit's Business Strategy

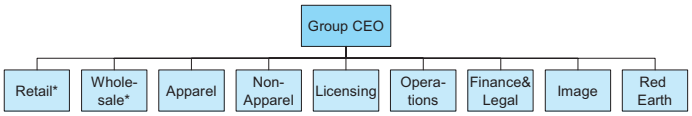
Global Brand – Global Organisation

Difficulties in the Late 1980s

After *Esprit's* success during the 1970s and 1980s, sales and margins began to erode due to new competitors offering young fashion, such as *Hennes & Mauritz* or *The Gap*. Furthermore, internal management difficulties arose. After the founders' divorce, a downward sales spiral ended when their share in *Esprit de Corp.* was sold to the investment companies *Oaktree Capital Management* and *Cerberus Partners* in 1996. These developments resulted in the regions America, Asia, and Europe being controlled and operated separately by different shareholders (Cooney 2002, p. 128), connected only by some shareholder interest. The plan to unify the brand started in the mid-1990s, when *Esprit Europe* and *Esprit Sourcing* were acquired by *Esprit Asia Holding Ltd*, as well as 63 % of *Esprit International*. In addition, *Esprit Asia Holding Ltd.* was renamed in *Esprit Holdings Ltd.* in order to make allowance for the company's global vision. In February 2002, *Esprit Holdings Ltd.* acquired the US and Caribbean trademark rights for the *Esprit* brand, totalling 150 million USD, from its franchisees, completing the so-called "global jigsaw" (Yeung 2002). For the first time since its beginnings in the 1960s, the *Esprit* brand was under one central control. This step was completed by acquiring the remaining 37 % stake in *Esprit International,* which had controlled *Esprit's* trademark rights outside the USA. Subsequent to the US acquisition, the group also implemented a new global management structure (see Figure 3.9).

Global Management Structure

Figure 3.9



Source: Ho 2003, p. 8.

Brand Unification

The restructuring encompassed a changed focus from a country-based reporting structure to a mixed functional and divisional reporting structure. The centralisation of each function for all geographical markets was intended to provide brand unification. Additionally, in the case of a function's or a division's poor results, management hopes that it can detect the underlying reasons more quickly (Bergmann 2004, p. 24).

From a strategic point of view, *Esprit* implemented a global strategy that combines international presence and economies of scale with local execution, ensuring timely responses to market and customer needs. As a result of the unification in 2002, the brand equity of *Esprit* is estimated to have risen greatly, thus enhancing the core asset of the company as the foundation of its global growth strategy.

Balanced Growth

Foundations of the Global Strategy

The group pursues a so-called balanced growth strategy of further extending its global reach, which is based on the following foundations:

- further penetration of existing markets
- entering new markets.

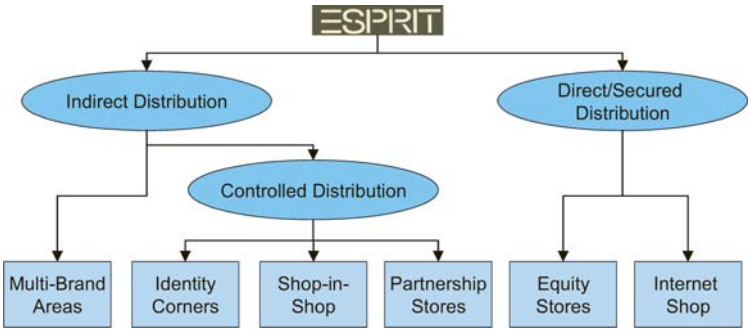
This simple business strategy builds on the following complex infrastructures:

- twelve product divisions
- twelve production cycles for each product line each year
- operating and distribution network on four continents
- sourcing activities in Europe and particularly in Asia.

* The terms "retail" and "wholesale" are used by Esprit and correspond to direct/secured distribution, i.e. own equity stores, and indirect distribution, respectively.

With respect to distribution, *Esprit's* business strategy is based on two channels, which the company calls "wholesale" and "retail" and which can be categorised into indirect (controlled and non-controlled) and direct/secured distribution. This is analogous to the systematisation presented in the sections "Secured Distribution Systems" and "Controlled Distribution Systems" (see Figure 3.10).

Figure 3.10 *Indirect and Direct/Secured Distribution at Esprit*



Minor Local Adaptations

Licensing is *Esprit's* other important business segment; products manufactured by licensing partners are again distributed via the controlled and secured distribution channels. According to the respective country conditions, for instance, in terms of intensity of competition and brand recognition, parts of the infrastructure are combined individually and appropriately and are also, if necessary, revised. Operating on four different continents implies the necessity to meet customer demands in specific markets. This includes accommodating trends and size requirements in the USA (Wilson 2002, p. 52), for example, or the tropical climate of the Caribbean islands (Rosa 2004, p. 30). However, these local adaptations must not undermine the global brand image. *Esprit* tries to achieve an optimum mixture of global standardisation and economies of scale on the one hand and local differentiation on the other.

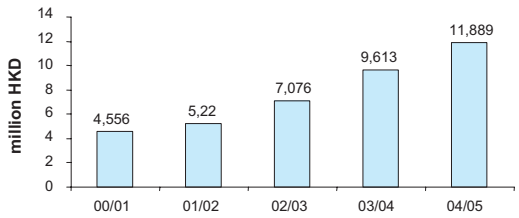
Indirect Distribution

Indirect distribution, i.e. distribution with the help of a retailer, used to be *Esprit's* sole channel of distribution. With a turnover underpinning about 58 % of *Esprit's* total turnover of 2,075 million EUR in 2004/2005, indirect distribution still represents the most important business segment (see Fig-

ure 3.8). Conventional multi-brand areas in department stores or independent retailers, where the *Esprit* brand is displayed along with numerous other brands, represent the non-controlled distribution channel. The retailer can dispose of the purchased merchandise as he wishes. Controlled distribution, on the other hand, allows the manufacturer to exert control over the retailer based on the underlying contractual arrangement. The level of control increases from identity corners, shop-in-shops to partnership stores (see Figure 3.10). In the case of identity corners, the brand's products are still sold on the respective floor, but displayed as an entity vis-à-vis the rest of the offered merchandise. Shop-in-shops are self-contained spaces within the department store or independent retailer, complete with *Esprit's* own fixtures and staff. Partnership stores are stand-alone stores managed by a franchisee that pays a fee and a monthly percentage of sales in exchange for the rights to sell the products. Furthermore, the franchising contract defines the pursued marketing strategy which the franchisee is obliged to follow.

Development of Indirect Distribution Turnover (in million HKD)

Figure 3.11



Source: Esprit Holdings Limited 2005, p. 26.

Since *Esprit* seeks to invest in controlled distribution at the expense of multi-brand areas, no official distinction is made between controlled distribution and multi-brand areas. Therefore, figures on direct distribution always include non-controlled distribution. Figure 3.11 illustrates the segment's overall development over the last five years.

Sales area accounted for 443,321 m^2 in 2004/2005. For the second half of the financial year 2005/2006, *Esprit* continued to expand its controlled distribution reach through opening over 500 shop-in-shops, partnership stores, and identity corners in core markets. Breaking down controlled distribution turnover into regions, Europe is revealed as the core market, accounting for 94 % of group turnover; Germany alone totals about 47 %.

Shift of Priority to Controlled Distribution

As of 31 December 2005, the group has been operating 6,591 identity corners, 3,227 shop-in-shops and 585 partnership stores. Since *Esprit* has shifted its priority to controlled distribution, thus strengthening its control over the retail partners, not only an increased number of openings of shop-in-shops and partnership stores is implied, but also the conversion of multi-brand areas into more controlled formats as part of the efforts to enhance brand positioning. This effort involves a careful selection of retail customers in order to increase the quality of distribution, as well as tightened control over visual quality within the department stores, achieved by creating a "defined Esprit ambiance" (Esprit 2005, p. 24) and by exclusively offering a certain number of *Esprit* products. With regard to the group's balanced growth strategy, the conversion to more tightly controlled distribution channels is pursued in the case of further penetration of existing markets. When expanding into new ones, shop-in-shops and identity corners are used in order to minimise capital expenditure.

Penetration of Existing Markets

Furthermore, a rough distinction is made in terms of the population. Partnership stores are preferred in cities with a population below 200,000. If this number is exceeded, *Esprit* tries to establish its own equity stores (see the following section), mostly in addition to already existing indirect distribution.

Relaunch in the USA

For its USA relaunch in 2002, the group first sold its 20 existing equity stores as well as its 20 off-price stores. (The controlled distribution business in the USA had already disappeared.) This step was undertaken with the aim of starting fresh, "with a clean slate" (Wilson 2002, p. 52). In accordance with its balanced growth strategy, the group focused on indirect distribution as its first priority in the new market in order to achieve synergies. Economies of scale could be generated by assimilating all US resources into the current operations in other regions. Minimising capital invested also minimised the business risks (Ho 2003, p. 6). On the one hand, *Esprit* tried to regain its former position as a leading apparel vendor to department stores in the USA (Scardino 2004, p. 60) and on the other hand, the indirect distribution business was a stepping-stone for testing the brand image with US customers after its long absence from the market. However, *Esprit* tried to present its products through shop-in-shops instead of mixing it with other brands on multi-brand floors (Greenberg 2004, p. 58). *Esprit* thus aimed at a higher degree of control in the US indirect distribution business, because the company itself knows best how to flow merchandise properly and what sells (Scardino 2004, p. 60). During the 1980s, *Esprit* had introduced the shop-in-shop concept in the USA. In 2003, it began selling the product lines women's wear and men's wear as well as the junior brand *edc* to the department stores *Macy's, Dillard's, Marshall Field's* and *Nordstrom* as a first step in reconquering its former home market.

Direct/Secured Distribution

Esprit pursues secured distribution through its own, directly managed equity stores (flagship stores, full price stores as well as off-price stores) and its e-commerce site *e*shop*. During the early 1980s, the company also operated a popular direct mail-order catalogue which was discontinued in 1984.

First Equity Store in 1983

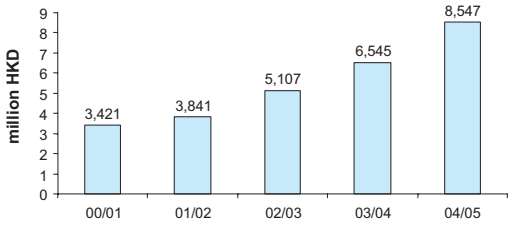
In 1983, *Esprit's* first free-standing, directly operated equity store opened in Hong Kong. In the mid-1980s, new *Esprit* stores were established in many major cities around the world. Innovative designs provided free advertising through press coverage and the company developed its unique display style. In 1985, secured distribution operations began in Singapore. The following year, a European design centre in Düsseldorf was established, and *Esprit* opened its first own equity store in Germany. During the 1990s, the Pacific Rim became the most active retail zone, with *Esprit* stores opening in Hong Kong, Korea, Taiwan, Singapore, Thailand, Malaysia, Indonesia, China, and Japan. In 2005, *Esprit* Australia opened its fiftieth store, and in the United Kingdom, Belgium and Holland, store numbers doubled in less than a year. *Esprit* is present in most of its markets with both indirect and direct/secured distribution channels, typically starting with retail partners to build market share with comparatively little capital investment and adding equity stores later on.

50th Equity Store in 2005

Currently, secured distribution accounts for about 41 % of group turnover (see Figure 3.8). Figure 3.12 provides an overview of the business segment's development over the past five years.

Development of Secured Distribution Turnover (in million HKD)

Figure 3.12



Source: Esprit Holdings Limited 2005, p. 30.

At *Esprit's* own equity stores, the merchandise is displayed in a distinct brand ambiance and the product assortment is deeper and wider than at identity corners or shop-in-shops. In the financial year 2004/2005 which

ended 30 June 2005, retail sales area comprised 194,000 m². During the first half of the financial year 2005/2006, 70 directly managed equity stores were opened and 30 were closed, resulting in an increase in sales area of 13 % to over 210,000 m² in 670 directly managed stores worldwide. The group plans to expand its retail network further by adding new stores primarily in Europe. Around 40 stores are scheduled to be opened in the second half of the financial year 2005/2006, representing an increase of selling space of over 12,000 m². With an increased focus on an enhanced local assortment of products that encompasses quality and newness, *Esprit* expects to drive traffic into its stores worldwide.

Customer Loyalty Programme e*club

Esprit offers its customer loyalty programme *e*club* only at its own equity stores. Customers can sign up free of charge, receive their *e*club* card and automatically become *e*club* members. For each purchase, customers collect *e*points* according to the value of their purchase. If a certain level of points is achieved, *Esprit* sends vouchers which can be redeemed against future purchase. Additionally, special promotions are held regularly, such as double *e*points* weeks or special promotions including a breakfast with the top customers. The *e*club* is available in *Esprit's* own equity stores in Austria, Belgium, Canada, Denmark, Finland, France, Germany, Liechtenstein, Luxembourg, the Netherlands, Norway, Sweden, Switzerland, the United Kingdom and the USA.

After having closed its previous own equity stores in the USA, *Esprit* opened a 1,000 m² flagship store in Manhattan, New York, in September 2004. As of 31 December 2005, the group operates 14 own equity stores in the USA, with eleven in the New York/New Jersey area. Despite the initial plan to focus on controlled distribution, the group now emphasises the development of its own equity stores (Moin 2004, p. 3). In adapting to US consumer habits and circumstances, *Esprit's* own equity stores in the USA are not stand-alone as in Europe, but mall-based, lifestyle stores with only about 800 m² selling space, as opposed to 2,000 to 2,500 m² of sales area in Europe (Chain Store Age 2004, p. 7).

Internet Shop

The online *e*shop* is an important part of the group's retailing strategy, offering a full range of apparel products and is currently available to consumers in the following countries: Austria, Belgium, Denmark, France, Germany Netherlands, Switzerland, United Kingdom, and USA. In 2003, the online shop attracted approximately 200,000 visitors a month. The company regards the *e*shop* as complementary to its equity stores and as an opportunity to collect customer data directly, which can then used to implement business improvements and attract new customers.

Licensing

Function of the Licensing Segment

Licensed products sold under the *Esprit* brand name help enhance the brand's penetration in various markets and contributed third party royalty income of 58.1 million HKD in the last financial year, representing about 1 % of group turnover (see Figure 3.8) as well as a year-on-year increase of 2.8 %. This growth is the result of *Esprit's* strategy of focussing on strong product categories and key licensees so as to maximise synergies. However, the increase was partly offset by a 36.5 % decline in licensing income from third party licensees in the recently-entered US market.

As of 31 December 2005, product licensees collectively offer 26 categories of licensed products to consumers worldwide. Core licensed product categories are watches and glasses/sunglasses which continue to develop rapidly. Newer categories which are gathering momentum include bed & bath, towels, cosmetics & fragrance, and umbrellas. New licensing contracts including furniture & carpets and soft toys for Europe were recently added in order to further strengthen the brand image.

Despite the limited contribution of licensed products to the group's total turnover, the business segment is estimated as vital and essential through its potential to enhance brand image. As a means of strengthening its own equity stores, *Esprit* distributes licensed products mainly through its secured distribution channel and limited product categories, such as jewellery, with controlled distribution, especially in department stores.

Summary and Outlook

Soon Equally Strong on Three Continents?

According to experts, *Esprit* is "in an excellent position to become the first brand equally strong on three continents: America, Europe and Asia" (Kuchment/Theil 2004, p. E24). Its vertically completely integrated supply chain allows it to react very fast to changing consumer trends. However, the group has encountered more difficulties than anticipated in the context of its re-entry into its former home market, the USA. Apart from the resignations of three top US executives, some key department stores have stopped carrying the brand and a number of licensing agreements have also been put on hold (DeCarlo 2005, p. 5). The company announced its plan to stop selling the women's career collection as well as the entire men's wear line and to concentrate on casual and junior women's wear and accessories in the USA after reporting a loss of approximately 15 million USD in the year ended 30 June 2005. Contracts with its retail partners are being renegotiated – currently, *Nordstrom* is the only major department store to carry the brand – and *Esprit* plans to only own equity stores in prime, "triple A" locations on the "North-West corridor" between Boston and Washington, D.C., where the

climate is very similar to that in Europe. This revision of its US strategy is necessary, due to sales which are between 35 to 70 % lower than anticipated. Furthermore, a number of license agreements were put on hold; e.g. *Nine West* prematurely terminated its contract to manufacture women's footwear, luggage, handbags and small leather goods, due to disappointing sales (Women's Wear Daily 2004, p. 12).

Retail Store of the Year Award

In 2005, *Esprit's* flagship store in Manhattan was honoured with the *Retail Store of the Year* award, a retail competition organised by the leading retail magazine *Chain Store Age*. The Manhattan store, with its modern and sleek look, is said to represent the brand's return to the US market (Chain Store Age 2005, p. 70). Given the success of *Esprit's* own equity store in the USA, as well as its difficulties with its controlled distribution channel via department stores, a trend for future development and future proportion in retail channels may be emerging. Group CEO Heinz Krogner reportedly said that the focus of the US business is now on secured distribution: "I want to make my own stores strong" (cf. Moin 2004, p. 3). Officially, the group plans to open over 500 new shop-in-shops, partnership stores and identity corners as well as about 40 new equity stores worldwide totalling over 12,000m² for the second half of the financial year 2005/2006.

Focus on Secured Distribution

Esprit Academy

The *Esprit Academy*, a design competition held in cooperation with the London College of Fashion in 2005, represents a further attempt to strengthen the brand image via the own equity stores. The collection under the *Esprit Academy* label is sold exclusively in the company's flagship stores in Europe's leading fashion cities Düsseldorf, Munich, Frankfurt, Hamburg, Berlin, Antwerp, Copenhagen, Amsterdam, London and Paris. The competition will be developed further in the coming years, with various different international fashion colleges and various disciplines.

Questions

1. Why is it attractive for apparel manufacturers such as *Esprit* also to distribute their products via secured channels? What elements of *Esprit's* global brand strategy reflect and enhance this secured distribution strategy?
2. From a retailer's point of view, such as a department store, what are the potential advantages and disadvantages if a manufacturer uses forward integration, i.e. opens its own equity stores in addition to selling its products through the retailer?
3. Discuss the prospects of a (future) reinforced secured distribution strategy, given *Esprit's* planned further global expansion.

Hints

1. See Ho 2003 for a detailed description of the various elements of *Esprit's* global strategy.
2. See Bell/Wang/Padmanabhan 2003 for a discussion of retailer behaviour in the face of a manufacturer's own secured distribution strategy.
3. See e.g. Hauptkorn/Manget/Rasch 2005 on success factors of verticalisation strategies.

Part II

Strategic Marketing in Retailing

Chapter 4

Growth Strategies

The aim of this Chapter is to introduce the alternative routes to company growth for retailers. Ansoff's matrix, as a strategy tool, branch multiplication, cooperation and mergers & acquisitions are considered as basic alternatives for expanding the retail store network.

Growth Options

Almost all retailing activities start as independent, single-outlet operations. Compared to other business sectors, such as manufacturing, entering into retailing by opening a retail store is relatively easy and does not require high capital resources. The desire to grow business and increase its value is often a fundamental objective from the very beginning. For retailers, among other benefits, sales growth provides benefits through purchasing from suppliers in large quantities and from economies of scale in operations (e.g. IT, logistics, and administration) (Ogden/Ogden 2005, p. 92).

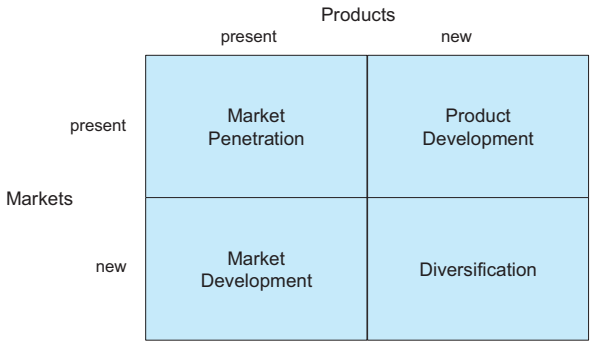
Product-Market-Matrix

For decades, strategic management has analysed the alternative routes to company growth. *Ansoff's matrix (*or *product-market-matrix)* is a well-known categorisation of growth strategies (see Figure 4.1). It consists of four separate strategies (Ansoff 1988):

- With present products and in present markets, growth can be achieved by *market penetration*. Higher sales from existing markets can either be obtained by attracting current non-customers, who either do not buy products in the offered categories at all or who buy them from competitors. Alternatively, the loyalty of existing customers of the retailer can be improved and the value of their shopping baskets increased.
- *Product development* is characterised by offering new products to existing markets. This can be done by providing the existing customer base with new product categories in the existing stores (see Chapter 8). Apparel stores expanding into selling shoes would be a good example. Considering the fact that the retailer's "products" are his stores (see Chapter 6), product development in retailing often means introducing new retail formats in existing markets (see Chapters 1 and 2). Store retailers starting to offer their products in the Internet, or supermarket retailers opening convenience stores are examples of product development.

- A current product offer can be targeted to a new customer segment, often in a new geographic area (*market development*). Regional retailers expanding their traditional store formats to other regions or national retailers expanding to new countries attempt to increase revenue for the company with this strategy.
- *Diversification* entails offering new products to new markets. *Tesco*'s *Personal Finance*, the *Rewe* Group's activities in the travel market, and *Virgin Airlines* are examples of this strategy. Because diversification often leads retailers beyond traditional retail markets, this strategy is not discussed in more detail in this book. It should be noted, however, that the management literature warns of the dangers of diversification, when the core competence of retailers lies in other fields.

Figure 4.1 *Alternative Routes to Company Growth – Ansoff's Matrix*



Source: Ansoff 1988, p. 109.

Withdrawal from Markets

While most companies focus on growth, some authors point out that Ansoff's matrix should be expanded to include the strategic withdrawal options from certain product or geographical markets (Zentes/Swoboda/Schramm-Klein 2006, pp. 118-126). Sometimes closing down or divesting (selling-off) the unprofitable parts of a business or those which do not match the current strategy, can help the retail company as a whole. For example, in 2005, *Metro* divested from the DIY market by listing its DIY retail chain *Praktiker* on the stock market, in order to focus on other, more profitable activities. In the same year, *OBI* sold its DIY stores in China to the competitor *Kingfisher*. Even though *OBI* operates about 500 DIY stores internationally and has sales of

more than six billion EUR, it decided strategically that the future investment needed to ensure success in this huge market would be too high. At the same time, the company announced the opening of 100 new stores in Europe over the next five years.

These examples demonstrate that in retailing, growth strategies are closely connected to withdrawal strategies. Retailer portfolios, with respect to their stores, store formats, and country markets, are often reassessed and a strategic withdrawal from one market often provides the starting point for expanding into other markets or for opening additional stores in the remaining markets.

Growth strategies for retailers can take two basic forms:

- enhancing sales in existing retail outlets
- enhancing sales by enlarging the outlet network.

Most retailers' statistics therefore differentiate between revenue changes in existing stores (also called *comparable store sales growth*), and changes in the scale of operations due to opening or acquiring new stores. The latter is the focus of this Chapter, because the establishment of new stores is the most important growth route for retailers. For example, *Tesco* opened more than 100 new hypermarkets in Eastern Europe between 2002 and 2006, *Kingfisher* added 27 new *B&Q* DIY stores in China in 2005, and *Fressnapf*, a German pet store retailer, was founded in 1989 and now controls a store network of about 800 stores in 11 European countries (see case study *Fressnapf* in this Chapter). These examples also indicate the most important options for outlet growth:

- *Organic growth*: Most of *Tesco*'s hypermarkets in Eastern Europe were established through *organic growth*.
- *Franchising*: Most of *Fressnapf's* growth comes from attracting new franchise partners, who open outlets under the *Fressnapf* brand.
- *Acquisition: B&Q*'s sudden growth in China originated largely from the acquisition of outlets from the German DIY retail chain *OBI*.

Organic Growth through Outlet Multiplication

Chain Stores

The direct establishment of own new outlets is usually the primary method for retailers to expand their businesses (Zentes/Morschett 2002, p. 173). It is also called *organic* or *internal growth*. The resulting *chain stores* operate multiple retail stores under common ownership, and usually engage in some level

of centralised decision-making (Berman/Evans 2007, p. 108). Large retail chain stores comprise up to several thousand stores.

Advantages of Outlet Multiplication

Opening new branches offers the advantage that the retailer's concept can be transferred to the new store right from the beginning. Location decisions, store layout and all attributes of the new store can be tailored to the existing strategy. The store managers are company employees, which enables activities to be monitored closely and decisions to be made centrally. Risk is limited as expansion is gradual.

Constraints of Outlet Multiplication

At the same time, considerable financial resources become successively tied up in the store network. The opening of branches requires substantial capital investment, which is a major constraint to growth. In many markets, organic growth is slow due to zoning restrictions, planning permission, the search for sites, including the acquisition and development of the premises, etc. This entails the risk that the critical mass is not reached fast enough and other retailers with similar concepts, but not similar constraints, expand faster. This problem particularly affects retailers that require large sites for their outlets (Zentes/Morschett 2002, pp. 173), e.g. category killers and hypermarkets (see Chapter 7), because approval for these sites is restricted in many countries.

Another drawback can be seen in a loss of flexibility over time. Many chain store operations are slower to respond to changes in consumer demand and other situational factors, due to bureaucracy and a decreasing motivation of employees which is typical of larger businesses. Tailoring the assortment to the specific local needs is often easier for independent retailers than for large chain stores (Ogden/Ogden 2005, p. 93). However, modern retail information systems increasingly allow combining centralised decision-making with a locally adapted marketing, including a locally adapted merchandise mix or prices.

Cooperative Arrangements

Joint Ventures

While the variety of cooperative arrangements is wide, joint ventures are clearly among the most popular forms of alliances. Since joint ventures are not retail-specific, they are only outlined briefly here. A joint venture is formed when two or more parties decide to undertake economic activity together and create a new enterprise as a legal entity in order to pursue a set of agreed-upon goals. The parties agree to contribute equity and share the revenue, expenses, and control of the enterprise (Zentes/Swoboda/Schramm-Klein 2006, pp. 275-278; Sternquist 1998, pp. 133-139). For example, the

French retailer *Leclerc* and the Italian *Conad* established the joint venture *Conalec* which operates a net of hypermarkets in Italy.

Combination of Resources

A major advantage of forming a joint venture is the *combination of the resources* of two companies. Both companies bring financial and management resources, know-how, store outlets or other assets to the deal. Especially when a retailer enters a new retail or service sector or a culturally distant foreign market, the market knowledge of a joint venture partner is valuable and can facilitate expansion.

Risk Reduction

Another benefit of joint ventures is the *reduction of risk* for each company by splitting the risk between the participating companies. The larger the retail company, on the other side, the more likely it is to expand on its own, because it can more easily afford the expenses and absorb the risk in this case.

Coordination Costs

The major drawback of joint ventures are the high coordination costs, because two independent partners with potentially conflicting objectives work together. Thus, managing a joint venture is more complex than managing a wholly-owned company. Full control over the strategy of the joint venture is not present, because all decisions have to consider the interests of all participating companies. As a consequence, the stability of joint ventures is often considered to be rather low.

Franchising

While the fast food chain *McDonald's* is the most-often cited example of a franchise system, many other well-known retailers also operate as franchise systems. *Benetton*, *The Body Shop*, *Fressnapf/Maxi Zoo*, *OBI*, and *7-Eleven* are examples.

Franchise Definition

Franchising is defined as a contractual agreement between two legally and financially separate companies, the franchisor and the franchisee. The franchisor, who has established a market-tested business concept, enters into a relationship with a number of franchisees, typically small business owners, who are allowed to use the franchisor's brand and must operate their business according to the franchisor's specified format and processes. The franchisor provides ongoing commercial and technical assistance. In return, the franchisees typically pay an initial fee as well as fees (royalties), which average about 5 % of gross sales, plus some advertising fees (Inma 2005, p. 29).

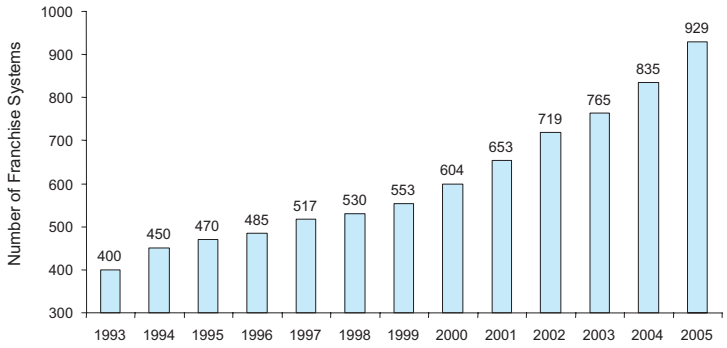
According to different national franchise associations, the franchising sectors in the different country markets have reached considerable sizes. In France, there are about 930 franchise systems, in Germany about 950, and in the United Kingdom about 700. On average, each franchise system has between 40 and 50 franchise outlets, but the largest often exceed 1,000. All statistics

show that franchising is growing continuously (see, for an example, Figure 4.2).

Division of Tasks

A fundamental characteristic of franchising is that it always involves two separate and independent companies which assume distinct roles and a strict division of tasks in order to achieve a joint objective. Since the franchisee owns his own business, he is entitled to all profits that are generated. Franchising thus combines the benefits of a large, efficient retail system, including economies of scale in procurement, logistics, national advertising, IT systems, and administrative activities, with the strength of an independent entrepreneur who manages the outlet, including customer contact and supervising store employees (Zentes/Morschett/Neidhart 2003). The common brand enables all participants in the franchising system to benefit from the advertising and goodwill generated by each outlet. From the consumer perspective, it is often impossible to detect the difference between franchising and own branches.

Figure 4.2 *Franchising in France*



Source: Fédération Française de Franchise 2006.

Forms of Franchising

There are two main forms of franchising (Sternquist 1998, p. 123):

- Direct *unit franchising* is the most basic form of franchising. In a unit franchise, the franchisor grants the franchisee the right to engage in a single franchised business operated at a specified location.
- In a *master franchising* agreement, the franchisor grants the master franchisee a set territory, and within this territory, the master franchisee is allowed to establish unit franchises.

Sources of prospective franchisees can vary:

- Often, *start-up entrepreneurs* are targeted. Their inexperience makes the franchisor's business package relatively more attractive.
- In *multi-unit franchising*, successful franchisees are allowed to open new branches. This strategy is a type of organic growth within a franchise system. The number of outlets per franchisee, however, is often strictly limited, because multiple franchise outlets diminish some of the advantages of franchising.
- *Conversion franchising*, a current trend which occurs when a franchisor adds new franchisees to the system by recruiting existing independent retail businesses (Hoffman/Preble 2003). The store owners may affiliate with the franchise system to take advantage of the brand and other components of the operating system.

Advantages for the Franchisee

For the franchisee, there are a number of benefits compared to a non-franchised independent business. He enjoys instant goodwill in the market, because he can use an established brand name, exploit a tried-and-tested business concept and standard operating procedures. He also receives comprehensive information on the business concept before starting, including information on necessary investment and likely profits. He obtains training and support, and financing is usually easier, since belonging to the franchise system provides the franchisee with access to financing that would otherwise not be available as easily (Brodersen 2006).

Advantages for the Franchisor

For the franchisor, as a growth strategy, franchising also has considerable benefits (Berman/Evans 2007, pp. 110-114; Zentes/Morschett/Neidhart 2003):

- Franchising allows for *rapid growth* of a retailing company. Especially when the success of a concept depends upon rapid market coverage, franchising is a way of multiplying a concept without the usual financial constraints. Franchisees also finance the investment for establishing stores.
- *Motivation* of franchisees is high, because they manage their own stores.
- Franchisees have *knowledge* of the local markets; customer and employee contact of franchisees is direct and personal.
- Written franchise agreements require the store owners to keep to *stringent operating rules* set by the franchisor.

Disadvantages for the Franchisor

One major disadvantage for a franchisor is that he has no direct, hierarchical control over the franchisee. The franchisee is an independent contractor, not an employee. Franchisees can harm the overall reputation of the franchise if they do not maintain company standards. Changes in the franchisors' strat-

egy may be slow to implement, because franchise contracts usually run for three to five years, and substantial changes are only possible through changing the contracts. Another drawback is that under European law, the franchisor is not allowed to fix the final consumer prices for products. Accordingly, the marketing and management of a franchise system is more complex than for a truly uniform and hierarchically managed system of company-owned stores.

From Franchising to Company-Owned Stores and Vice Versa

Often, the dynamic of the balance between the benefits and drawbacks of franchising leads to a change in the use of this growth strategy during the life cycle of a retailer. The resource scarcity that motivates retailers to embrace franchising as a growth strategy in the expanding stages of their life cycle, lessens as the system becomes more established and growth rates decline. The costs associated with managing a complex franchise system gradually outweigh the benefits associated with the resources provided by the franchisees. Consequently, over time, franchisors tend to buy back franchises and increase the number of company-owned stores (Oxenfeldt/Kelly 1969). However, over the last few years, the opposite development has also been occurring. Since, for many chain stores, operating small stores with low turnover in certain market areas is not profitable in the form of company-owned stores, and the higher motivation in manager-owned stores has often proven capable of making a store profitable, some large chains have started to spin-off certain retail outlets and transform them into franchised stores. Smaller supermarkets and convenience stores are typical objects of such transformations (Zentes/Morschett/Neidhart 2003, p. 227).

Plural-Form Networks

Often, franchising is not used as an exclusive company strategy, but franchisors also own a substantial number of retail outlets themselves. The complexity of managing such *plural-form networks* is higher than that of managing monolithic systems of own stores or franchises. Synergies can be drawn from applying two different growth strategies simultaneously in the company, such as higher franchisor flexibility when deciding on new store openings. At the same time, the risk of conflict throughout the network is substantially higher, and often, the management culture required to manage a franchise system of independent store owners is different from the culture needed to manage a chain store (Cliquet 2000).

Mergers & Acquisitions

Companies also have the option of *external growth*, that is, to expanding by acquiring resources from other companies. Expansion through mergers & acquisitions (M&A) involves the consolidation or purchasing of existing retail companies or retail outlets (Zentes/Morschett 2002, pp. 173-174). In a merger, two companies are combined and at least one of them loses its legal

independence. In an acquisition, one company acquires a majority interest in another or takes over certain assets (stores) of another company. The term acquisition is often used restricted to a full takeover. The legal independence of the acquired company can remain intact (Zentes/Swoboda/Schramm-Klein 2006, pp. 278-281).

M&A have played a major role in structural changes in the retailing sector over the last decades and constitute a well-established growth mechanism (Burt/Limmack 2001). For example, in 1999, *Carrefour* merged with *Promodès*, to form the largest European retail company and the second largest worldwide. In 2004, *Wm Morrison*, which formerly had about 120 stores, completed the takeover of more than 200 *Safeway* stores. Major British food retail groups had made offers, but the Competition Commission had opposed the takeover by *Tesco, ASDA*, or *Sainsbury's*. In 2006, the *Metro Group* took over 85 *Wal-Mart* stores in Germany, expanding its own *Real* outlet network of 330 stores by a quarter. The Austrian *XXXLutz*, the second largest furniture retailer in the world after *IKEA*, bought five furniture chains in Germany. The largest acquisition, *Mann Mobilia*, added seven stores to the company's network with a total sales space of 480.000 m^2. A list of similar examples would be long.

Advantages of M&A

M&A allow rapid expansion by overcoming the bottleneck created by the difficulty of establishing and developing adequate retail locations, which can take years from the site selection to finally opening a store (Burt/Limmack 2001, p. 4). Within a short period of time, an acquisition makes an entire bundle of resources available to a company. Especially when *first-mover advantages* are pursued in a new market, this can be a crucial success factor (Meyer 2001, p. 359). Since the customer base of the acquired retail company can often be preserved, market share is gained quickly.

After an acquisition, either the integration process includes a change in the brand name of the outlets, or the original retail brand of the acquired retail outlets is retained. The latter is often the case, when the acquisition is used to expand into other retail sectors or formats. A food retailer entering the DIY market, or a supermarket company acquiring a discount chain, for example, could be well advised to keep the acquired chain's established retail brand. The acquired company's existing resources - management expertise, personnel, sites, etc. - focus on their established field of businesses and an objective also often pursued with an acquisition is that of exploiting the know-how and dedicated assets of the acquired company.

Disadvantages of M&A

However, integration costs following an acquisition can be high. An incompatibility of company strategies, capabilities, resources, and cultures often results in an insufficient exploitation of existing potential for synergies. The takeover and associated cultural change in the acquired company may also

result in a *brain drain* and the loss of significant management skills. Also, in many markets, it is difficult to find suitable takeover candidates. Successful retailers are, in most cases, not available for acquisition and less successful retailers often have retail locations, stores and premises that are not attractive enough for acquisition. Adequately evaluating the value of a retail company before an acquisition is, however, not an easy task and often, the real value and quality of the acquired company can only be assessed correctly after the acquisition (Burt/Limmack 2001, p. 4). For example, in Germany, *Wal-Mart* faced the problem that the store network acquired for market entry was unfavourable, and over time, other targets for takeover were not available on the market. The option of further expansion through acquisition may also be limited by anti trust laws, as the example of *Safeway* in the United Kingdom illustrates. In already highly concentrated markets, the acquisition of other outlet networks by the largest players is often not approved by the authorities.

In summary, acquisition is a very fast growth strategy when adequate takeover objects are available, but the associated risk is substantially higher than with organic growth.

Minority Investment in Retail Companies

Due to the difficulties associated with full-scale acquisitions, acquiring a minority stake in another retail company is also a frequently pursued strategy. For example, *Kingfisher* bought a 21 % stake in the German DIY retailer *Hornbach* and supports *Hornbach*'s national and international expansion, for example by providing funds. In 2004, Hong Kong-based *AS Watson* purchased a 40 % stake in German drugstore chain *Rossmann*.

Acquiring partial ownership of another retail company involves similar advantages and disadvantages to the acquisition strategy in general. However, successful retail companies generally prefer to accept another company buying an equity stake in their company than to be acquired. Equity participation by a larger company can add resources that support its further expansion. Furthermore, the strategy can be useful in situations where full-scale acquisitions are difficult, because of the particular market conditions or government control. At the same time, the remaining equity stake of the initial company reduces the risk of a brain drain (Zentes/Morschett 2002, p. 174), since the established management team of the acquired company often retains control, frequently only supplemented by additional management capacity from the acquiring company. The risk of over-estimating the value of the acquired company is reduced, because the acquiring company achieves full transparency over business processes and results, facilitating a potential full acquisition after a certain time period.

Conclusion and Outlook

Growth continues to be highly relevant for the success of a retail company, but at the same time is more difficult to achieve, because of several factors. These include the power of large retailers and the crowding out of independent retailers and small chains as well as the already high and increasing level of concentration in many retail markets combined with market saturation in many product categories.

Flexible growth strategies therefore become more important. Retail companies usually do not use the above outlined strategies in isolation, but in combination, as the phenomenon of plural-form networks has already illustrated.

Combination of Growth Strategies

Especially larger, divisionalised retail store groups with different store formats often implement different growth strategies for different formats and/or markets. For example, *Carrefour* operates its hypermarkets in most parts of the world as own outlets, while it franchises its system in the Middle East (United Arab Emirates, Egypt, Saudi Arabia, etc.) to the *Majid Al Futtaim Group* that operates a number of large *Carrefour* hypermarkets in the region. The difficult market conditions in this region and the local knowledge of its franchise partner are the probable reasons for this strategy. Most of *Carrefour*'s convenience stores all over the world are franchised, and the expansion with supermarkets stems at least partly from franchised outlets, while there is also a substantial number of own outlets. This is a fairly typical picture of retail companies that use different growth strategies over time and which tailor the growth strategy to the retail format and specific situation.

Further Reading

HOFFMAN, R.; PREBLE, J. (2003): Convert to Compete: Competitive Advantage through Conversion Franchising, in: Journal of Small Business Management, Vol. 41, No. 2, pp. 187-204.

Case Study: Fressnapf/Maxi Zoo[1]

Profile, History, and Status Quo

In 1990, Torsten Toeller founded *Fressnapf* by opening his first store in a small city in Germany. The then 24-year-old entrepreneur was inspired by pet supply category killers in the USA. This store format – specialising in pet products with a very large selection and low prices – had not yet reached the German pet supply market (or other European countries) at that time. The market was dominated by small, independent specialist stores on the one hand, and by food supermarkets and hypermarkets on the other.

Toeller recognised there was a latent customer need for such a concept. Soon after the opening, though, it became evident that offering pet supplies at low prices is only possible with a system that enjoys scale advantages in buying and in other processes. Therefore, rapid growth was necessary to become competitive in the market. Understanding that a rapid multiplication of the system could not be achieved from his own resources, but only through cooperation with a steadily growing group of partners, Toeller created the *Fressnapf* franchise system. The *Fressnapf Tiernahrungs GmbH* has been issuing franchise licenses since 1992, and after an impressive growth record, now operates about 800 stores throughout Europe via a network of about 300 franchise partners (see Figure 4.3). In 2005, *Fressnapf* (i.e. the company and all its franchisees) achieved gross external sales of 733.3 million EUR (553 million EUR in Germany). The company is presently by far Europe's leading retailer of pet food and accessories. While the company uses the retail brand *Fressnapf* ("feeding bowl") in German-speaking countries, in most other countries the stores are branded as *Maxi Zoo*.

Differentiation and Speed as Success Factors

In addition to a clear *differentiation* from the competition (mentioned as success factor no. 1), *speed* is considered as success factor no. 2 by the company (Toeller 2005). The pet supply category killer concept is usually new to the markets that *Fressnapf* enters, and a quick expansion strategy is pursued in order to gain *first-mover advantages*. The fast growth rate of *Fressnapf* has developed a momentum that is now partly self sustaining.

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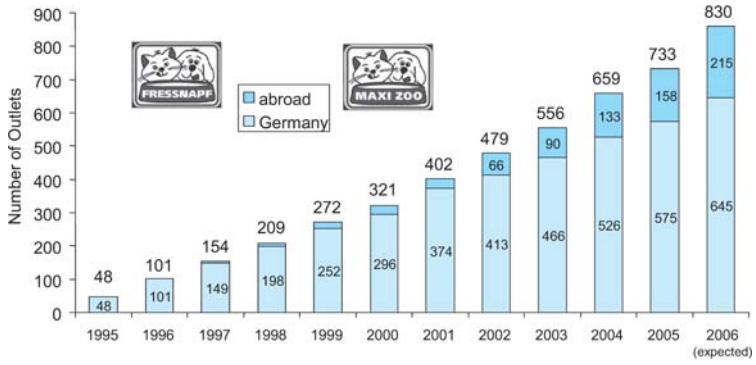
1 Sources used for this case study include the web site http://www.fressnapf.com, various presentations by Fressnapf's CEO Torsten Toeller as well as other company information sources, trade press coverage and press releases and explicitly cited sources.

Development of the Number of Outlets of the Fressnapf Group

Figure 4.3



Awards

In 2003, Torsten Toeller was named "Entrepreneur of the Year 2003" in Germany for his entrepreneurial commitment, the company's innovative capabilities, enduring growth and future potential. In 2004, the *Fressnapf Tiernahrungs GmbH* was selected as "Franchisor of the Year" by the German magazine *Impulse* in cooperation with the *German Franchise Association*. The judges commented that *Fressnapf* had achieved phenomenal growth, while sustaining high levels of satisfaction amongst its partners and providing exemplary franchisee support.

Franchising as Growth Strategy

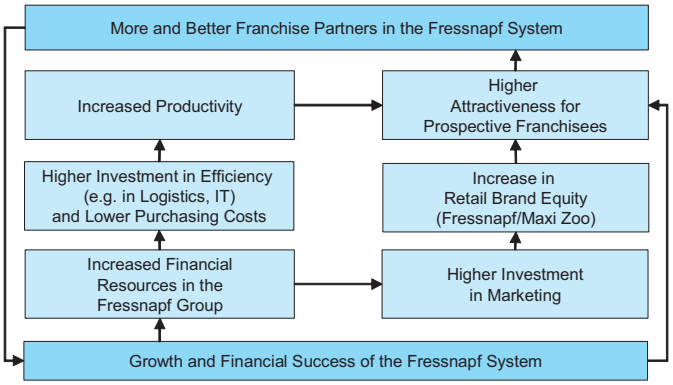
In Germany, *Fressnapf* focuses solely on growth by franchising. Only a small number of stores (18 in Germany) are company-owned. From the perspective of the customer, all *Fressnapf* franchise stores appear to be branches of a large multiple, while in reality, the stores are owned by highly motivated, legally independent store owners, who operate the stores. The actual work is divided between the *Fressnapf Tiernahrungs GmbH* and the franchisees.

Achieving Speed

To ensure speed in developing the system, *Fressnapf* offers its prospective franchisees a *low budget business model*. An investment of only 200,000 EUR is needed on the part of the franchisee, so that expansion is not usually limited by the capital required. Speed is also maintained by using *standardised concepts*. *Fressnapf* has developed three main store formats for its franchise stores – a small format (400-599 m^2), a standard format (600-799 m^2) and a large format (800-1,200 m^2). For these concepts, *Fressnapf* provides detailed knowledge on how to develop and design a store, including the optimal merchandise mix and space allocation. By offering three different formats,

Fressnapf also ensures that it can adapt flexibly to different locations. The fast growth of the system proves that it satisfies both franchisor and franchisees. If the existing franchisees were not satisfied with the cooperation with the franchise headquarters, this information would spread among prospective new franchisees, and a growth rate like *Fressnapf's* would not be possible. In this way, a successful franchise system like *Fressnapf* can experience an upward spiral (see Figure 4.4).

Figure 4.4 *The Self-Enforcing Success System for Fressnapf*



Source: Adapted from Zentes/Morschett/Neidhart 2003, p. 226.

Functions of the Franchisor

Fressnapf Tiernahrungs GmbH offers many services to its franchisees. Those functions that guarantee a coherent market appearance of the franchise system are mainly carried out by the franchisor, which helps standardise processes and exploits the advantages of a large-scale retailing system with many outlets.

Franchisee Support in the Pre-Opening Stage

For new franchisees, who are often start-up entrepreneurs, cooperation with the franchisor starts long before the store opening. *Fressnapf* thoroughly analyses the store location (in terms of customer potential, buying power,

competition, etc.) and forecasts the profitability of the store as well as the likely development of liquidity in the first years after the opening.

Financial Planning

From the experience of opening between 50 and 100 new stores each year, the franchise headquarters has accumulated detailed knowledge about the store opening and financial results that can generally be achieved in the first few years. While an independent store owner would have to develop a business plan on its own in order to receive financing, a business plan provided by *Fressnapf* headquarters enjoys credibility at a bank, because it has been tested and proven hundreds of times.

Acquisition of Premises

In order to accelerate expansion, *Fressnapf* headquarters often searches for new potential sites parallel to the search for new franchisees. It regularly advertises that premises for rent are required. In this context, the minimum requirements for premises are 400-1,200 m^2 on the ground floor. For existing buildings, *Fressnapf* has developed a detailed list of requirements, with regard to parking spaces, delivery area, storage facilities, including such physical requirements as minimum weight capacity of the floors. Independent start-up retailers would not usually have complete knowledge of what aspects of the store will become important for subsequent operation. Given *Fressnapf's* experience with rental agreements, it usually leads the negotiations for store premises and helps with official authorisations as well as construction projects.

Services Regarding the Store Operation

In the opening phase, *Fressnapf* supports new franchisees intensively in order to prepare for the store opening. Decisions concerning the (exterior and interior) store design are determined largely by the headquarters, since this plays a crucial role for the uniform market appearance of the entire franchise system and for the productivity of the store itself. The fixtures, store layout and space allocation are planned by the system headquarters.

Continuing Assistance

In the opening phase and during the entire relationship between franchisor and franchisee, personal on-site support is provided by representatives of the *Fressnapf Tiernahrungs GmbH*. This includes support during daily business, the ongoing improvement of store operations by benchmarking between all stores in the franchise system, that is, comparing their performance, tracking target/performance deviations, assessing the strengths and weaknesses of each store and identifying best-practice processes in order to employ them as quickly as possible in all stores.

Fressnapf Academy

Employee knowledge of merchandise, pets in general, and sales expertise are considered fundamental competitive differentiators. In 2006, *Fressnapf Tiernahrungs GmbH* set up the *Fressnapf Academy* to provide further training

for its staff. *Fressnapf* offers the store managers and employees a large variety of basic, advanced or professional seminars, depending on their personal qualifications. This deals with specialist knowledge, sales skills, process management/IT and business expertise.

Marketing-Related Services

Fressnapf provides franchisees with the marketing power of a large organisation, with professional advertising in regional and national print media as well as on TV, intensive public relations (donations to pet sanctuaries, zoos, sponsoring of pet events, etc.) and a range of store brands. *Fressnapf* has achieved a very high level of brand awareness over the years. About 80 % of all German pet owners know the retail brand *Fressnapf*.

Advertising and Communication

The *Fressnapf* group spends about 30 million EUR a year on advertising. This advertising money is spent partly by the headquarters directly (financed by an advertising fee from the franchisees and marketing allowances from suppliers). In addition, each franchisee is expected to spend a certain amount of money (at least 2.5 % of gross sales are recommended by the headquarters) on local and regional advertising. In both cases, advertising design and development is managed centrally. There is weekly advertising in regional newspapers, with a circulation of about 25 million copies, and in special interest magazines. *Fressnapf*'s own customer magazine ("*Fressnapf Journal*") that is distributed for free in the outlets has a readership of about 3.6 million each month. *Fressnapf* headquarters provides the stores weekly with leaflets and posters advertising ongoing promotions. *Fressnapf* also designs and organises national radio and TV advertising campaigns and maintains the *Fressnapf* homepage. Here, besides promotions, extensive customer information is provided and customers can register for a large *online community* in the pet sector. An online forum with about 130,000 members has been created, and *Fressnapf* headquarters additionally promotes this customer interaction by providing expert advice (from veterinarians) in the forum and by rewarding customer activity with points that are collected and transformed into donations to pet sanctuaries.

Store Brands

Fressnapf offers its customers a choice of store brands that cover different price/quality segments (Toeller 2005):

- *Premiere* and *Select Gold* are two premium store brands. The former focuses on specialities and special wet dog food and *Select Gold* covers an array of super premium cat and dog dry nutrition products.
- *MultiFit* is the standard store brand.
- *fit + fun* covers the budget segment.

All store brands are heavily advertised and help the franchisees build store loyalty and strengthen differentiation from competitors, especially food retailers, which offer pet food, but usually cannot invest the effort to establish specific store brands for pet food. In 2004, *Fressnapf*'s store brand sales reached 80 million EUR, and their share in turnover is steadily rising. Shrinking margins for manufacturer brands are a further reason for introducing store brands. Gross profit for the *Fressnapf* store brands is increasing constantly and has now reached about 33 %.

Fressnapf headquarters manages the four store brand ranges, from product selection and development, contracting with production partners, quality assurance, designing the packaging to advertising.

Services Regarding Buying and Logistics

Economies of scale in buying and logistics constitute a major advantage of a large retail system over smaller competitors. The system headquarters of *Fressnapf* predominantly plans the merchandise mix in the stores. Usually, well over 90 % of a store's assortment are standardised with the rest of the group. Only a small percentage is adapted locally by the store owner. While this deprives the store owner of some decision authority, it substantially benefits the system as a whole. The sales volume of the group can be bundled in a way that is very similar to a large chain store and headquarters' buyers have a strong negotiation position with suppliers, which ensures favourable purchasing conditions compared to competitors. This is particularly important is this industry, because the supply is dominated by a handful of international market leaders. These include *Masterfoods* (with brands such as *Pedigree*, *Whiskas*, *Sheba*), *Nestlé Purina* (*felix*, *Gourmet*, *Friskies*), *Royal Canin* and *Procter & Gamble* (*Iams*/*Eukanuba*). Those companies would not be willing to negotiate with a small zoo store or pet specialty store, but *Fressnapf*, with its combined sales volume, has developed into a strong and important customer.

In terms of wholesaling, a stage in the value chain that is usually needed by smaller stores, since manufacturers do not deliver directly to them, is bypassed by *Fressnapf*, because *Fressnapf Tiernahrungs GmbH* serves partly as a wholesaler itself, including an own central warehouse for the group. Thus, *Fressnapf* also supports the franchisees with logistics. It maintains an inventory control system and monitors inventory in the central warehouse.

IT-Related Services

Efficient and sophisticated IT systems have developed into very important bases of successful retailing over the last years, as mentioned in various

Chapters of this book. The franchise headquarters can also provide a valuable service to its franchise partners. *Fressnapf* centrally purchases hardware and software products and supports its franchisees in the event of any hardware and software queries. Software systems are maintained and developed further by the headquarters. IT-based performance controlling systems are developed and an ongoing performance controlling carried out.

The Role of the Franchisee

While all central functions are managed by *Fressnapf Tiernahrungs GmbH*, the franchisee manages the daily store operations. The local entrepreneur has to use his skills and motivation to exploit the local market opportunities. It is the *Fressnapf* franchisee who is responsible for *local public relations* (such as the communication at local pet events or participation in the local animal protection organisation and supporting pet shelters). It is also the store owner who presents and represents his store to customers. Especially in this sector, in which the relationship between a customer and his pet is very close, customers want experts in the store and salespersons and a store owner who understand their needs and feelings. It is also the franchisee who is in direct contact with the store employees, selects them, and supervises their daily work. Thus, customer relations and human resource management are two main responsibilities of a *Fressnapf* franchisee.

Another franchisee responsibility is the operational merchandise management. He has to ensure that *no out-of-stocks* occur at the point-of-sale, and that merchandise is ordered early enough. Yet, overstocking must also be avoided, because this ties up capital and reduces return-on-assets. While this logistics process is supported by the central merchandise management IT system, it is the job of the store owner to forecast sales, in the context of the specific local circumstances. The franchisee is obliged to adhere to the merchandise mix planned by the franchisor, but has, at the same time, the right and the responsibility to supplement this standardised assortment optimally with additional products that might be important for local customers. Since the franchisee owns the store and its profits are his main source of income, he is invariably highly motivated to ensure that all profit potential is exploited. Very often, this refers to small and operational details in the store operations.

Costs for the Franchisee

To set up a store, a new franchisee must invest about 200,000 EUR, of which he can borrow a part from a bank. Most of this money is invested in merchandise stock in the store. The *Fressnapf Tiernahrungs GmbH* does not invest its own money in the outlets, but supports franchisees in obtaining bank financing. The equity capital required by franchisees is 40,000 EUR. In order to enter the franchise system, new franchisees must make a one-off payment

of 5,000 EUR as an initial fee. Ongoing royalties are 1 % of gross turnover per month and in addition, the franchisee pays 0.33 % of gross turnover per month as an advertising fee, his share of the central advertising expenditure. A franchise store usually achieves a turnover of about 1 million EUR per year. With the strong system support, it often breaks even in the first year of operation.

The assurance of service quality in every outlet is crucial for the success of a franchise system, since every outlet influences the retail brand image, and independent store owners operate stores under a common retail brand. An important aspect of partner management, therefore, is to provide incentives for store owners to adhere to quality and concept standards. *Fressnapf* regularly carries out quality checks of the stores and also employs "mystery shopping", i.e. hires a market research institute to test-shop franchise outlets and report on the store performance. The results of the quality control are then discussed with the franchisee and measures for improvement are planned. Depending on the service quality of the franchise store, a store-specific incentive bonus is paid at the end of the year. In extreme cases of ongoing nonconformity to standards, the franchise contract will be terminated at the end of the initial period.

Multi-Unit Franchising

The headquarters can reward adherence to quality standards and success by offering a franchisee a second franchise as an opportunity to grow his business. Today, many *Fressnapf* franchisees have two or three stores in a region, so that *multi-unit franchising* is common. This shows that franchisees are satisfied with their profits and do not regret their decision to become a *Fressnapf* partner. This incentive also enhances partner satisfaction, because successful store owners can grow by "opening branches".

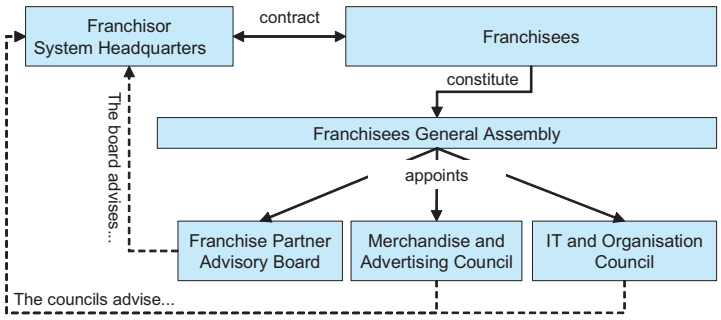
Influence of the Franchisees on the Company Decisions

As an almost pure franchise system (in Germany), the rapid growth of *Fressnapf* has only been possible through a combined effort of franchisor and franchisees. Franchisee satisfaction is important and *Fressnapf* tries systematically to ensure that this prevails. Emotional aspects are also targeted in addition to the rational factors (such as economic success). A strong corporate vision is one pillar of a strong organisation culture. Successes are celebrated and parties and events are an important element of the culture of the system. This leads to a strong identification of the independent store owners, their employees and headquarters employees with the franchise system.

Motivation and a feeling of commitment to the system are also achieved by enabling the franchisee to participate in company decisions. This participation is beneficial for both the franchisor and the franchisee. The franchisee

can influence company decisions, which he will eventually have to carry out in his own store. Furthermore, it is the franchisee who operates the store, works with the centrally provided systems (such as IT systems) and talks to customers. Therefore, franchisees frequently detect potential improvements in company processes and perceive changes in consumer demand.

Figure 4.5 *Participation of Franchisees in Company Decisions*



Fressnapf uses an intense system of franchise partner participation (see Figure 4.5). All franchisees meet biannually in a general assembly. They appoint an advisory board and councils for merchandise and advertising as well as for IT and organisation. Those councils have regular meetings and advise the headquarters on all important decisions. With these mechanisms, *Fressnapf* franchisees exert a strong influence on corporate policy. This type of participation enhances identification with the decisions and facilitates a quick and coherent implementation of decisions.

International Market Entry Strategies

After its early success in Germany, *Fressnapf* recognised that the need for a pet supply category killer also exists in other European markets and that quick expansion would be an important success factor in other markets as well (see Morschett/Neidhart 2006). Currently (as of mid-2006), *Fressnapf* is present in nine foreign markets: Austria (62 stores), the Netherlands (37 stores), Switzerland (24 stores), France (11 stores), Hungary (10 stores), Denmark (7 stores), Luxembourg (4 stores), Italy (2 stores) and Ireland (1 store). The stores in Germany, Switzerland and Austria are operated under the retail brand *Fressnapf*; most other countries use the retail brand *Maxi Zoo*.

The first expansion abroad was to Austria in 1997. *Fressnapf* formed a joint venture with a local partner, but due to conflicts, *Fressnapf* now owns 100 % of the *Fressnapf Handels GmbH Austria*. Most of the stores in Austria are operated and owned by this company and only a minority is franchised. In Switzerland, which *Fressnapf* entered in 1998, the company *Pet Vision AG* owns and operates all *Fressnapf* stores. *Fressnapf* headquarters hold only a minority stake in *Pet Vision*.

In the Netherlands, *Fressnapf* started by opening company-owned outlets under the retail brand *Fressnapf*. However, some time later, it became evident that another expansion strategy would promise more success. In 2001, *Fressnapf* headquarters acquired a minority stake in the Dutch pet supply specialist retailer *Jumper B.V.* The local company's market knowledge is used and the established retail brand *Jumper* is maintained, while the corporate design of the stores (e.g. the corporate colour and the logo) has been changed to the *Fressnapf* design. *Jumper* is a plural-form network. The 37 stores are mainly franchised, but *Jumper B.V.* also owns a number of stores.

Fressnapf's first store in Hungary was opened in 2002 in Budapest. It is *Fressnapf*'s medium-term target to open about 25 company-owned *Maxi Zoo* outlets in the larger agglomerations in Hungary. All existing stores are owned by *Fressnapf Hungaria Kft.*, a joint venture of *Fressnapf* (holding 85 %) with a local industry expert with experience in the Hungarian market.

In 2003, *Fressnapf* acquired 51 % of the Danish company *PetGo*. Its three stores were subsequently transformed into *Maxi Zoo* outlets and additional new outlets opened as well. The aim is to establish about 25 company-owned outlets.

In France, *Fressnapf* took over the majority of the French company *City-Zoo* in 2004. The company had previously operated ten stores in the South of France. After *Fressnapf*'s expansion into different markets, the entry into France, a market with a total sales volume in the pet food and pet supply sector that almost equals that of Germany, it became necessary to secure the market leadership in Europe. The former owner of *City-Zoo* is now the managing director of *Maxi Zoo France S.A.S*. At the moment, only company-owned stores are operated in France, because *Fressnapf* considers this a test phase in which it can get to know the French market. In the medium-term, the plan is to establish an extensive franchise network in France, which will be tied directly to franchise contracts with *Fressnapf*'s French subsidiary.

Recently, *Maxi Zoo* stores were opened in Italy (in December 2005) and in Ireland (in July 2006). It is evident that *Fressnapf* applies a very flexible internationalisation entry strategy, adapting its growth strategy to the specific market needs and potential partners.

Summary and Outlook

Over the last 16 years, *Fressnapf* has grown from one outlet into a European store network of about 800 outlets. Its growth stems mainly from franchised outlets. This enduring success is only possible with a very efficient division of tasks between the franchisor, who takes over all functions that have potential advantages of large scale and through standardisation across a large store network, and the franchisee, who operates the specific franchise store. In a large system of this kind, with about 300 separate and independent store owners, managing the coherence of the system and assuring the quality of each store is crucial and *Fressnapf* has managed this very well so far.

The main strategy elements for the next years are establishing sustainable *cost leadership* (e.g. by optimising internal processes and further standardisation of assortments) and continued *growth* (by opening new stores with comparable store sales growth) (Toeller 2005). It seems likely that the *growth* of *Fressnapf* will continue for years to come. While the German home market might be close to saturation for this store format, the international market potential is still enormous. *Fressnapf* has already announced that it intends to enter one or two new countries each year over the next few years. At the end of the decade, *Fressnapf* plans to have a store network of about 1,200 stores in Europe and reach a turnover of about 1.2 billion EUR (Lebensmittel Zeitung, 04.08.2006).

Questions

1. *Fressnapf* has focussed its growth strategy on franchising. An alternative option would have been to multiply the concept by opening company-owned branch stores. Discuss the advantages of franchising from the perspective of the franchisor.
2. The franchising literature sometimes refers to "two markets" from the perspective of a franchisor: the consumer and the market for/of franchise partners themselves. Explain why prospective and existing franchisees can also be considered as (potential) customers of a franchisor and discuss how a franchisor can employ the marketing instruments of product, price, and promotion in his marketing approach towards franchisees.
3. While franchising is the growth strategy used in Germany, *Fressnapf* also chooses other growth strategies in other country markets. Why does *Fressnapf* select different strategies in different markets instead of using a standardised approach?

Hints

1. See the section on "Franchising" in this Chapter and analyse the innovativeness of the store concept.
2. Refer to Kotler et al. 2002, or any other marketing textbook for an overview of marketing instruments.
3. Read the discussion of different growth options in this Chapter and refer also to Chapter 5.

Chapter 5

The Internationalisation of Retailing

The purpose of this Chapter is to discuss the key themes relating to the internationalisation of retailing. The Chapter describes the various facets of international retailing and the scope of retailer internationalisation, considers the basic strategic options, the methods and ways of market selection and market entry/market operations and reviews the international retail marketing opportunities.

The International Activities

International Sourcing

The internationalisation of retailing has two main elements: sourcing and selling. International retail sourcing has a long tradition and is by no means a new phenomenon. "Even if their stores are entirely domestic, many retailers have been buying goods from foreign countries for a long period" (Howard 2004a, p. 96).

Cross-Border Retailing

The internationalisation of store operations (*cross-border retailing*) is the form of internationalisation on which this Chapter concentrates: "Cross-border retailing has accelerated dramatically through the last two decades, though of course it began much earlier" (Howard 2004a, p. 97). However, it remains a limited activity for most retailers.

Table 5.1 compares the relative importance of international activities conducted by the largest retailers. In only three cases does turnover outside the domestic market exceed 50 % of total turnover.

Basic Strategic Options

Standardisation vs. Adaptation

The major dilemma for international retailing – and for international marketing – is that of *standardisation vs. adaptation*: "Some products are global products, meaning they can be sold in foreign markets with virtually no adaptation. This is what is meant by standardisation.

Most products, however, need some changes in the product or promotion strategy to fit new markets. This is what is meant by adaptation. In retailing, the product is the retail business" (Sternquist 1998, p. 7).

Table 5.1 *International Sales of the Largest Food Retail Companies in 2005*

Rank	Company	Country	Total Turnover (Net Sales) (in million USD)	International Turnover as % of Sales
1	Wal-Mart	USA	312,427	22.4
2	Carrefour	France	92,597	52.4
3	Tesco	United Kingdom	69,631	23.1
4	Metro Group	Germany	69,260	51.7
5	Kroger	USA	60,553	0.0
6	Ahold	Netherlands	55,307	82.0
7	Costco	USA	52,935	20.5
8	Target	USA	52,620	0.0
9	Rewe	Germany	51,832	30.5
10	Sears	USA	49,124	11.9
11	Schwarz Group	Germany	45,802	43.3
12	Aldi	Germany	45,008	44.7
13	Walgreens	USA	42,202	1.3
14	Edeka	Germany	41,266	6.7
15	Albertson's	USA	40,358	0.0
16	AEON	Japan	40,230	8.2
17	Safeway	USA	38,416	16.1
18	Auchan Group	France	38,216	47.0
19	CVS Corporation	USA	37,006	0.0
20	E. Leclerc	France	35,424	5.6

Source: Adapted from M+M Planet Retail Ltd.

There are four basic options with regard to standardisation vs. adaptation (Helfferich/Hinfelaar/Kasper 1997; Zentes/Swoboda/Schramm-Klein 2006):

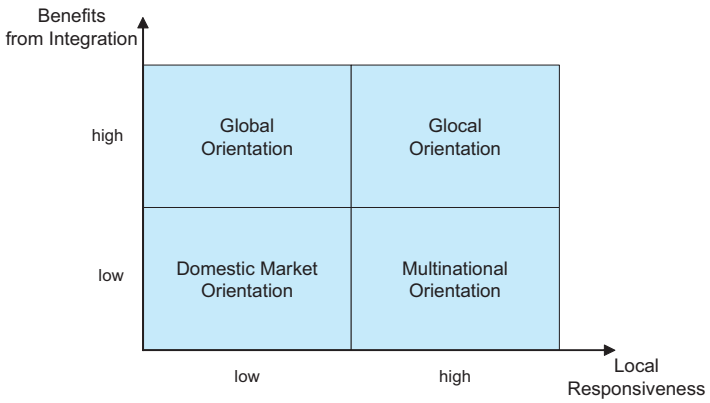
- domestic market orientation
- global orientation
- multinational orientation
- glocal orientation.

Figure 5.1 shows these basic options in the "local responsiveness/benefits from integration" matrix.

Domestic market orientation means that the retail concept from the home market is transferred to other countries. This approach leads to a unified programme of an ethnocentric kind ("transference"). The *global orientation* in international retailing therefore does not adapt to differences in local markets. This kind of standardisation is characterised by focussing on exploiting similar markets across the world and benefiting from economies of scale. In contrast to the domestic market approach, the company seeks homogeneous markets worldwide, which are the basis for developing a retail strategy or concept.

Four Basic Types of International Retailing

Figure 5.1



This approach can be described as diametrically opposed to the *multinational orientation*, which is characterised by substantial adaptations or diverse formats/concepts operating in heterogeneous markets. The *glocal orientation* ("think global, act local") seeks the advantages of both: moderate adaptations to heterogeneous markets. The retail company brings together economies of scale ("efficiency") and a concentration on country markets ("effectiveness").

These four basic kinds of international retailing largely determine the decisions as to market selection and timing, the mode of entry or mode of operations in foreign countries and, of course, the marketing concept itself (site selection, assortment, pricing, communication mix, etc.).

Market Selection and Timing

Assessment of Potential Markets

International Retailing and Market Evaluation

The issues of market selection and the assessment of potential markets and timing are closely connected. "Timing is crucial – taking opportunities as they arise, particularly as markets open to foreign investment, and as consumer spending reaches absolute levels and levels of growth that are sufficient to support a new entrant" (Howard 2004a, p. 108). These questions of international market appraisal and timing are also closely connected to the basic options of domestic market orientation, global orientation, multinational orientation and glocal orientation.

Retail companies following a global approach, for example, consider to what extent there are shared customer aspirations and similar infrastructures (logistics, media, norms, regulations) in different nations, in order to implement a relatively standardised strategy that conforms to these needs. The multinational approach concentrates largely on country markets, developing a specific strategy for each market. For this strategy, the market size or the spending power and competitive environment are primary consideration in market evaluation.

Table 5.2 contains a general checklist for evaluating international markets. This table "is designed to help appraise national opportunities; specific locations must then be evaluated" (McGoldrick/Blair 1995, p. 170).

Table 5.2 *International Market Appraisal Checklist*

Spending Power	Barriers and Risks
• Total GDP • Disposable incomes: spending patterns, spending improvements, seasonal fluctuations, taxes on income, taxes on spending, saving ratios • Population size: age profile, cultural/ethnic groupings, expatriates and tourists, lifestyles, religion • Residential structure: urban vs. rural, housing density, ownership levels • Adjacent markets: cornerstone status, market proximities, market similarities, market accessibilities	• Entry barriers: tariffs, quotas, development restrictions, competition laws, barriers to foreign entry, religious/cultural barriers • Political risks: change of government, nationalisation or controls, war or riot, international embargoes • Civil risks: effectiveness of policing, rate of theft, rate of murder/violence, level of organised crime • Economic risks: inflation, exchange rate fluctuations, employment structure and stability, taxes on business • Other risks: geological, climatic
Costs and Communications	**Competition**
• Factor costs: land availability and costs, costs of acquisition targets, taxes on business, energy costs, labour availability and costs, training costs, development costs • Logistics and costs: road networks, rail transport, air freight, sea freight, available carriers, distances between markets, transport safety, transport reliability • Communications and costs: telephone/fax lines, automatic international dialling, available international lines, costs of calls • Marketing communications: TV/Radio advertising, direct mail agencies, outdoor advertising, print/magazine advertising, cable TV penetration	• Existing retailers: competition same or similar formats, indirect competition, specialist retailers, other marketing channels, price competitiveness, extent of differentiation • Existing retailers: co-operation synergies from partnerships, international alliances, franchising activities, cumulative attraction, acceptance of format • Saturation levels: structure of outlets by sector, concentration levels, primary/secondary markets • Gap analysis: positioning of competitors, viability/size of gaps, reasons for gaps, age of existing stores • Competitive potential: site availability, financial strength of home retailers, attractions to international retailers, opportunities to reposition

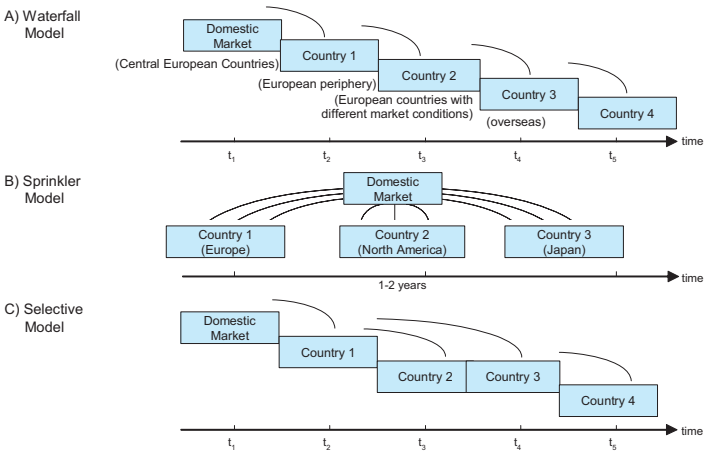
Source: McGoldrick/Blair 1995, pp. 169-170.

Expansion Patterns

Three approaches to the strategic sequencing of foreign-market entry are discussed in the literature (Zentes/Swoboda/Schramm-Klein 2006) (see Figure 5.2). Ayal/Zif (1979) propose a hierarchical approach "that produces a slow sequence of entries to different markets depending on the receptivity. This approach has been dubbed the waterfall model to depict the situation where innovations trickle down in a slow-moving cascade" (Bradley 2002, p. 258).

Strategic Sequencing of Market Entry

Figure 5.2



Such a procedure helps the company to exploit experience gained in the various markets. With every additional step, there is an increase in the degree of heterogeneity of foreign markets, which must also be accepted.

Ohmae (1995) recommends an alternative approach. He argues that the *sprinkler diffusion strategy* means simultaneously entering all relevant markets in the triad countries (Europe, North America and Japan). The reasons for these internationalisation steps relate to competitive strategies such as reaching a critical mass as fast as possible for products with a short lifetime.

The third approach entails selective action, which can often be observed in reality (*selective model*). The selective model or ad hoc internationalisation represents a combined procedure. Within the context of this strategy type, a company's resources are concentrated on the development of and adaptation to individual foreign markets. Conversely, other markets are developed simultaneously or successively, depending on the situation, and are treated less intensively. The companies concentrate their resources on selected markets which they work intensively (Zentes/Swoboda/Schramm-Klein 2006).

Entry and Operating Strategy

The choice of market entry mode or operating strategy depends on the basic strategic option, the market position of the firm, market conditions in foreign countries as well as on the amount of resources the retail company can

allocate to expansion in foreign markets. "In particular, the selected entry method indicates the level of control that the retailer seeks to exert over their foreign operations, the degree of flexibility required in order to effectively respond to market conditions that their foreign enterprise may face" (Moore/Fernie 2005, p. 16).

Export

Five modes of market entry or modes of operations can be identified within the international retailing literature (see Figure 5.3). The lowest level of involvement/commitment and risk is associated with *export*. This alternative requires fewer resources, but is generally associated with a low degree of control. In retailing, exporting is fairly rare. "Where retailers have a distinct product profile, such as an own brand which is attractive to consumers in others markets, it is possible for retailers to begin to internationalise through the export of their merchandise. Marks & Spencer with its St Michael own brand label exported merchandise before it began to establish its international chain of stores" (Alexander 1997, p. 279). Exports by (traditional) *mail-order companies* or *Internet retailers* such as *Amazon* are more important (see Chapter 3).

Licensing

The next level of involvement for a retailer is through a *licensing arrangement*. Such contracts allow a foreign company to use the licensing company's name or concept (Sternquist 1998, p. 8). For example, *Migros*, the largest Swiss food retailer, licenses its name in Turkey. Another example is *Garant Möbel*, a German cooperation of furniture retailers, which licenses its marketing concept (formats) and name to roughly 20 countries in Europe, Asia and the Middle East. Like exporting, licensing arrangements are relatively rare international expansion choices for retailers.

Franchising

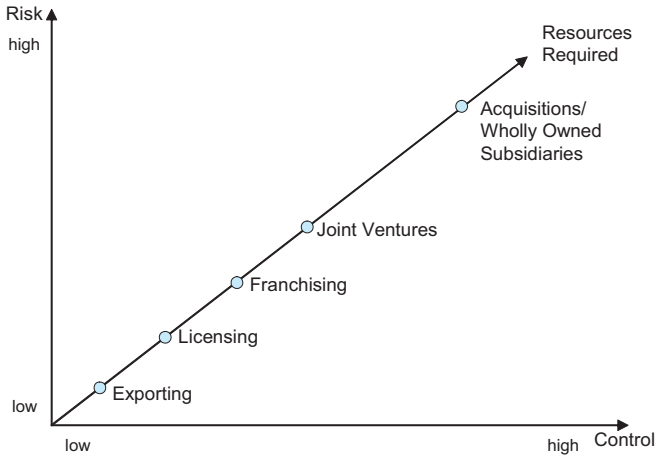
Franchising is a market entry mode which has led to the rapid expansion of a large number of well-known global retailers (see Chapter 4). Through the franchising arrangement, the franchisor gives other companies (franchisees) the right to use the franchisor's (retailer's) name and concept (format, retail marketing). In turn, the franchisor supports the franchisees in running their business (marketing, training, controlling, and logistics).

Joint Ventures

A joint venture is the next level of international involvement for a retailer. This entry and operation strategy has become an important aspect of international activity. In most cases, joint ventures involve a local and a foreign (incoming) company. However, there is no reason why two or more retailers should not establish a joint company in order to enter a new market. "Joint ventures provide the incoming retailer with an opportunity to learn about operations in a new market, while at the same time giving indigenous retailers the opportunity to learn from the international player" (Alexander 1997, p. 287). The French company *Carrefour*, no. 2 worldwide (see Table 5.1), often enters foreign markets with this mode.

Entry and Operation Modes in Foreign Markets

Figure 5.3



Source: Adapted from Bradley 2002, p. 254.

A good example is the relationship between *Carrefour* and the Arabian *Majid al Futtaim Group*, which operates more than 25 hypermarkets in Saudi Arabia, United Arab Emirates, Egypt, Oman, and Qatar.

Acquisitions

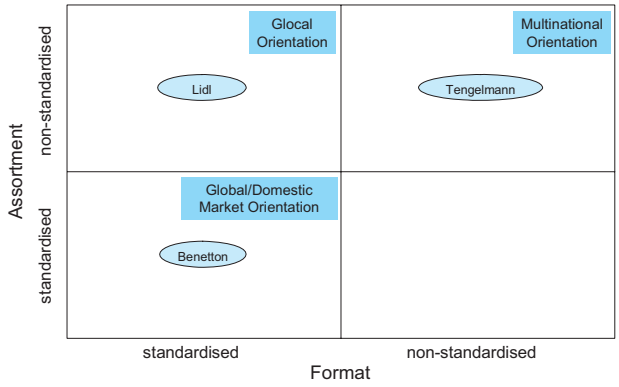
Acquisitions (and *mergers*) are often the only way to internationalise. "Without a suitable concept to internationalise, many retailers are forced to consider acquisitions rather than the internationalisation of their domestic format" (Alexander 1997, p. 285). The replication of domestic operations abroad through new store development is a growth strategy based on experience (and success) in the domestic market. This strategy means *internal expansion* (Dawson 1994) or *organic growth*. Acquiring a foreign retail operation can also be the starting point for transforming existing stores into the domestic market concept or into the global concept. This is the case when legal constraints in foreign countries are barriers to developing new stores, for example in large-scale retailing (like superstores or hypermarkets). Acquisitions can also be the appropriate entry and operation mode for implementing a specific country market approach (multinational orientation).

International Retail Marketing

Retailers that internationalise their operations must define their marketing mix in domestic and foreign markets with regard to the four basic types of international retailing (as illustrated in Figure 5.1). Figure 5.4 displays the

retail marketing concepts in terms of the main elements of format and assortment in the cases of a domestic market, global, multinational and glocal orientation.

Figure 5.4 *Standardisation vs. Adaptation of Retail Formats and Assortment*



Source: Adapted from Liebmann/Zentes 2001, p. 273.

The domestic market and global approaches are characterised by both standardised formats and assortments. The standardised format includes the locations of the stores and the mode of instore marketing (see Chapter 7 and Chapter 10). The standardisation of assortment refers to merchandising and the principles of category management (see Chapter 8). In general, in this case, the price positioning of the format is the same in each country. There may still be differences in the disposable income of consumers.

With glocal orientation, the assortment and price/promotion activities are adapted to local conditions, e.g. in food retailing, to the local/regional taste. Multinational operations mean different formats (i.e. positioning, retail brands) with different assortments and different price/promotion policies in different countries.

Concluding Remarks and Future Challenges

The successful operations of retail companies in non-domestic markets revolve around one main principle. Only companies which have proven themselves in a highly competitive domestic market have a chance of earning

money abroad. An attempt to "escape" into foreign markets, because of weakness in the domestic market, will fail (Liebmann/Zentes 2001).

One of the greatest challenges facing "cross-border" retailers is presently the market appraisal of new emerging markets in Eastern Europe, especially in countries which are not members of the European Union, and in Asia (China, India). The right strategic choice in terms of timing and the appropriate mode of entry in these markets constitutes a substantial challenge.

Further Reading

AKEHURST, G.; ALEXANDER, N. (Eds.) (1997): The Internationalisation of Retailing, London et al.

LAMEY, I. (1997): Retail Internationalisation: Cross Border Strategies, London.

Case Study: Aldi[1]

Profile, History, and Status Quo

The retail company *Aldi* is currently a synonym for successful hard discounting, in its domestic market of Germany as well as internationally. The success story began in 1946 when the brothers Theo and Karl Albrecht took over their parents' grocery store. By 1960, they had built up a chain of about 300 stores. In 1962, the first *Aldi* (short for *Albrecht Discount*) in the form of a hard discounter opened in Dortmund (Cliquet 2006, p. 130). In the same year, the brothers decide to split their business into two legally independent companies: *Aldi Nord* located in Essen (Theo Albrecht) and *Aldi Süd* located in Mühlheim/Ruhr (Karl Albrecht). The reason for this separation, leading to a (still prevailing) regional segmentation of the market at both national and international levels was a quarrel about integrating cigarettes into the regular assortment. Karl Albrecht was against this integration, not because of health considerations, but in order to minimise shoplifting. Since then, both companies have been operating independently as far as their organisation and their finances are concerned, but they cooperate on basic decisions such as the selection of important suppliers or pricing policy. In the following case, the name „*Aldi*" refers to both companies, unless explicitly indicated to the contrary.

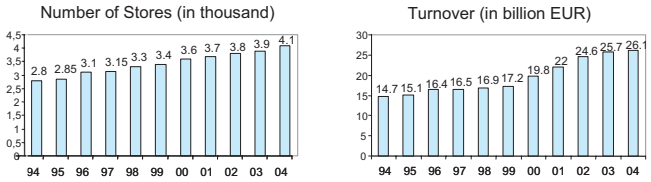
Separation into Aldi Nord and Aldi Süd

1 Sources used for this case study include various volumes of the Lebensmittel Zeitung, LZ Net, Lebensmittelpraxis International, several German and European daily newspapers as well as explicitly cited sources.

Success Story in Germany

In Germany, *Aldi* has grown rapidly since the 1960s and was present in 2005 with about 4,100 stores all over the country (about 1,600 *Aldi Süd* sites and about 2,500 *Aldi Nord* stores). This expansion is reflected in the wide acceptance by German customers, such that an *Aldi* store is currently within walking distance of about 80 % of all Germans and 85 % of German customers shop there at least sometimes (AC Nielsen 2003, p. 48). Figure 5.5 depicts this expansion by showing the development of the key figures – number of stores and annual turnover.

Figure 5.5 *Aldi's Development in Germany: 1994-2004*



Source: Twardawa 2006, p. 382.

By 2004, *Aldi* was Germany's fourth largest player in the food retail sector. The company was also able to transfer its strategy abroad successfully, so that the discounter is now placed eighth in the European ranking of food retailers and twelfth in the worldwide ranking list (see Table 5.1).

Secrecy

This family business is not only characterised by its success, but also by its secrecy, which is reflected in a complex ownership structure with currently about 60 independent regional companies throughout Germany as well as a service head office with a different legal form. This structure allows for an extensive evasion of disclosure regulations. Additionally, there is no PR department, neither on a national nor an international level. At the moment, an end to the present expansion is becoming apparent.

Thus, further expansion with the same high pace is hardly possible without cannibalising existing outlets (Freitag/Hirn/Rickens 2006, p. 30), so that the company is now concentrating less on the expansion of the marketing network, and more on enhancing the existing network. *Aldi Nord*, for example, refurbishes about 60 old sites every year. Furthermore, as observed in recent years, the hard discounter will have to react to a greater extent to current trends such as the customer preferences for more organic food or fresh products.

The Hard Discount Grocery Store Concept

The denotation *hard discounter* or *hard discount store* is used as a synonym for *limited-line store* (see also section "Hard Discounters" in Chapter 1). This retail format which was invented by *Aldi*, is defined as a store that focuses on high volume sales of a limited and flat product range, items which are displayed in cut cases, limited hours of operation, few services and low-priced own brands (Berman/Evans 2007, p. 141).

The following typical features characterise the hard discounter and define it compared to other retail formats of food retailing (Haas 2000, p. 57):

- simplification and efficiency (concentration on essentials, no-frills)
- cost leadership, which can be passed on to customers, in the form of price leadership.

Typical Elements of an Aldi Store

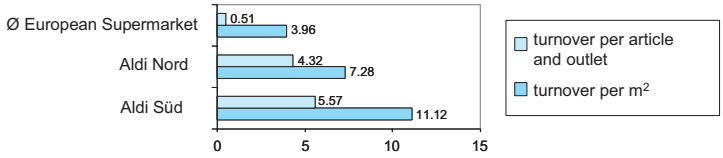
The hard discount concept, which has a market share of 40 % of the entire food retail sector in Germany, becomes manifest in the following key data for a typical *Aldi* store:

- very limited assortment with about 700 articles; additionally 15-20 promotion articles ("special buys") twice a week
- floor space at an average of 800-1,200 m² with about 100 parking places
- store brand share of over 90 %
- plain and functional shop design concentrating on easy and quick shopping, minimum service, plain presentation of goods.

Figure 5.6 shows *Aldi's* efficiency, which has been achieved on the basis of the consistently implemented discount strategy.

Annual Turnover Per Outlet and Article and Turnover Per m² (in 1,000 EUR)

Figure 5.6



Source: Adapted from McKinsey 2004, p. 7.

Internationalisation of Aldi

Aldi's International Activities at a Glance

At present, with a turnover of about 15 billion EUR, the international operations of *Aldi* represent a share of well 45 % of the total turnover (see Table 5.1). By 1967, the internationalisation of the company was initiated by the takeover of the Austrian food retailer *Hofer*, other market entries in European countries and overseas markets followed later. Table 5.3 gives a review of current foreign commitments – broken down into *Aldi Süd* and *Aldi Nord* – which currently comprises 14 countries.

Table 5.3 *Sequence of Aldi's Market Entries*

Country	Aldi Nord or Süd	Market Entry	Number of Stores (2005)	Market Position (2005)
Austria	Hofer (Süd)	1967	370	3
Netherlands	Nord	1973	410	3
Belgium	Nord	1976	395	4
USA	Süd	1976	700	24
Denmark	Nord	1977	240	3
France	Nord	1988	800	10
Great Britain	Süd	1990	320	10
Luxembourg	Nord	1990	11	4
Ireland	Süd	1999	30	7
Australia	Süd	2001	100	5
Spain	Nord	2002	120	12
Switzerland	Suisse (Süd)	2005	10	N/A
Slovenia	Hofer (Süd)	2005	11	N/A
Portugal	Nord	2006	15	N/A
Poland	Nord	planned for 2006	/	N/A
Greece	Hofer (Süd)	planned	/	N/A
Hungary	Hofer (Süd)	planned for 2008	/	N/A

Source: Adapted from M+M Planet Retail Ltd.

Expansion in Europe

The international operations can be grouped roughly into the entry in the neighbouring country Austria, a first wave of internationalisation into smaller adjacent markets in the 1970s, a second wave into Western Europe at the beginning of the 1990s, the entry into Southern and South-Eastern Europe and Switzerland after 2000 as well as the overseas commitments in the USA and Australia. Within the scope of its foreign commitment, *Aldi* often established the hard discount segment in various foreign markets and

therefore the individual steps have to be evaluated in connection with the share of the hard discount segment in the respective market.

Market Entry in the Neighbouring Country of Austria

In 1967, the first step towards the internationalisation of the German hard discounter was made with the takeover of the Austrian food retailer *Hofer KG*. By doing so, *Aldi Süd* promptly acquired an established network of stores. Because of the level of awareness of *Hofer* in the Austrian population *Aldi Süd* still uses the retail brand *Hofer*. *Aldi* – having been active for nearly 40 years – has successfully established the hard discount concept in Austria. The current market share of all hard discounters, apart from *Hofer*, but including *Lidl*, *Mono!* and *Penny* (both *Rewe*) as well as *Zielpunkt* (*Tengelmann*), amounts to about 20 %, so that hard discounters rank second in Austrian food retailing, after the supermarkets. The market share of *Hofer* alone amounts to a turnover of about 2.5 billion EUR in 2004, thus 16 %. By the end of 2006, the branch network should rise to 400 outlets (Schuhmayer 2006, p. 31).

The main reason for this successful development lies in the extensive market experience of the hard discounter which, combined with the high price sensitivity of Austrian customers, conforms strongly to the preferences of Austrian consumers. The market has been developing very much analogously to the German one, with its standardised assortment of about 700 products, floor space of about 900 m² and almost exclusively store brands (Rudolph/Schröder 2006c, pp. 240-246). The arch-competitor *Lidl* has only been operating in the Austrian market since 1998. Traditionally, Austria is regarded as an important gateway to Eastern and South-Eastern Europe. Thus in December 2005, the market entry into Slovenia was organised via *Hofer*. Furthermore, *Hofer* management is currently being expanded in order to handle the planned expansion to Hungary and Greece.

Market Entry in North West European Bordering States

Between 1975 and 1977, *Aldi Nord* began to internationalise with the expansion into the bordering countries of the *Netherlands*, *Belgium* and *Denmark*. In the Netherlands, the market share of *Aldi* now amounts to almost 9 %, whereas *Lidl*, which entered this market in 1998, covers only about 3 % of Dutch food retailing. At present, the fast organic growth within the country which was necessary for the profitable operation of the established central warehouses, has slowed down somewhat.

Until the market entry of *Lidl*, *Aldi* held an unchallenged monopoly in the hard discount segment, which also applied to domestic competitors. The strategy of price leadership is also important here. The assortment size corresponds to that of the domestic market, but there is a greater supply of fresh products (Rudolph/Schröder 2006a, p. 228). Shop design is of only limited importance for *Aldi Nord*.

The commitment in the Netherlands was an important stepping-stone for the company's market entry into Belgium which was made in 1976. At present, the market share of *Aldi* amounts to about 6 % and the hard discount concept which had been established by *Aldi*, developed into the second most important retail format. At first, *Aldi* concentrated on the border region to Germany to maximise spill over effects and because of a high level of awareness. The expansion was subsequently accelerated throughout the country in order to achieve an efficient multiplication of the standardised operations concept. Packaging and assortment size are geared to the domestic market (Rudolph/Schröder 2006b, pp. 226-227).

In Denmark *Aldi Nord* was apparently able to break even only ten years after its market entry in 1977. Here, too, the hard discounter grew organically by gradually developing a branch network throughout the country. Meanwhile, the market share is now about 4 %, ranking third in retailing behind *Coop Danmark* and *Dansk Supermarked* (Rudolph/Schröder 2006a, p. 252). The Danish food retail has changed structurally after *Aldi's* market entry; local chains opened hard discounters themselves and the market share for this segment in the entire food retail sector currently amounts to about 10 %. At present, in Denmark, *Aldi* is concentrating increasingly on local needs with regard to assortment (e.g. fresh milk, fresh meat and organic food) and store design.

Market Entry in Western Europe

Traditionally, *France*, where hypermarkets have a market share of about 35 % and represent the strongest segment of food retail, is known as a difficult terrain for foreign retailers, partly because of a very distinct food culture. Altogether, the hard discount segment established by an almost simultaneous market entry of *Aldi Nord* and *Lidl* at the end of the 1980s, has a market share of about 10 % and thus shows potential for further growth. In 2005, the growth of this retail format was stagnant for the first time (apart from the German discounters this also applied to the French hard discounters *ED* (*Carrefour*) and *Leader Price* (*Casino*)), the reason for which is seen in the price-pushing reactions of the local full-range providers. Yet, *Aldi* was able to increase its market share marginally to 2.1 % in 2005 and ranks third in the hard discounter list behind *Lidl* and *ED*. However, *Lidl* is represented by 1,200 outlets which means twice as many stores compared to *Aldi Nord*, although the duration of market presence is almost the same.

Because of a relatively bad acceptance on the part of the French consumers, *Aldi* has adapted its market operation more and more to local competitors in recent years. Thus, in 2005, the assortment has been enlarged by about 25 %, although *Aldi* is usually careful with line extensions, because they normally put a strain on the cost structure. Additionally, *Aldi Nord* entered the *Luxembourg* market in 1990, the market with the highest per capita income in Europe, and where the hard discounter currently runs about ten stores.

In 1990, *Aldi* entered the *United Kingdom* market, but has not yet been able to gain ground. The company only has a marginal share of 1 % in British food retailing. The entire hard discount segment is also stagnant at 4 %, contrary to prognoses in 1992 which estimated that the market share of all hard discounters would be 20 % by 2000 (IHA-GfK AG 2005, p. 77). The reasons for this poor performance are the following: the reaction of supermarkets (price reductions, introduction of store brands), the pronounced British supermarket culture, the poor image of hard discounters, and high rents. All these reasons render a low price concept at attractive sites difficult. Given this lack of acceptance, *Aldi* recently undertook a series of measures:

- improved fresh ranges: focus on meat and produce
- improved consumer marketing campaigns: used to emphasise the new quality store brand *Especially Selected* and overall value for money
- new store designs and merchandising concepts
- re-locating and opening new stores in average income areas
- sale of non-food items
- new product packaging to portray a premium image
- greater use of brands: *Aldi* is offering a limited number of leading manufacturer brands for the first time (IGD 2005, pp. 15-20).

First image successes have already been achieved. Furthermore, the hard discounter is changing its growth strategy from a slow, successive development to a more expansive strategy striving for 1,500 outlets in the long run.

Based on the ten-year experience in the United Kingdom, the market entry in *Ireland* was undertaken in 1999, but here, *Aldi Süd* was confronted with strong opposition from the government and lobbyists representing local food retailers. Nonetheless, the market share is already about 4 %. Following the innovations in the United Kingdom, *Aldi* now strives for a higher-value positioning with a large number of convenience products and appealing packaging in Ireland. The newly designed and attractive shopping bags bear the slogan "We've never looked so good". *Aldi* pursues a "site by site" growth route, probably because of the absence of any suitable retail chain to acquire.

Market Entry in South and South-East Europe

In March 2002, *Aldi* became active in *Spain*, which is known as a classic "toehold" for *Portugal*. Here, the first fifteen outlets were opened in late June 2006. In both Spain and Portugal, *Aldi* is active as a second mover. The German competitor *Lidl* has already been present in these two countries since 1993 and 1996 respectively and ranks second and first of all hard discounters there.

In December 2005, the market entry in *Slovenia* was made via *Hofer*, the Austrian subsidiary of *Aldi Süd*, and represents the first contact with the Eastern European region. Slovenia has the highest per capita income of all Eastern European countries and is therefore classified as a mature market. In Slovenia, an assortment of about 700 products is offered under the retail brand *Hofer*. National preferences have to be taken into consideration adequately in this assortment. Almost simultaneously, ten sites were established countrywide and this net can be expanded further in the future.

There are also plans for market entries in *Hungary*, *Poland* and *Greece*. However, the market entry in Hungary will only take place in 2008 and thus later than initially scheduled, because, at present, only about 40 sites have been found. This is not sufficient for a rapid achievement of critical mass. Contrary to *Lidl* which has been planning or implementing market entries in Poland, Solvenia, Hungary, Croatia, Slovakia and the Czech Republic as well as in the Baltic States since 1996, *Aldi* held off operations in the (South-) Eastern European market. Amongst other reasons, this was the result of lower purchasing power, as well as of the belief that *Aldi* can never enter a new market "too late" (Freitag/Hirn/Rickens 2006, p. 32).

Market Entry in the "High Price Island" of Switzerland

Retailing in Switzerland is dominated by the three confederate companies *Migros*, *Coop* and *Denner*, which have a combined market share (in food retailing) of 80 %. The announcement of *Aldi Süd's* intention to become active in the high-price Swiss market was accompanied by considerable media attention and "defensive activism" from the unions, for example. As in the other country markets, the operating strategy for this non-EU country is non-cooperative. *Aldi* will initially operate in the German-speaking part of Switzerland and only later in the French- and Italian-speaking regions. In formulating the assortment, *Aldi Suisse* concentrates not only on the 700 products for daily use, but also on the adaptation to eating and consumption habits which are typical of the country (IHA-GfK AG 2005, p. 90). Thus, for example fondue cheese is offered.

Compared to Germany, the prices of *Aldi Suisse* are significantly higher, caused, inter alia, by the customs surcharge and required packaging with labelling in all three national languages of Switzerland. The retailer also has to consider restrictions on site development, because, for example, the right of complaint of societies as well as strict planning restrictions (Schäfer 2006, p. 113). According to the literature, the following incentives have prompted *Aldi* to undertake the market entry, despite the mentioned adversities: the high Swiss purchasing power, higher margins than in almost all other European countries due to the elevated price level, as well as Switzerland as proving grounds in general.

Activities Overseas

In 1976, the first overseas activities by *Aldi Süd* entailed taking over 50 outlets of *Benner Tea of Iowa*. The number of *Aldi* outlets in the USA currently numbers about 700 so-called "box stores". At present, *Aldi* is very densely represented in the so-called Midwest States such as Illinois, as well as on the East Coast. Apparently, *Aldi* plans to open about 40 new outlets a year in the USA in order to have about 1,000 sites by 2010 and to increase the market share in US food retailing from 0.65 % in 2004 to about 2 %.

In 1979, *Aldi Süd* purchased *Trader Joe's* and thus became a 100 % owner of the supermarket which was established in 1967, and now has about 200 outlets in 20 American states. The assortment consists of high quality food in the organic, gourmet and ethno segments and more than 80 % of the products are store brands (*Trader José's*, *Trader Giotto's*, etc.). With a range of about 2,500 to 3,000 articles as well as an average floor space of under 1,500 m², *Trader Joe's* dimensions are rather modest by American standards. *Aldi's* engagement is a purely financial investment. There is evidently no intervention in the operative business. The company, which is characterised by a Hawaiian shop atmosphere, has gained cult status among above average wage-earners who have an ecological orientation and was able to increase its profit tenfold between 1990 and 2001. Just like the parent company, *Trader Joe's* finances its growth through cash flow, and thus grows free of debt and consistently, but not aggressively.

Furthermore, the retailer is active on the North American continent with a 6.2 % participation of *Aldi Nord* in the US chain *Albertson's Inc*. in Boise (Idaho). This is also a purely financial engagement. Because of the sale of *Albertson's* to the US competitor *Supervalu* at the beginning of 2006, future developments remain unclear.

In 2001, *Aldi Süd* became active on a third continent by opening the first outlet in *Australia*. This caused a press sensation, particularly as *Aldi* introduced the hard discount concept in a highly competitive and saturated environment. As in the USA, the discounter also maintains some aspects of its standardised concept in Australia, and these are unusual for the local customers, such as the coin system for the shopping trolleys. Although these measures are new to the local clientele, their response has been positive nonetheless and therefore, in 2005, *Aldi* was able to open the hundredth outlet in Australia, a figure reached again by organic growth. There is a lot of conjecture as to *Aldi Süd's* plans to enter New Zealand and Canada. These countries could be entered via the neighbouring countries Australia and USA. This development again reveals the separation between *Aldi Nord* and *Aldi Süd*, with the latter being responsible for English-speaking markets.

Conclusion and Outlook

Up to the present and over an extended period of time, successful growth of *Aldi* in the domestic market has been characterised by a high degree of continuity which is often compared with the annual rings of growing trees: "Every year a bit more" (Wolfskeil 2005). Over the years, the outstanding position in Germany could thus be attained. However, the enormous growth over the last few decades cannot be maintained.

The company is faced with the dilemma that the potential for quantitative growth will only be marginal, because of the almost 100 % market coverage. Also, a switch to qualitative growth, through, for example, line extension, better service or modernisation of the branch network seems to be necessary. However, this strategy implies a movement away from the key competency of greatest possible reduction, from the "plainness" and thus from the original and successful hard discount business model. This inevitably involves considerable risk, such as the possible loss of its distinct image.

For almost four decades, the company has also been active abroad. During this period, it has been possible to gain considerable internationalisation experience and to transfer important elements of the hard discount to foreign markets. The increase in activities abroad since the turn of the millennium is striking, including the plans for market entry into Hungary, Poland and Greece as well as rumours about Turkey and Russia. As described above, a mere "escape" to foreign countries is no solution to stagnation in the domestic market.

Yet, already in 1976, in the face of a short-term declining market share, line extension and international engagements in the Netherlands, USA and Belgium, the following question arose: "Is Aldi the end of the line?" (absatzwirtschaft 1976, p. 23). At that time, the retailer was able to revise this prediction by its impressive subsequent development. Thus, it remains to be seen whether this time "the discount wunderkind" (Private Label Magazine 2005) will again dispel current fears through successful internationalisation.

Questions

1. Within the context of its internationalisation, *Aldi* enters new markets through organic growth and its own branches. What are the advantages and disadvantages of this market entry strategy in general, as well as specially from the point of view of a hard discounter?
2. The basic decision, within the framework of the internationalisation of a company, entails the choice between standardisation and adaptation. The standardised marketing (the strategic attributes of the retail format hard

discount) has been an important key characteristic of *Aldi's* internationalisation in the past. Discuss in which countries there has recently been a deviation from this process and indicate possible reasons. Can you detect long-term trends?

3. Market selection**:** Does the sequence of foreign markets entries conforms to the theoretical concepts of psychic distance? Can patterns be detected regarding an explicit evaluation of foreign markets before the actual market entry?
4. Ideally, it is possible to differentiate between a first-mover (pioneer) and a second-mover (successor) strategy in the course of entering foreign markets. What are the prevailing advantages and disadvantages? Can *Aldi* be assigned clearly to one of these strategies?

Hints

1. See section "Entry and Operating Strategy" in this Chapter for the five modes of market entry or modes of operation, as well as Akehurst/Alexander 1997 or Lamey 1997 for general advantages and disadvantages.
2. Take into account the current press coverage in the United Kingdom and Switzerland, for example.
3. See Sousa/Bradley 2005 on the concept of psychic distance.
4. See Lamey/Alexander 1997.

Chapter 6

Retail Branding and Positioning

The purpose of this Chapter is to explain the concept of retail branding and the advantages of establishing and strengthening the retail brand. The brand architecture of retailers, approaches to measuring brand equity, the concept of brand positioning and principles of successful retail brand management are discussed.

Emergence of Strategic Retail Marketing

Even though retailing has long had the opportunity to be marketing-oriented because retailers are in closer contact with customers than manufacturers, mass retailing has been slow to take advantage of this aspect. Higher priority has been placed on buying decisions, operational concerns and short-term objectives than on strategic marketing concepts (Mulhern 1997, p. 104). A lack of a well-defined differentiation from competitors has been a frequently criticised consequence in many retail sectors.

However, this has changed. Mainly as a result of changing industry conditions and increasing management capability in retail companies, a change of attitude towards strategic marketing can be observed. Within the context of strategic marketing, the relevance of establishing a clear-cut and differentiated profile is clearly recognised by retailers, and retail brands are systematically being established and managed (Morschett 2006).

Retailers as Brands

While in the past, the term *brand* has been applied mainly to manufacturer brands (such as *Coca-Cola, Nokia* or *Gillette*), the brand concept can be applied to all kind of products and services, including retailers (Keller 2003, pp. 13-22).

Brand Definitions

Some authors define a brand as a name or formal sign. According to the *American Marketing Association*, a brand is a "name, term, design, symbol, or any other feature that identifies one seller's good or service as distinct from those of other sellers" (www.ama.org). However, separating the brand name from the product or service alters the nature of the brand. If one were to take the *IKEA* logo and link it to a grocery supermarket, it may keep part of its brand strength, but the character of the brand would change with the under-

lying product. Other definitions therefore encompass the brand name (or brand logo, brand sign) and the branded product to define a brand: "A brand is therefore a product, but one that adds other dimensions that differentiate it in some way from other products designed to satisfy the same need" (Keller 2003, p. 4).

Stores as Branded Products

Retail branding is a strategy based on the brand concept and which transfers it to a retail company. A retailer's "products" are his stores that can be marketed in a similar way to a branded good. A *retail brand* is then a group of the retailer's outlets which carry a unique name, symbol, logo or combination thereof. While all retailers constitute brands to some extent, some retail brands are strong, while many are not. Recognition and appreciation by consumers are the essential elements of a strong retail brand (Morschett 2002, p. 108). Retail branding can be understood as a comprehensive and integrated marketing management concept, focussing on building long-term customer loyalty and customer preference.

Retail Brand and Store Brand

The term *retail brand* has to be distinguished from the term *store brand* (see Chapter 8). While *retail brand* refers to stores (e.g. *B&Q, Lidl, FNAC*), the term *store brand* refers to the product level and is used synonymously with private label. Often, the retail brand is also used to label the store brands, though this is not a universal characteristic (Wileman/Jary 1997, p. 17, 134).

Retail Brand Complexity

Retail brands are characterised by enormous complexity, which results from the service attributes of retailers as well as from the multiplicity of brand attributes and consumer-retailer interactions. While manufacturers frequently offer only a few products under one brand and the industrial production process is completed through quality control, customer experience with the retail brand is often shaped by several hundred outlets, with different locations and store designs, thousands of products, and dozens of employees in each store, who are also influenced by their moods and emotions. A uniform, consistent, and standardised performance and brand message is therefore difficult to convey (Wileman/Jary 1997, pp. 40-42).

Advantages of a Retail Brand

Establishing a strong brand can be the key to long-term performance (Aaker 1996, p. vii) by providing the retailer with considerable advantages (Keller 2003, pp. 8-12, 59-61; Morschett 2002, pp. 31-41; Bruhn 2005, pp. 27-49):

- An existing retail brand strengthens brand awareness and differentiation from the competition, because it can serve as an anchor for associations with the brand. An established brand enhances the *effect of marketing measures*. In an age of increasing consumer information overload, established and well-known brands receive more attention than unknown

brands. For example, advertising for strong retail brands is more likely to be perceived and recognised by the consumer, resulting in a higher efficiency of marketing budgets.

- From the consumer perspective, strong retail brands *simplify the purchasing process* because there is already some knowledge about the retailer and buyers do not have to search for additional information about assortments, prices, service, etc. Strong retail brands also reduce perceived purchasing risk. Buying well-known product brands as well as from well-known and trusted retail brands are purchasing strategies which aim at risk reduction. Consequently, strong retail brands may lower the price sensitivity of consumers. A well-defined brand profile can establish a preference position that allows a retailer to minimise price competition.
- Strong brands exert *halo-effects*. A positive general attitude towards the brand in total positively influences the perception of all specific brand attributes. Considering the impact of these evaluations on the general attitude, a *virtuous cycle* can develop.
- Strong brands not only represent functional benefits, they can also serve as *symbolic devices*. They represent different values, traits, and characteristics. Shopping at a certain retailer might, therefore, allow consumers to project a certain self-image to themselves and others.
- If a retail company operates in different market segments, *differentiated marketing* with different retail brands facilitates approaching each market segment with a targeted approach. Cannibalisation is easier to avoid and each retail brand can develop its own image – without contradictory image transfers. Conversely, a strong brand can be used as a platform for expansion. This already occurs when retailers open new outlets, which, from the very start, are loaded with a certain image. Franchising concepts, in which the retail brand is transferred to independent shop owners, clearly illustrate this advantage. A strong retail brand can also facilitate diversification into new product ranges. This type of brand extension occurs when retailers use their image in one merchandise category to expand into additional categories.

Measurement of Brand Equity

These advantages are enjoyed especially by strong retail brands. However, the measurement of brand equity is not easy and there is no generally agreed-upon concept. Nonetheless, measurement approaches can generally be classified into two streams, which also differ in their definition of brand equity (Lassar/Mittal/Sharma 1995, p. 12):

- financially-oriented, monetary approaches
- consumer-oriented approaches.

Monetary Brand Equity

The following definition is typical of the monetary approach: "Brand equity can be thought of as the additional cash flow achieved by associating a brand with the underlying product or service" (Biel 1992, p. RC7). For example, using a complex formula to forecast future revenues for the brand and capitalising them into a present value, the consulting company *Interbrand* estimates that the world's most valuable brand is *Coca-Cola* with a brand equity of about 67 billion USD. The most valuable global retail brands in the *Interbrand* ranking are *Dell* (13.2 billion USD), *The Gap* (8.2 billion USD), *IKEA* (7.8 billion USD) and *Zara* (3.7 billion USD) (Business Week, 1.8.2005, pp. 90-94; www.interbrand.com).

Consumer-Oriented Brand Equity

While in some situations, deriving a monetary brand value is important (e.g. for the purpose of selling or licensing the brand), the equity is the result of a long-term investment in the brand. For brand management, consumer-oriented brand equity concepts might be more appropriate and sensitive to changes. Here, Keller (1993, p. 1) provides a typical definition: A brand is said to have positive customer-based brand equity when consumers react more favourably to an element of the marketing mix for the brand than they do to the same marketing mix element when it is attributed to a fictitiously named or unnamed version of the product or service. This type of brand equity or brand strength is developed in the mind of the consumer and the consumer's attitude towards the brand, his associations and experiences with the brand, his evaluation of the brand quality are the most important aspects of measuring brand equity.

Indicators for Retail Brand Equity

Different researchers propose different indicators for measuring consumer-oriented brand strength, which can, aggregated or individually, be considered when managing the brand and when evaluating the success of certain marketing measures (e.g. Aaker 1996, p. 7-25, 318-333; Lassar/Mittal/Sharma 1995; Zentes/Morschett 2002, p. 165). Indicators of consumer-oriented retail brand equity are, for instance:

- brand awareness
- trustworthiness of the brand
- customer satisfaction with the brand/customer loyalty to the brand
- brand liking
- brand differentiation.

Some other indicators suggested in literature for brand equity are not generally appropriate for retail brands. *Price premiums*, for instance, are sometimes used for evaluating brand value. Many successful retailers, however, emphasise their low prices, and trade off potential price-premiums for higher sales volumes or higher sales productivity.

Brand Architecture

As defined above, a retail brand refers to the level of the store. However, the brand system of a retailer is more complex. *Brand architecture* refers to the internal structuring of the retailer's brands and revolves around how many and what kinds of offers are provided under a certain brand (Ailawadi/Keller 2004, p. 338). Within the *brand hierarchy*, a retailer's brands can be divided into different levels (Keller 2003, pp. 534-565). Retailers have brand names at the level of the retail company as a whole ("corporate brand"), the retail stores, the merchandise (e.g. the store brands), and specific retail services (i.e. banking services or loyalty programmes). Besides the individual branding decision at each level, the interconnection between the levels has to be considered. Merchandise branding is discussed in Chapter 8.

Brand Hierarchy

As in industrial multi-product companies, retailers with more than one store have to decide whether the stores should carry the same or different brands.

Branding Strategies

Branding Strategies at Different Retail Companies

Table 6.1

Brand Strategy	Retail Company	(Selected) Retail Brands of the Retail Company
Umbrella Brand	Tesco	Tesco Extra, Tesco (Superstores), Tesco Express, Tesco Extra
	Edeka	Edeka aktiv markt, Edeka neukauf, Edeka center
	Système U	Marché U, Super U, Hyper U
Mixed Strategy	Coop (CH)	Coop, Coop Pronto, Coop bau + hobby, Coop City, Coop@home Interdiscount, TopTip, Impo, Christ
	Migros (CH)	M, MM, MMM, Migros Restaurant, m-electronics Globus (department stores), OBI (as franchisee), Office World, interio
Family Brand	Metro	Metro Cash&Carry, Real, Media-Markt, Saturn, Kaufhof
	Kingfisher	B&Q, Castorama, Brico Dépôt, Screwfix, Koçtas
	Casino	Géant, Casino, Leader Price, Monoprix
	Carrefour	Carrefour, Dia, Champion, Ed, Minipreço, Ooshop.com
	DSG international	Currys, Dixon, Dixon.co.uk, PC City, Electro World, Elkjøp

Three general branding strategies can be distinguished at the level of the retail brand (see Table 6.1 for examples):

- an *umbrella brand strategy*, where all the stores of the company carry the same brand, in most cases differentiated by a sub-brand
- a *family brand strategy*, in which groups of stores of the retail company (usually different retail formats) carry different brands, i.e. the brands are strictly separated
- a *mixed strategy*, which applies an umbrella brand for some store formats and separates others by using different brand names.

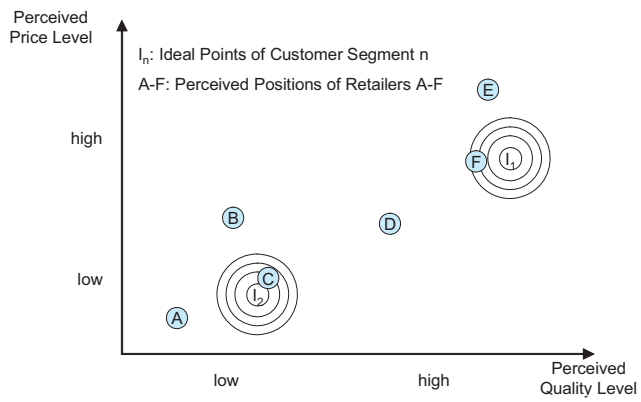
The main decision in this context is brand image transfer vs. brand image separation. Using an umbrella brand strategy, the common brand name leads to a substantial image transfer. Consumers transfer the associations they carry for *Tesco Superstores* at least partly to *Tesco Express* stores. All stores are part of one large brand and have to convey the same message to the consumer, if the brand image is to remain strong. A family brand strategy, on the other hand, is usually the result of market segmentation and an unambiguous brand focus with different brand attributes for each store format. *Carrefour* hypermarkets, for example, target a different market segment than *Carrefour*'s discount chain *Dia*. An image transfer would, therefore, probably not benefit either of the stores.

Retail Brand Positioning

Strategic brand management starts with a clear understanding of what the brand is to represent and how it should be positioned relative to competitors (Keller 2003, p. 44; Wortzel 1987, p. 47). *Positioning* is the deliberate and proactive process of defining and influencing consumer perceptions of a marketable object, with a strong focus on the competitive position. A product is thus positioned in the minds of the consumers (Arnott 1993, p. 24).

Positioning usually applies certain fixed dimensions along which the retail brand defines its position relative to its competitors. Positioning diagrams represent the location of different brands as well as the different target groups' ideal points in a two-dimensional space (see Figure 6.1).

Figure 6.1 *Differently Positioned Retailers in the Price-Quality-Space (Fictitious Example)*



Market segmentation is often considered necessary for successful brand positioning. Market segmentation refers to the process of dividing a (heterogeneous) total market by certain attributes into (more homogeneous) partial markets. Segmentation criteria can be demographic, socioeconomic, lifestyle, geographic location and many others. Segmentation therefore includes the selection of one or several market segments and targeting the marketing towards the purchasing behaviour, motives, or expectations of these groups (Kotler et al. pp. 316-346). However, segmentation is often considered difficult for retailers with given catchment areas and the need for high customer traffic in their stores which require appealing to broad customer groups (Wileman/Jary 1997).

Positioning is often based on the two generic competitive strategies of Porter (1980): cost/price leadership vs. differentiation (similar to Figure 6.1). While this broad classification can also be applied to retailing, researchers propose other frameworks, because retailing reality shows that there are many options for differentiation. The following are among the positioning dimensions most frequently proposed (see e.g. Wortzel 1987, p. 50; Davis 1992, p. 14; Morschett/Swoboda/Schramm-Klein 2006):

- quality of merchandise
- variety of merchandise
- convenience
- price
- customer service
- location
- store atmosphere.

Successful positioning can be based on any retail activities and a unique profile along the various dimensions yields a clear position that is the prerequisite of a strong brand. At the same time, the advertising spending of retailers has increased strongly over the last few decades and – as an indicator of the increasing relevance of retail branding – in many countries, retail stores are among the most heavily advertised "products" in terms of media spending.

Retail Brand Image

Retail brand positioning is based on a set of fixed dimensions along which a retailer is perceived to be located. However, the retail brand is broader than the actual positioning. The total brand knowledge which a consumer associ-

ates with a brand is relevant to the brand strength. The *associative network* model views memory as consisting of a network of nodes, representing stored information, and connecting links. Any type of information connected to the brand is stored in the memory network, including verbal, visual, abstract, and acoustic information. *Retail brand image* can be defined as perceptions about a retailer as reflected by the brand associations stored in consumer memory. The strength of the brand can be evaluated by analysing the various relevant associations. Their uniqueness, favourability, strength, and the certainty with which consumers link the information with the brand, are the dimensions to consider (Krishnan 1996; Keller 1993). The retail brand image is complex and it is connected to an array of other images, both at a higher level as well as in the form of sub-images. The retail store format image (i.e. category killer image), shopping centre image, location image, price image, merchandise image and other components of the store or its context are all connected to the retail brand image and are part of the memory network of the consumer.

Principles of Successful Retail Branding

All retail marketing instruments affect the retail brand, as illustrated by the notion of the comprehensive retail brand image, which is made up of a universe of interconnected associations. To develop a strong and successful brand, three basic principles are mentioned in literature (Morschett 2002, pp. 43-47):

- differentiation from competitors
- long-term marketing continuity
- coherence of different marketing components.

Differentiation

Achieving *differentiation* (in consumers' minds) is a central characteristic of a brand (Aaker 1996, p. 329), as has already been pointed out in the discussion on positioning. Higher levels of differentiation from the competitor are expected to lead to higher profitability. Only brands that are well distinguished from their competitors can build up long-term customer loyalty and avoid store switching by the consumers.

Continuity

Establishing a clear brand image is a long-term process. Brands are established through consumer learning processes. Consumers store associations in their memory. Brand associations become stronger over time and must be reinforced by repeated exposure to the same brand messages, because they might otherwise fade away. The past investment in the brand-building is at least partly lost if the brand marketing is changed. Thus, *continuity* is important. Also, risk reduction is one of a brand's main functions. Consumers trust

a brand, because it entails a standardised and uniform offer under a certain brand name. Some of the world's most successful brands demonstrate that retaining the same brand message and communication (with slight variations) for years and even decades is one of the key prerequisites of successful branding.

The *retail marketing mix* includes all marketing instruments that a retailer can deploy. The term *mix* indicates that the instruments are not used in isolation, but that they jointly influence the consumer. In order to be successful, all marketing measures must be coordinated to ensure a close *fit* with one another and that all measures convey the same brand message. Because inconsistency makes a brand image fragile and consumers strive for internal harmony or congruity in their knowledge and information ("theory of cognitive dissonance"), creating *coherence* between all the different facets of the retail brand is crucial for success. Considering the complexity of the retail environment, ensuring a fit among the marketing instruments and all brand contact points is challenging. *IKEA* (see case study *IKEA* in this Chapter), *Sephora*, *dm-drogerie markt*, *The Body Shop*, *Boots*, *Zara* and others are examples of successful brands that succeed in projecting a uniform image with their store atmosphere, merchandise, pricing, communication, and service.

Coherence

Conclusion and Outlook

Some of the most successful retailers in the world have developed into strong brands without having consciously managed their brands (Wileman/Jary 1997, p. 20). While this is true, it is important to note that many successful retailers have developed strong brands by – even if unconsciously, adopting the above mentioned principles of branding. From the very beginning, *Aldi*, *IKEA*, *Tesco*, *Wal-Mart*, *Lidl*, and others have had a clear and distinct profile. They pursued their own marketing approach over several decades and, supported by a strong corporate culture, have been very coherent in all their activities. Differentiation, continuity and coherence in these cases were often ensured by the founder(s), who, over the years, developed a clear understanding of what their company should stand for – and followed that through rigorously.

Brand management gains additional relevance through the internationalisation of retailers (e.g., should retailers use the same name in all countries?), with the ongoing wave of mergers & acquisitions in retailing (e.g., should an acquired retailer keep his retail brand or be adapted to the acquirer's brand?) and with multi-channel retailing. Especially in the case of store retailers expanding their business to the Internet, the strategic decision on using the same retail brand across channels or separating the Internet shop from the

store outlets, is crucial and far-reaching (see case study *Media Markt* in Chapter 2).

In recent years, competition and changing consumer behaviour have increased the relevance of retail branding tremendously. Such branding aims at enhancing differentiation and customer loyalty. Retail brand management includes all components of the retail marketing mix and develops a strategic understanding of the intended positioning of the retail company. Developing a retail branding strategy helps to ensure the coherence of all marketing messages and market appearances of the company. Successful companies change over time, but considering the prerequisites of successful branding, the brand core should remain stable.

Further Reading

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Case Study: IKEA[1]

Profile, History, and Status Quo

Since its foundation by Ingvar Kamprad in 1943, *IKEA* has become the world's largest furniture retailer, specialising in stylish, but inexpensive Scandinavian-designed home furnishing and furniture. The following numbers convey this privately-held retailer's extraordinary dimensions:

Dimensions of the World's Largest Furniture Retailer

- more than 270 outlets in 35 countries on four continents
- 14.8 million EUR turnover in the financial year 2005
- 410 million customers in the financial year 2005

1 Sources used for this case study include the web sites http://www.ikea.com and http://www.ikea-group.ikea.com, the social & environmental responsibility report 2005 as well as explicitly cited sources.

- 160 million printed catalogues, published in 25 different languages (2005)
- around 90,000 employees, so-called co-workers.

Even today, after more than 50 years of business activity, *IKEA* is still strongly associated with its founder, Ingvar Kamprad. In 1943, he founded *IKEA*, selling such items as pens, wallets, jewellery and picture frames. The name *IKEA* is an acronym. *I* and *K* are the founder's initials; *E* stands for Elmtaryd, the name of his parents' farm, and *A* represents Agunnaryd, his hometown in the Southern Swedish province of Småland. A small mail-order catalogue was established and furniture was introduced into the product range in 1947 and has been the focus since 1951. Due to customer scepticism towards buying furniture unseen, Kamprad opened a showroom in the village of Älmhult in 1953, where customers could examine the products before ordering. In 1955, due to a suppliers' boycott caused by pressure from competitors, *IKEA* started designing its own furniture. One of *IKEA's* central characteristics, knocked down furniture sold in flat packs, was invented in 1956. In 1958, the first *IKEA* store was opened in Älmhult. Since then, the company has expanded steadily and its first venture into internationalisation was in 1963, when the first store outside Sweden was opened in Oslo, Norway.

Knocked Down Furniture in Flat Packs since 1956

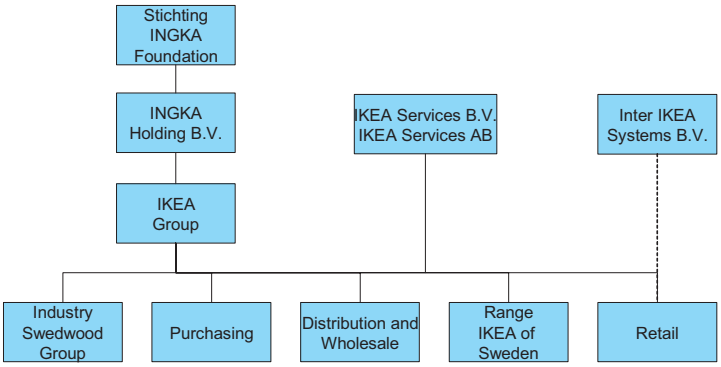
Traditionally, the home furnishings market was very local in orientation, because consumers' tastes vary substantially between regions and because the transportation costs over long distances often render international activities uneconomic. However, the *IKEA* concept has proven itself to be efficient and internationally viable. That is why this retailer currently faces no direct competitors with an equivalent global scope.

Complicated Ownership Structure

Despite the retailer's retail brand positioning being thoroughly Swedish, *IKEA* has, ironically, not been Swedish in a "strict legal sense" (The Economist 2006, p. 69) since the early 1980s. This is the result of its complex ownership structure which is designed to minimise tax and disclosure. Also, the structure renders *IKEA* almost immune to a possible takeover (The Economist 2006, p. 69).

The whole *IKEA* group is owned by the *Stichting INGKA Foundation*, registered in the Netherlands. *INGKA Holding B.V.*, the parent company for all the companies comprising the *IKEA* Group is owned by the foundation. Support for the work within the companies of the *IKEA* group is delivered by a total of nine staff units in the Netherlands (*IKEA Services B.V.)* and Sweden (*IKEA Services AB*). *Inter IKEA Systems B.V.* owns the *IKEA* concept and trademark. It also has franchising agreements with the *IKEA* stores worldwide. (See Figure 6.2 for *IKEA's* ownership structure.)

Figure 6.2 *Ownership and Organisation Structure*



Retail Branding at IKEA

IKEA's Profile

The company's officially published vision is "to create a better everyday life for the many people" which is achieved by combining aesthetic and pragmatic furniture design and solid quality with the constant drive to cut costs and pass the savings on to customers. This vision is manifested in the business idea "To offer a wide range of well designed, functional home furnishing products at prices so low that as many people as possible will be able to afford them".

The cornerstones of the *IKEA* concept, which are the basis of achieving this vision and business concept, are, in many cases, the exact opposite of conventional furniture retailing and have turned the traditional basis of the furniture business upside down:

- Whereas traditional home furniture stores are located as boutiques in city centres, *IKEA* has developed large, even huge stores on the outskirts (category killer).
- Instead of shop assistance, customers serve themselves.
- As opposed to traditional sourcing, the scope of which was always very local, *IKEA* has sourced on a global scale from the very beginning.

- The traditional focus on middle to upper-middle-aged customers has been shifted to younger people.
- Instead of the assembled furniture being delivered at a relatively high price, customers both transport and assemble the flat pack furniture themselves. This self-service on the part of the customers allows *IKEA* to lower their prices tremendously, in comparison with traditional home furnishing retailers.
- When *IKEA* started in Sweden, dark and heavy furniture was popular, but *IKEA* introduced its trademark light Scandinavian style, characterised by blonde wood, natural material and modern design (cf. Kling/Goteman 2003, pp. 31-32).

Positioning Dimensions

Hence, the main dimensions of retailing which establish *IKEA's* positioning (see section "Retail Brand Positioning") are clearly price, variety of merchandise, and store atmosphere. *IKEA* offers the same product range on an international scale, and adapts the store layouts, presentation of the products, home services offered, and prices only where necessary in accordance with national economic and cultural conditions and circumstances. This enables *IKEA* to transfer its profile appropriately worldwide (Miller 2004, p. 37). The retailer standardises as much as possible and adapts only what is necessary. There is, for example, only one set of instructions for the assembly of a piece of furniture, regardless of country, because it contains no written language, but only visual instructions (Levy/Weitz 2007, p. 141).

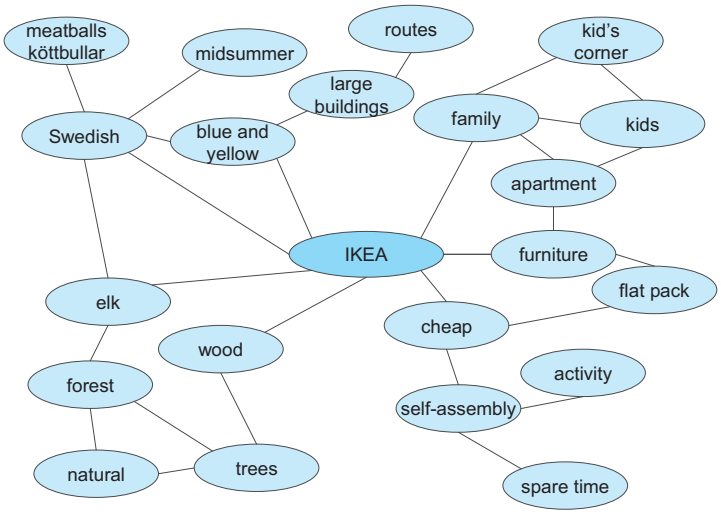
Brand Image

Swedishness

The roots of *IKEA's* profile and brand image are located within the company's Swedish origins and heritage. In order to emphasise this Swedish image, all items sold by *IKEA* carry Swedish or Scandinavian names. Beds are named after Norwegian cities and bedding after flowers and plants by *IKEA of Sweden*. The bookcase *Billy*, four million of which were sold in 2005, and the sofa *Kipplan* are examples of the worldwide bestsellers. Sweden and Swedish characteristics are often associated with, for instance, an open-minded and healthy society, nature and freshness.

The company also explicitly communicates its Swedish management style of a "consensus culture" (Campaign 2005, p. 34) in which employees are encouraged to take responsibility and learn through their mistakes. Due to its specific profile which is dramatically different from traditional furniture retailers, the brand image is very clear and distinct. Figure 6.3 gives an example of a possible associative network which customers typically have of *IKEA*.

Figure 6.3 *Consumer's Associative Network of IKEA (Fictitious Example)*



Source: Adapted from Morschett 2006, p. 532.

This associative network is a reflection of what is being referred to as the "IKEA world" (Capell 2005, p. 46), an entire state of mind. *IKEA* is not a mere furniture merchant, but sells an entire lifestyle, a modern, well-educated and liberal way of life. Typical characteristics of this lifestyle also include a balanced mix between self-realisation at work and leisure time, joy of life and a sense of justice and for political and ecological correctness.

Distinct Retail Experience

At its outlets, which are usually at the outskirts of urban agglomerations, *IKEA* offers its customers a unique, "360-degree retail experience" (Cook 2003) which speaks to the senses and is largely the same in all parts of the world. The brand logo and the outside painting of the stores themselves are yellow and blue, the Swedish national colours. Inside the store, strategically placed bins containing various accessories, paper measuring tapes and pencils provide the shopper with haptic sensations. Customers inside a store follow a marked path along the different showrooms, thus ensuring that all the merchandise is visible. As a result of this fully-guided customer flow, the outcome of a typical shopping trip is that the customer purchases various items he did not initially intend to buy or even knew he needed.

A cafeteria where shoppers can rest and refresh is located at the middle of each vast building. This strategically placed cafeteria prevents customers

from leaving the store to get something to eat, which would often result in customers not coming back to the store at all.

Commitment to Cutting Costs

A very strong association with *IKEA* are its inexpensive prices. It is widely accepted that if it was not for *IKEA,* most people would have no access to affordable contemporary design (Capell 2005, p. 47). In order to achieve its vision of providing "the many" with excellent value for money furniture, *IKEA* is committed to cutting costs wherever possible. Apart from the flat-packed furniture that customers assemble themselves, thus actively participating in making *IKEA's* business model work, the following other elements along the value chain also reduce costs:

- Product range development: About 9,500 products are in *IKEA's* range which are sold globally. They are developed by *IKEA of Sweden* according to the principle of target cost pricing, where defining the final selling price of a new product is the first step in the product's manufacturing process. All subsequent steps in the value chain are designed to meet this pre-defined selling price.
- Production: *IKEA's* industrial group *Swedwood,* established in 1991, produces wood-based furniture and wooden components. It has nine production units mostly located in Eastern and Central Europe in order to benefit from low labour costs.
- Sourcing: 46 trading offices are operated in 32 countries, managing the mostly long-term relationships with 1,300 suppliers.
- Distribution: 28 distribution centres in 16 countries provide for cost-efficient and environmentally friendly distribution.
- *IKEA* outlets: Products are bought and transported in bulk; stores are located in inexpensive areas.

It is also widely known that all *IKEA* employees, even top management, always travel as cheaply as possible, proof of how deeply the maxim of cutting costs is rooted in the company's values. The strict cost-orientation results in operating profit margins of 16 % to 17 % which is "phenomenal" (The Guardian 2004) in retailing.

Distinct Corporate Culture

Another major key to *IKEA's* brand image is its very clear and coherent corporate culture. Employees are called co-workers and are "invested in" by the company. For example, there are internal education and training programmes which ensure that everyone understands *IKEA's* philosophy of simplicity and humility as well as the company's origins. The goal is to achieve a feeling of being part of the *IKEA* family. Since the organisational structures are very horizontal, the distance between managers and employees is small, which fosters a feeling of unity. In order to avoid bureaucracy,

Feeling of Unity

being allowed to make mistakes and to accept responsibility is a core value at *IKEA* and has always been supported proactively by the company's founder (Martenson 2001, p. 33).

Marketing Activities

The company's "Swedishness" is at the core of every marketing message. All marketing activities are carefully harmonised with each other and promote the retail brand in order to strengthen its positioning. The marketing process includes the following important activities:

- Catalogue: The catalogue is the main marketing tool, accounting for 70 % of the marketing budget. Since *IKEA's* beginnings, the catalogue, combined with showrooms at the outlets, has been the primary channel for reaching the customers. It demonstrates the breadth of *IKEA's* product range and is intended to be a source of inspiration to its readers. With 160 million copies printed in 2005, it is also the world's largest free commercial publication.
- TV advertising raises awareness of the brand and drives customers into the stores. The advertisements always provoke controversy and debate, leading to increased consumer involvement, whether or not emotional reactions are positive or negative. The often controversial and "attention-getting" (Martenson 1987, p. 13) advertising supports *IKEA's* uniqueness and thus strengthens the brand. It is precisely the self-deprecating wit and self-irony typical of *IKEA's* commercials that contribute to the congenial and "cuddly public image" (The Guardian 2004). Examples are the controversial "Don't be so English" TV commercials which aired in the UK, which encouraged UK customers to be more adventurous in their choice of furniture or the yearly "IKEA celebrates Knut" campaign in Germany and Austria which airs shortly after Christmas, prompting customers to renew their old furniture while getting rid of their old Christmas trees.
- Customer relationship management: *IKEA* offers a free customer card (*IKEA FAMILY*) which provides card holders and automatic club members with, for example, special promotions and a quarterly magazine with current home furnishing trends and inspirations. An electronic newsletter is also available for free. Events and workshops are offered regularly and enhance the retailer's Swedish image, e.g. crayfish meals.

In applying all the various marketing instruments, *IKEA* has remained "consistent over time" (Davis/Green 2000, p. 30) which has strengthened the uniqueness of the retail brand.

New Store Brand for Groceries

In 2006, *IKEA* launched its own store brand for groceries. The products are sold at its *Sweden Shops* for groceries inside the outlets and further strengthen the brand image. Since the store brand range concentrates on Swedish specialties such as smoked elk sausage, it will further intensify *IKEA's* Swedish brand image. The retailer expects the store brand to account for 30 % of all specialty sales by 2007 (Wellman 2005, p. 7).

Target Group

IKEA's key target market comprises all customers "just starting out who are in need of relatively cheap, sturdy furniture" (Cook 2003). This includes young, low to middle income families, college students, single households as well as young urban professionals. This "eclectic mix of customers" (Moon 2005, p. 89) constitutes a whole new customer segment, as opposed to the traditional target market of furniture. *IKEA* itself has described its target market as "young people in all ages" (Martenson 1987, p. 15). The global middle class which *IKEA* targets shares many buying habits (Capell 2005, p. 48), allowing the retailer to transfer its successful business model in an almost standardised manner to its foreign markets. This international expansion has worked almost flawlessly, with the exception of the US market, where the retailer struggled after its market entry in 1985. *IKEA's* reluctance to make some necessary adaptations to US habits and preferences, because of the drop in economies of scale, is normally regarded as the reason for these initial problems (Lewis 2005).

Brand Image Tailored to the Target Group

The entire retail concept is designed to fit the target group's needs: affordable, yet stylish furniture, in many cases for a couple's first common apartment, one-stop-shopping under one roof, a kid's corner called *Småland* where children are taken care of while the parents are shopping, and a restaurant inside the store. *IKEA's* brand image caters perfectly to its target group. *IKEA's* retail branding has led to a degree of commitment among its customers which even leads to intimacy and advocacy. In many cases, customer attitudes towards the furniture retailer can be compared with a love-hate relationship: The clientele has been brought up with *IKEA* and is drawn to it because of its powerful retail branding and unbeatable value for money ratio. Yet, the nuisance of transportation and self-assembly is almost unavoidable. Therefore, customers usually have to be "educated" (Martenson 2001, p. 32) to understand the *IKEA* concept that requires the customer to take an active part in the business model in order to have both low prices and modern design.

Strong Loyal Customer Base

Once these objectives have been achieved, customer emotional involvement is almost unparalleled. The customer base is very loyal and can be described as a "solid brand community" (Cook 2003). It has become common for cus-

tomers to queue up in front of a new *IKEA* outlet even days before the opening. This is usually accompanied by local press coverage, thereby providing the company with free advertising. Due to the distinct brand image, there is always a certain level of brand awareness even before the retailer enters a new market. The fascination with *IKEA* has even been called "fanaticism" (Capell 2005, p. 49).

Summary and Outlook

Since its modest beginnings, *IKEA* is now referred to as a "global cult brand" (Capell 2005, p. 47), complete with genuine *IKEA* fans and their obsession that "has no bounds" (Booth 2005, p. 22). This has even spared the company the globalisation-related accusations with which almost all large companies have to deal. The company's positive image has not even been tainted by the public relations disaster following the rumours about the company's founder's early involvement in Nazism (The Guardian 2004). Also, press coverage accusing *IKEA* of using child labour in the early 1990s did not harm the retailer's image as a child and family-friendly company.

High Customer Involvement Pre-Sale

The high customer involvement and participation at the core of this fascination with the brand is secured along all the steps of the buying process. Pre-sale, the retailer actively works to create the need to replace furniture more often on the part of the consumer. As the retailer's most important marketing activity, the catalogue also directly involves the customer who can browse through it and try to picture the proposed designs in his own home. *IKEA's* controversial TV advertisements which often provoke lively discussions also involve the customer and build an emotional bond.

During the Sales Process

During the sales process, the customer is guided through the different showrooms which visualise the products in real-life situations. Since the path through the store is guided, the customer sees the store in its entirety and is thus probably surrounded by all the different situations he also finds at his own home. The kid's corner allows parents to fully experience the *IKEA* world without disturbance. Furthermore, the high-touch experience during the shopping trip also helps to draw the customer in on an emotional level, enhancing his involvement.

Post-Sale

Post-sale, the direct involvement on the part of the customer becomes apparent when he has to transport and assemble his furniture himself. As *IKEA* pushes the notion of frequent furniture replacement, this three-step process starts once again and is a crucial cornerstone of the *IKEA* philosophy which can be summarised as "You do your part. We do our part. Together, we save money" (Levy/Weitz 2007, p. 141).

IKEA is one of the most impressive examples of successful retail branding. *Interbrand,* a brand consultancy which publishes an annual ranking of the 100 top global brands by dollar value, ranked *IKEA* number 41 in 2005, up 12 % in brand value compared to the previous year (www.interbrand.com). *IKEA* was the only home furnishings and furniture retailer to be listed, a sign of its global uniqueness and success in retail branding. Despite the enormous dimensions of *IKEA's* global business, it is estimated that the brand awareness "has always been higher than the company's actual size and sales volume" (cf. Kling/Goteman 2003, p. 33). This discrepancy implies *IKEA* still has considerable growth potential.

Questions

1. As demonstrated, *IKEA's* main target group comprises young couples and families. How could the retailer try to retain this clientele for their second or third furnishing, which is often not bought at *IKEA* anymore? Discuss critically.
2. Where can you identify discrepancies and potential conflicts between *IKEA's* brand image and its everyday operative practices?
3. Which principles of successful retail branding can be identified in *IKEA's* business model?
4. What are *IKEA's* chances of achieving sustained success over time?

Hints

1. Take into account the cohort effect.
2. Also consider the ownership structure of the retailer.
3. Refer to the principles described in Chapter 6.
4. Consider, for example, the geographical repartition of sales. Visit *IKEA's* homepage (http://www.ikea-group.ikea.com) for additional information.

Part III

Marketing Mix in Retailing

Chapter 7

Store Location – Trading Area Analysis and Site Selection

Retail location is considered to be one of the most important elements in retail marketing strategy, because it is a long-term decision, associated with long-term capital commitment. Site selection is therefore associated with distinct planning processes to solve the complex location decisions. In this Chapter, the focus is on bricks-and-mortar retail outlets. The different types of retail locations, the main elements of location decisions and techniques for retail site assessment will be discussed.

The Importance of Location to Retail Companies

"The three most important things in retailing are: location, location and location."

The selection of retail store locations is one of the most significant decisions in retail marketing, because in store-based retailing, good locations are key elements for attracting customers to the outlets and sometimes can even compensate for a mediocre retail strategy mix. A good location therefore can lead to strong competitive advantages, because location is considered one of the elements of the retail marketing mix that is "unique" and thus cannot be imitated by competitors.

Location decisions are very complex, due to the large number of factors that have to be considered, and costs associated with, for example, the opening of new stores, can be very high. Site selection is therefore a *long-term decision* that implies long-term capital commitment. Once a retail site has been chosen, there is only little flexibility, because this decision usually cannot be changed easily without high losses.

Because of its *fixed nature*, location cannot be changed in the short term, contrary to other elements of the retail marketing mix such as prices, customer service, the product assortment or advertising. These latter factors can be altered if the environment (e.g. consumer behaviour, competition) changes (Wrigley 1988).

Types of Location Decisions

The main attention in the context of retail location strategies usually focuses on the opening of new stores. However, location decisions relate to the entire physical structure of retail outlets and are thus more comprehensive. The main types of decisions are (1) the *opening* of new stores, (2) the *extension* of floor space of existing stores, (3) the *relocation* or movement of a store from one place to another within a particular town or area where a better site is

available, (4) *rationalisation* decisions, e.g. the closure of individual stores, (5) *repositioning* of locations, e.g. altering of store image by changing the name or appearance, (6) *refurbishment* such as improving or updating the physical environment of an existing outlet or (7) altering the product range and assortment ("*remerchandising*") to tailor the offer more closely to local customers (Hernández/Bennison 2000).

The opening of new stores comprises the most complex type of decision, because it is usually the starting point of activities in a specific geographic area. This section therefore focuses mainly on retail location decisions of this type.

Types of Retail Locations

Advantages and Weaknesses

There are three basic *types of locations* available for retail stores: solitary sites, unplanned shopping areas and planned shopping districts. Each of the basic location types is associated with specific advantages and disadvantages (see Table 7.1) according to, for example, the size of the catchment area, occupancy costs, pedestrian or vehicle customer traffic, restrictions placed on store operations or convenience of the location.

Table 7.1 *Types of Locations*

	Size (1,000 m²)	Trading Area (km)	Shopping Convenience	Pedestrian Travel	Vehicular Traffic	Restrictions on Operations	Typical Tenants
Unplanned Areas							
Free Standing	varies	5-15	high	low	high	limited	convenience, drug stores, category killers
Urban Locations/ Central Business Districts	varies	varies	low	high	low	limited to medium	specialty stores
Planned Areas							
Neighbourhood/Community Shopping Centres	2.5-30	5-20	high	low	high	medium	supermarkets, discount stores
Power Centres	25-55	5-25	medium	medium	medium	limited	category killers
Enclosed Malls	35-100	5-40	low	high	low	high	department and specialty stores
Lifestyle Centres	15-45	5-25	medium	medium	medium	medium to high	specialty stores and restaurants
Fashion/Specialty Centres	7.5-25	5-25	medium	high	low	high	high-end fashion-oriented specialty stores
Outlet Centres	4.5-40	40-125	low	high	high	limited	off-price stores/ factory outlets
Theme/Festival Centres	7.5-25	N/A	low	high	high	highest	specialty stores and restaurants

Source: Adapted from Levy/Weitz 2007, p. 186.

Solitary Sites (Free-Standing Sites, Isolated Sites)

This type of location relates to single, free-standing outlets that are *isolated* from other retailers (Gilbert 2003, p. 288). They can, for example, be positioned on roads or near other retailers or shopping centres. Such sites are used, for instance, by large store formats in food and non-food retailing or for convenience shops.

Unplanned Shopping Areas

Unplanned Shopping Area Types

Unplanned shopping areas are retail locations with several outlets in close proximity to each other that have evolved over time. The retail mix is not the result of long-range planning and for such locations, there is no centralised management (Levy/Weitz 2007, p. 188). The main kinds of unplanned shopping areas are (1) *central business districts* (traditional "downtown" areas in cities/towns), (2) *secondary business districts* in larger cities and main street or high street locations in smaller cities, (3) *neighbourhood districts*, and (4) *strip* or *string* locations (locations along a street or motorway) (Berman/Evans 2007, pp. 293-294).

Planned Shopping Districts/Shopping Centres

Planned shopping areas are retail locations that have been architecturally planned to provide a unified theme for a number of outlets (Gilbert 2003, p. 288). These sites are developed deliberately and usually have some large, key retail brand stores ("anchor stores") and a number of smaller retailers to add diversity and special interest (Reynolds 1992).

Retail Parks and Shopping Centres

The basic types of shopping centres are *retail parks* that consist of a purpose-built cluster of free-standing retail outlets. There are (large) parking facilities and *shopping centres* that consist of single buildings which are marketed as a unified shopping destination, usually with one name and logo. The retail mix is different from retail parks, as the range of stores is wider and often includes luxury and leisure items as well as clothing, footwear and other typical central location merchandise (Gilbert 2003, pp. 289-290).

Types of Shopping Centres

Several specific types of retail parks and shopping centres have been developed (Levy/Weitz 2007, pp. 190-191): (1) *neighbourhood* or *strip/community centres* that are typically anchored by a supermarket, (2) *power centres* that consist primarily of large format retailers, (3) *shopping malls* that are enclosed, climate controlled and lighted shopping centres (regional or super regional shopping malls), (4) *lifestyle centres* that encompass an open-air configuration of upscale specialty stores, entertainment and restaurants, (5) *fashion/specialty centres* that comprise mainly upmarket clothing shops and

boutiques carrying high quality and price fashion merchandise, (6) *outlet centres* that contain manufacturers' and retailers' outlet stores or off-price retailers (see Chapter 2), and (7) *theme or festival parks* that typically employ a unified theme carried by the retail outlets, their architectural design and their merchandise and can be anchored by restaurants or entertainment facilities. The main types of planned shopping areas are presented in Table 7.2.

Table 7.2 *Planned Shopping Area Types*

	Types	Examples
Intermediate Centres (10,000 – 20,000 m²) *(Centres intercommuneaux, centros intermedios, regionale Shopping-Center)* (at least one anchor, integrated)		
Locational Variants	• non-central suburban community • greenfield site, transport node	• Auchan, Torino, Italy • Cameron Toll, Edinburgh, UK
Compositional Variants	• hypermarket-anchored • specialty non-food anchored	• Euromarché • BHV, Cergy, France
Regional Shopping Centres (30,000 m²+) *(Centres commerciaux régionaux, grandes centors periféricos, überregionale Shopping-Center)* (two or more anchors)		
Locational Variants	• central area in traditional core • central area adjacent traditional core • non-central suburban growth zone • greenfield site, transport node	• Eldon Square, Newcastle, UK • La Part-Dieu, Lyon, France • CentrO, Oberhausen, Germany • Curno, Bergamo, Italy
Compositional Variants	• hypermarket-dominated • department and variety-store dominated • food, non-food and leisure anchors	• A6, Jönköping, Sweden • Lakeside, Thurrock, UK • Parquesur, Madrid, Spain
Retail Parks (5,000 – 20,000 m²) *(parques des entrepôts, parques commerciales, retail warehouse parks, Fachmarktzentren)* (not obviously anchored, not wholly integrated centres)		
Locational Variants	• non-central suburban community • greenfield site, transport node	• various • Lakeside Retail Park, UK
Compositional Variants	• large retail format tenant mix • factory outlet tenant mix • hybrid tenant mix	• Fairacres Retail Park, Abingdon, UK • Marques Avenue, Troyes, France • Fosse Park, Leicaster, UK
Specialty Centres (1,000 m²+) *(Arcades, galeries marchandes, galerias comerciales, Galerien/Passagen)* (fashion-oriented, specialty stores)		
Locational Variants	• central area in traditional core • adjacent to traditional core	• Galleria, Hamburg, Germany • Albert Dock, Liverpool, UK
Compositional Variants	• non-food specialty stores • department store conversions	• Powerscourt Centre, Dublin, Eire • Karstadt Arkaden, Mühlheim, Germany

Source: Adapted from Reynolds 1992, p. 57.

The decision as to which kind of retail location to select depends on the company's strategy. It is an integral part of the retail location decision process.

Retail Location Decision Process

Site Selection Process

Retail location decisions typically follow a systematic process that starts with a *general* assessment of geographic areas and leads to a *detailed* assessment of specific site characteristics. This process can broadly be described as a three-step selection process (Brown 1992, p. 16):

1. *Market selection*: The first step is the consideration of a region that has potential for a new retail outlet.
2. *Area analysis*: Within the chosen region, a potentially optimal area for the store is selected.
3. *Site evaluation*: In the chosen geographical area, the best available site(s) are examined in terms of all features that are relevant to potential store performance. This step concludes with a final decision as to the specific site.

Catchment Area

The analysis of the catchment area (*trading area, market area*) of a specific region or a specific site is of high importance in each phase of this retail location-decision process. The *catchment area* is the geographic area that contains the customers of a particular site or region for a company or a group of companies for specific goods or services. Thus, it determines the potential demand at a particular site and, among other factors, influences potential sales and profitability.

Trading Area Segments

Usually, the catchment area is divided into three parts. The *primary trading area* is the zone in which the majority of customers are based. It encompasses 50 % to 80 % of the customers. The *secondary trading area* contains about 15 % to 25 % and the *fringe* or *tertiary trading area* includes the remaining customers that shop occasionally at a location as an alternative to local shopping (Berman/Evans 2007, pp. 270-272; Gilbert 2003, p. 280).

Mapping and GIS

These catchment area segments are often described in terms of the *distance* between customers' homes or work places and the area or site. Usually, either the linear distance (e.g. concentric circles drawn around a site), the travel distance (by car or public transport) or time distance measures (by car or public transport) are used to delineate trading area segments. *Mapping techniques* are used to forecast or survey and map such store trading areas (McGoldrick 2002, p. 247). *Geographical information systems* (GIS) are important support systems for location research and trading area analysis. These are software systems that combine digitalised mapping with key locational data in order to depict trading area characteristics such as population demographics, customer purchase data, competitor locations.

Location Assessment Techniques

Location Factors

The *appropriateness* of a specific site is based upon the retailer's strategy (retail formats, merchandise, pricing strategy, etc.) and is influenced by a substantial number of factors that need to be investigated. A selection of location factors is presented in Table 7.3.

Table 7.3 *Selected Location Factors*

Customers (potential/actual)	Accessibility	Competition	Costs
• numbers by demographics (e.g. population size, age profile, household size) • income level • disposable income per capita • employment by occupation, industry, trends • housing density • housing age/type • neighbourhood classification • home-ownership levels • building/demolition plans • main employers • spending patterns • shopping patterns • population growth, density and trends • lifestyle measures • cultural/ethnic grouping	• site visibility • pedestrian flows • pedestrian entry routes • barriers such as railway tracks, rivers • type of location zone • car ownership level • road network (conditions, driving speeds, congestion, restrictions, plans) • parking (capacity, convenience, cost, potential) • public transport (types, cost, ease of use, potential) • visibility • access for staff • access for transport and delivery	• existing retail activity (direct competitors, indirect competitors, anchor stores, cumulative attraction, compatibility) • existing retail specification (selling area, turnover estimates, department/ product analysis, trade areas, age of outlets, standard of design, car parking) • saturation index • competitive potential (outlet expansion, refurbishment, vacant sites, interception, repositioning, competitor policy) • proximity of key competitors, traders, brand leaders	• purchase price • building costs • rent costs • leasing terms • site preparation • building restrictions • development concessions • rates payable • refurbishment needs • maintenance costs • security needs • staff availability • labour rates • delivery costs • insurance costs • promotional media/costs • turnover loss/other branches

Source: Adapted from McGoldrick 2002, p. 240; Gilbert 2003, p. 293.

In order to guide retail location decisions and to assess or forecast the potential sales or profitability of retail stores in a specific region, area or at a specific site, a number of techniques have been developed to assess the sites.

Table 7.4 *Location Planning Techniques*

Technique/s	Subjectivity	Cost	Technical Expertise Required	Computing and Data Needs	GIS
Experience	very high	low	low	low	limited role
Checklists/Analogues/Ratios	medium	low	low	low	limited role
Multiple Regression/ Discriminant/Analysis	low	medium	high	medium	information
Gravity Modelling	low	high	very high	high	information, modelling, analysis and modelling
Expert Systems/Neural Networks	low	very high	very high	very high	information

Source: Adapted from Hernández/Bennison 2000, p. 360.

The techniques range from very simple to very sophisticated (see Table 7.4). Either way, most are used to identify and evaluate potential *new sites*, but they can also guide decisions on *existing locations* with respect to extensions, rationalisation, repositioning, etc.

Managers' Experience

Location is a retail function which requires knowledge and expertise. In practice, managerial experience ("*retail nose*") plays an important role in assessing retail locations. For example, *rules of thumb* are often used as subjective and intuitive guidelines for site assessment. Such rules are developed from knowledge of the company (Hernández/Bennison 2000).

Location Evaluation Checklists

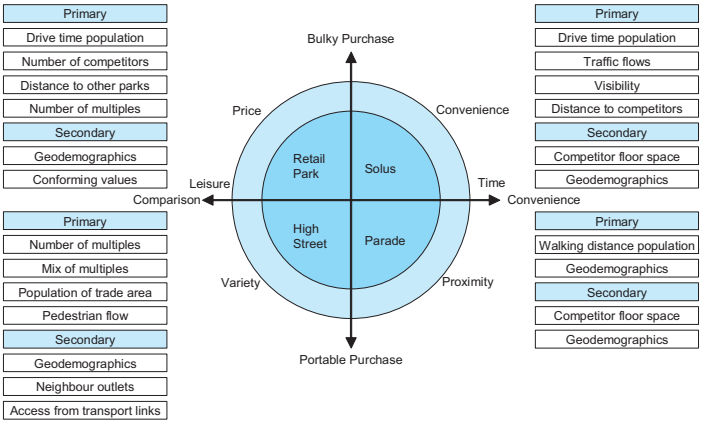
Checklists consist of a number of chosen variables (e.g. location factors) to be considered when evaluating retail locations. One of the first detailed checklist evaluation formats was developed by Nelson (1958).

Checklist Elements

Companies select factors that they believe to influence store performance. While some elements of such checklists are common to all types of retailers, each company is likely to have its own list with factors that reflect its particular strategy and situation (McGoldrick 2002, p. 239).

Locational Positioning

Figure 7.1



Source: Davies/Clarke 1994, p. 7; CCN Marketing 1993.

Figure 7.1 illustrates linkages between retailers' strategic positioning, typical locations and major factors that are considered to be important influences and which should be analysed in the context of site assessment.

Analogue Method

The principle behind the *analogue method* (Applebaum 1966) is that new store sites are compared to existing ones that have many features in common with the new store (e.g. store size, merchandise or location characteristics). The likely turnover and profitability of the new store site are estimated on the basis of sales achieved and profits earned by similar stores in existing areas. Such comparisons can be done by *extrapolating* own store data or by comparing the new site with existing competing stores (e.g. stores at the prospective location).

Multivariate Statistical Techniques

Given the increasingly complex array of data available for location analysis, multivariate statistical techniques can be used to construct models that harness the predictive power of the available predictor variables for (new) store performance (McGoldrick 2002, p. 257).

Regression Analysis

Most of the important techniques are forms of *multiple regression analysis* which predict store sales and estimate market potential or potential profit. *Discriminant analysis* can be used to predict category membership. Such more sophisticated procedures can identify relationships between store sales and predictor variables such as population in the surrounding area, the spending power of the population, store accessibility, quality of transport links to sites, average distance to population or nearby competition (Moutinho/Curry/Davies 1993).

These techniques provide more objective and systematic insight into the impact and importance of location attributes and are useful in screening large numbers of locations. On the other hand, they require more data than the simpler methods and a higher degree of technical expertise.

Cluster and Factor Analysis

Cluster and *factor analysis* are techniques aimed at *grouping data cases or variables* together for segmenting a portfolio of stores into similar groups (*cluster analysis*) or grouping together a range of variables that can be used to predict site profitability (*factor analysis*). The application of these procedures is particularly suited to new store-format development or the segmentation of retail networks. These techniques also require a large amount of good quality data as well as a high degree of statistical expertise and business acumen (Hernandéz/Bennison 2000).

Spatial Interaction Models

Gravity Models

Spatial interaction models are also referred to as "*gravity models*", because they are based on an analogy with the physical law of gravitation. They have evolved as a major stream of development in retail location theory. The basic principle of *spatial interaction* is that the aggregate movements of shoppers are positively related to the attractiveness of a store and negatively related to the distance from the store or other deterrence factors (Craig/Ghosh/McLafferty 1984).

Reilly's Law

Gravity models can be used to forecast store performance based on the simultaneous consideration of such factors as store size, store image, distance, population and distribution. One of the earliest models of this type is *Reilly's law of retail gravitation* (Reilly 1929). This law establishes a point of indifference between two towns in order to determine the catchment area of each town. This point of indifference is the *breaking point*, defined as the point up to which *one* town dominates and beyond which the *other* town dominates (see Figure 7.2). Thus, it is the point at which consumers are indifferent as to which location they use (Rogers 1992).

Figure 7.2

Reilly's Law of Retail Gravitation

$$d_{01} = \frac{d_{12}}{1 + \sqrt{A_2 / A_1}}$$

d_{01} = distance or journey time of the breaking point 0 from town 1
d_{12} = distance or journey time between town 1 and town 2
A_1, A_2 = population of town 1 and town 2

Source: Adapted from McGoldrick 2002, p. 261; Berman/Evans 2007, p. 275.

This model aids in the delineation of the trading area from which retailers draw customers. However, the model has many limitations (see, for example, Rogers 1992; Craig/Ghosh/McLafferty 1984). For example, the breaking point formula does not provide estimates above or below the break-even point between the two towns. Also, the model cannot predict trade areas of more than two towns and the form of the function is not constant for all

types of shopping trips. Retailers can offer additional competitive advantages and thus – contrary to the model assumptions – can differ in terms of location attractiveness (McGoldrick 2002, p. 261; Gilbert 2003, p. 295).

Huff's Law

In order to overcome these limitations, *several refinements and extensions* of the model have been developed, including *Huff's law of shopper attraction* (Huff 1964), which is based on the utility that a shopper derives from shopping at a particular store. It describes catchment areas on the basis of the product assortment carried at various shopping locations, travel times and the sensitivity of the kind of shopping to travel time (trip's purpose and type of product sought).

Knowledge-Based Techniques

Simulation Tools

Knowledge-based techniques are the most recent models that have been developed to assess retail store locations. The most important techniques are *expert systems* or models developed based on *artificial intelligence*, such as neural networks or computer systems modelling the retail environment and shopper behaviour as "software agents" that simulate store performance at prospective locations. Such systems depend heavily on powerful computer capacities and immense data requirements and are still in the development phase.

Conclusion and Outlook

Location decisions have a major impact on a retail outlet's success, as location is an important factor in consumers' store choice. The location decision also has a *long-term impact* as it is not very flexible. Thus, location decisions are of critical importance for retailers' competitive advantages. To guide and support retail site assessment, the various location assessment techniques have become more and more sophisticated. Such improvements have been triggered largely by advances in computer and software technologies (e.g. artificial intelligence).

It should be noted that retail location decisions consist not only of opening new stores, but that *monitoring existing stores* is of equal importance. This entails, for example, decisions concerning repositioning, relocation or closing outlets. This is important, as retail environments change rapidly (e.g. customer behaviour or competitive structure) and companies must also respond in terms of location decisions.

City Management

However, retail location decisions cannot be made without taking into account the *retail environment* in terms of the interests of *towns/cities or residents*. Establishing a retail store can, for example, influence shopping patterns,

traffic and pedestrian flows or the retail structure of a town. A major concern of local communities is out-of-town vs. inner-city retail centres. Also important in this context are *business improvement districts* (BID). BIDs are public private partnerships (PPP) that comprise property and business owners of a defined area, who try to improve it by collective contributions to the maintenance, development and marketing of their commercial district.

Restrictions and Interventions

To ensure that the specific objectives are met, retail locations are influenced or constrained by local or *central government planning policies*. Thus, the opening of new stores or even changing or extending existing stores may require planning permission. For example, most European countries have restrictions on setting up *large retail formats* and *out-of-town shopping centres*. The reason for these interventions is the potentially adverse impact of large stores on small businesses and of new shopping centres on old ones (see Davies 1995 for a broad overview).

City Marketing

However, local authorities not only restrict retail store settlement. In many *city marketing* initiatives, an attractive retail mix is known to be one of the key elements of attracting customers to a particular town or city. Local authorities, therefore, try to attract retailers with a good image so that retailers open stores in their towns or cities.

Further Reading

GHOSH, A.; INGENE, C.A. (Eds.) (1991): Spatial Analysis in Marketing: Theory, Methods, and Applications, Greenwich et al.

GUY, C. (1994): The Retail Development Process: Location, Property and Planning, London.

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Case Study: ECE Projektmanagement[1]

Profile, History, and Status Quo

Founded in 1965 by Dr. h.c. Werner Otto, *ECE Projektmanagement GmbH & Co. KG,* a German real estate development company headquartered in Hamburg, is presently the European market leader in inner-city shopping centres. In its home country of Germany, *ECE's* market share of all shopping centres' rentable area is approximately 20.5 % (Bender 2006, p. 20).

Additionally, the company also operates in the following business sectors:

- office buildings
- industrial construction
- transport-related real estate
- buildings in the healthcare sector.

With respect to these business sectors, the company is organised into five operating units employing approximately 2,200 retail specialists. Table 7.5 provides an overview of the basic figures for *ECE's* other business activities.

Table 7.5 *Key Figures of ECE's Business Areas*

Business Sector	Area/ Premises in m²	Tenants	Investment/ Construction Volume
Office Buildings	600,000	500	N/A
Industrial Properties	375,000	e.g. Airbus, Beiersdorf	750 million EUR
Transport Projects	N/A	e.g. railway stations Cologne, Leipzig, Hanover	400 million EUR (railway stations)

1 Sources used for this case study include the web site http://www.ece.de and miscellaneous ECE publications, downloadable documents as well as explicitly cited sources.

ECE's business activities comprise developing, building, leasing, and managing innovative shopping centres as well as property in the other mentioned sectors. Additionally, it also revitalises older shopping centres so as to adapt them to changing trends and consumer demand. Annual revitalisation projects amount to approximately 50 million EUR.

ECE Projektmanagement is a company owned by *Otto*, the world's largest mail-order operator. It was also founded by Werner Otto and generated a turnover of more than 14.5 billion EUR in the financial year 2005 with its business activities in 19 countries. *ECE* itself also has two sister companies which are active in the USA and Canada.

It was Werner Otto's vision to adapt the US model of shopping centres to fit the specific needs of the largely decentralised European retail market. The first *ECE* shopping centre, the *Franken-Center* in Nuremberg, Germany, which was built according to the US model of separate shops in an interconnected, covered mall, was opened in 1969 and is still run and managed by *ECE Projektmanagement*.

Today, the company is the clear European market leader in shopping centres with 84 centres (comprising more than 2.4 million m^2 in sales area) being managed as well as another 14 being currently built or planned. In 2005, more than 10 billion EUR in sales were generated by the *ECE* shopping centres and their 8,100 tenants. Some of the most prestigious centres are shown in Figure 7.3.

Prestigious ECE Shopping Centres

Figure 7.3

Figure 7.4 shows the current geographic allocation of *ECE's* business activities, both on a national and international scale.

Figure 7.4 *ECE's Centres and Projects*

The initials "*ECE*" initially stood for the name of the company – "*Einkaufs-Center-Entwicklung*" (which translates as "shopping centre development"). However, the company, which was founded in 1965, has been active in a broader range of areas from the outset.

Since the business activity in areas other than shopping centres has increased steadily and since the planning and construction of a hospital, for example, has little in common with that of shopping centres (and as the reference to shopping centres on the site board for a hospital project caused some irritation to passers-by), the company was renamed "*ECE Projektmanagement*" – or *ECE* for short.

Success Factors

Careful Site Selection

Apart from a focus on creating an appealing and convenient customer experience, the selection of only prime locations for shopping centres was central to Otto's philosophy for *ECE* from the start. For this reason, the company conducts "extensive research on a target city" (Knutt 2003, p. 20). The following basic location factors of a potential shopping centre site are assessed critically:

- location
- catchment area
- purchasing power
- accessibility by foot, car and public transport (Schliebe 1998 p. 114).

The assessment of potential sites for a shopping centre is the first stage in project management, comprising ultimately, the development and management of a shopping centre. *ECE Projektmanagement* always makes extensive use of primary statistics on the number and structure of inhabitants, other demographics, purchasing power and the centrality of the respective city. These data are easily accessible through census offices, for example (Schnermann 1998, p. 145). *ECE* always includes local civic councils and financial investors in the assessment process as soon as possible, because the latter in particular, ultimately decide whether or not a location is appropriate for constructing a shopping centre. On the other hand, local civic authorities and citizens' initiatives or action groups which oppose a potential shopping centre, can make it very difficult for the project management process to be pursued.

In terms of catchment area, *ECE* distinguishes between different zones in terms of their distance from the shopping centre, as measured in driving time by car. The distinction is made as follows:

- zone I/primary catchment area: 0-5 minutes driving distance by car
- zone II/secondary catchment area: 5-15 minutes driving distance by car
- zone III/fringe/tertiary catchment area: 15-30 minutes driving distance by car
- zone IV: 30-45 minutes driving distance by car.

In order to depict the catchment area of a potential shopping centre site, the different zones are represented in concentric circles on a map, indicating the respective number of inhabitants. In this respect, *ECE Projektmanagement* uses various *geographical information systems* (GIS). Another key prerequisite for building a shopping centre is accessibility, which includes sufficient parking and landscaped entrances for pedestrians. For example, *Limbecker Platz* in Essen will be Germany's largest inner-city shopping centre after its completion in 2009, with 70,000 m² floor space on 3.5 storeys and approximately 200 shops. The estimated catchment area for zones I – III will comprise more than 1.7 million inhabitants and more than 2,000 parking lots will be provided.

Use of GIS

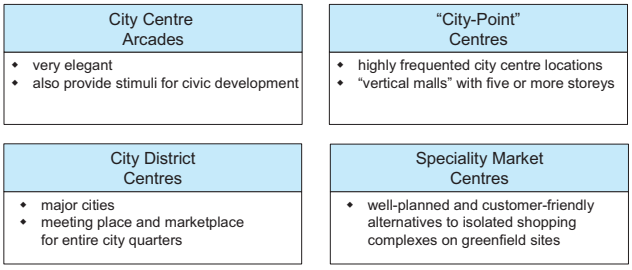
Shopping Centre Architecture

ECE only chooses locations where it can integrate its hallmark high-grade and high-quality architecture into the city. An example of this location factor is the *Potsdamer Platz Arkaden* in Berlin, with its 40,000 m² of retail area which includes an *IMAX* cinema. The *Arkaden* have become a focal point of attraction and offer everything *ECE* expects "for a good location – the infrastructure is excellent, famous architects have designed the architecture so that the Potsdamer Platz has become a brand, and the Arkaden has the right size to offer a broad variety of shops and restaurants for the customers. Potsdamer Platz Arkaden is a real urban entertainment center, which attracts a lot of tourists as well" (cf. Knight 2005).

In its site-selection process, the company is also faced with a number of legal restrictions. Since *ECE* shopping centres are at present only built in inner-city locations and because the company has very high expectations as to the architecture of its centres, preferred locations are historical buildings and sometimes even former castles. However, there are often legal restrictions in terms of monument preservation. A current example is the shopping centre at the Schlosspark Brunswick, due to open in 2006, which caused much controversy among residents, consumers, local civic authorities, etc. (see www.schlosspark-braunschweig.de). Furthermore, the Land Use Ordinance and environmental-related issues have to be taken into account in the site selection process. For this purpose, *ECE* always uses external expertise to support the selection process.

As *ECE* has four different kinds of shopping centres in its portfolio (see Figure 7.5), the site selection process is always tailored to the shopping centre in question.

Figure 7.5 *ECE's Portfolio of Shopping Centres*



Since inner-city locations which meet *ECE*'s high standards and prerequisites are limited, the company began expanding into foreign markets outside Germany in 1996/1997, assessing potential markets, areas, and shopping centre sites. The *Galeria Dominikanska* in the Polish city of Wroclaw was the first *ECE* shopping centre outside Germany. Before entering a foreign market, the company analyses national economic data and key figures in great detail in order to obtain a realistic assessment of the potential market. This data includes:

- GDP real growth and GDP per capita
- domestic demand, purchasing power index
- unemployment rate and available labour, quality of available labour
- demographics, e.g. age and gender structure, level of education, or family size
- traffic connections and infrastructure
- political and legal conditions.

Another main criterion for *ECE Projektmanagement* in deciding whether or not to enter a country is the potential to become market leader. Only if there are reasonable prospects of doing so, will the company enter a foreign market. This is the case in Poland or Turkey, for example (Knutt 2003, pp. 19-20).

Staggered Rent System

Tailored Leasing Policy

The staggered rent strategy is a cornerstone of the *ECE* shopping centre concept. It is obvious that a hair salon cannot afford the same rent as a jeweller's shop, for example - but a shopping centre needs both. This is where tenants profit from *ECE*'s tailored leasing policy. They pay sector-dependent rents based on the financial potential of the outlet in question. The system facilitates a complementary tenant mix. By contrast, individual owners always try to demand the highest possible rent for their shop premises - with the result that entire types of business disappear from inner cities. It is *ECE's* official policy and strategy to counteract this tendency by applying rent discrimination to its tenants.

Close and Long-Term Relationship With Tenants

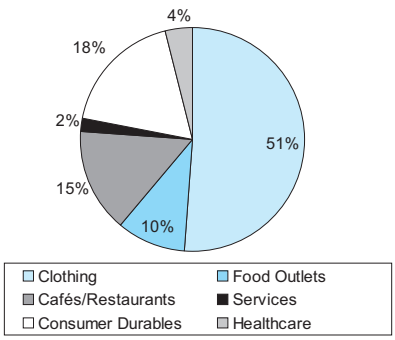
With the help of the staggered rent system, *ECE* pursues a strategy of having an attractive and varied mix of its tenants, encompassing large anchor stores such as department stores as well as branch stores, often in the textile sector, and regional retailers which all give the respective shopping centre its

unique identity, thus increasing the feeling of identity among tenants and customer acceptance. *ECE* refers to this approach, combined with the characteristic high-quality architecture, as the "vibrant marketplaces" concept, which generates beneficial stimuli for the inner city, thus winning back purchasing power from, for example, category killers on greenfield sites outside the city centres.

Tenant Structure

On average, large national chains account for 49 % of shop types in an *ECE* shopping centre; regional retailers comprise 22 % and single outlets 29 %. Figure 7.6 shows the tenancy by sector for the *Potsdamer Platz Arkaden* in Berlin as an example for the branch mix.

Figure 7.6 *Tenancy by Sector – Potsdamer Platz Arkaden, Berlin*



Source: ECE 2003, p. 8.

Because the company does not engage in outsourcing, but itself handles the entire centre planning, development, management, and leasing, it can develop closer-than-average relationships with its tenants, thereby gaining considerable retail know-how. *ECE Projektmanagement* attaches great importance to direct and close communication with its retailers, resulting in an excellent reputation and a loyalty "bonus" on the part of the retailers. It is not unusual for the take-up rate to be as high as 120 % when a new shopping centre is opened (Knutt 2003, p. 19).

Retail Know-How "All-In-One"

It is considered "unusual in an age of outsourcing" (Knutt 2003, p. 19) that *ECE* handles all management activities itself. The company, which sees the

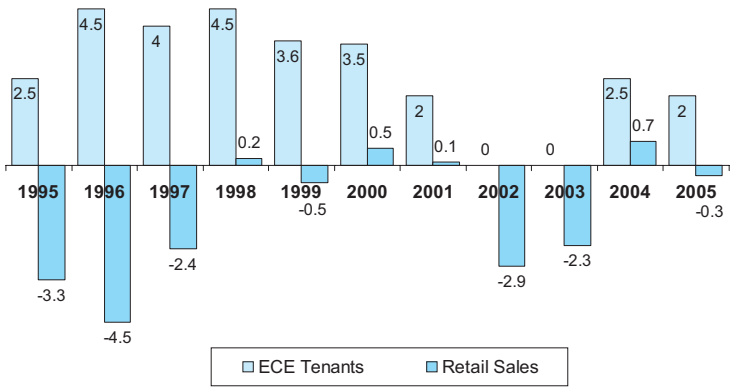
centre manager as the "mayor" of the "town within a town", regards the following characteristics as central to its success:

Characteristics of ECE's Strategy

- *ECE* developed the job profile of "centre manager" in Germany and now runs its own *Center Manager Academy*, an in-house university, where future shopping centre managers are trained and educated
- first-rate specialists, including around 100 centre managers and 50 leasing experts
- trademark of bright, friendly, safe and clean centres
- professional management underpinned by a network of local, regional and national specialists
- high-impact marketing concepts
- synergistic benefits from 84 centres under management - in areas such as "bulk booking" of events, for example
- management of a tenants' association
- media planning for a total advertising budget of around 100 million EUR
- responsibility for technical services and facilities
- operation of multi-storey car parks (46 car parks under management)
- liaison with regional and civic authorities, associations, clubs and the media.

ECE Tenants' Turnover Growth vs. Sector Trend (in %)

Figure 7.7



Over the last decade, *ECE* tenants have enjoyed a favourable sales increase compared to the general sector trend (see Figure 7.7).

Summary and Outlook

ECE's strategy of building and managing innovative inner-city shopping centres has, to date, proven very successful. Its combination of ex-ante extensive research on potential locations for establishing a new shopping centre and of actively managing it is the cornerstone of its strategy.

In Germany, where the current per capita shopping-centre ratio is low in comparison with the European average (namely 114.5 m^2 per 1,000 inhabitants), considerable growth potential for shopping centres is projected for the next couple of years. However, a large discrepancy can be observed between Western and Eastern Germany, where the per capita shopping centre area is sometimes six times as high as in some parts of Western Germany. Since there are currently 372 centres with more than 10,000 m^2 of rentable area, it is estimated that future growth rates will equal approximately 4 % (LZNet 2006).

Questions

1. Why is it not uncommon for citizen activist groups to protest against large shopping centres as built by *ECE*? What are the most frequently expressed fears and anxieties associated with such inner-city centres?
2. What are the advantages and disadvantages of greenfield vs. inner-city locations for different retailers?
3. Why was it attractive for *ECE* to enter Central and Eastern European countries? What are the future growth prospects in these countries and in general?

Hints

1. See local press coverage of the run-up to the installation of a large inner-city shopping complex.
2. Consider aspects such as national planning policies.
3. Take into account, for example, national statistics about these countries.

Chapter 8

Merchandise and Category Management

The purpose of this Chapter is to explain the different attributes of a retailer's merchandise mix and the aspects to be considered in merchandise planning. The Chapter deals with the merchandise mix, the development and importance of store brands and the integration of merchandise planning into the broader process of category management.

Merchandise Mix

The product assortment is the core of the retailing service. A retailer's total product offering is called a merchandise mix or product range. At a strategic level, merchandise management includes the process of selecting the right items for a store and, at an operational level, ensuring that they are available when customers want to purchase them. The latter function is discussed in more detail in Chapters 13 and 14.

Items in the assortment are organised into groups, the so-called *categories*. Merchandise planning encompasses selecting the right categories and the items within them. The selection of the appropriate items for a store refers to the breadth and depth of the assortment, quality levels and the brand portfolio.

SKU

The lowest level of detail identifying a product in the retailer's assortment is the *stock-keeping unit* (SKU), which identifies a particular item. For example, a pair of pants of a certain brand, in a particular style, colour, and size, is one SKU. The number of SKUs at various retailers varies tremendously. While hard discounters often carry less than 1,000 SKUs, a typical hypermarket assortment accumulates to around 100,000 SKUs. Items in the assortment can be grouped in terms of many different criteria. The product life cycle is one important classification criterion (Berman/Evans 2007, pp. 416-417):

- *Staple merchandise* consists of those products that are carried permanently by the retailer and that have relatively stable sales over time. A hammer or a paint-brush at a DIY retailer or jeans and white T-shirts at a department store would be examples of staple goods.
- *Fashion merchandise* refers to products that have cyclical sales due to changing tastes and lifestyles. Colours and cuts of clothing change and merchandise offered this year is usually out of date next year.

- *Seasonal merchandise* consists of products that do not sell equally well over consecutive time periods. Barbecue grills, skiing equipment, short pants and similar products have very high sales during one season of the year, but are not sold at all in other seasons.
- *Fad merchandise* generates very high sales for a short time period. Often, toys and games, certain clothing accessories, or certain music CDs are fads. *Tamagochis* and *Pokémons*, for instance, were classic fads. Movie merchandise (e.g. *Batman* accessories) also constitutes typical fads. Price sensitivity is often very low and ensuring supply, while demand is high, is crucial for success.

The product life cycle of merchandise is also important, because it emphasises that all products in the assortment need to be replaced after a (varying) period of time.

Quality Level

Another merchandise categorisation is the quality level, which is closely related to the price positioning (see Chapter 9). Should the retailer focus on premium products and target high-income customers, offer standard products or focus on lower quality, less expensive items to target mainly (but not only) low-income customers? Another strategic option is to cover different quality segments and thereby approach a broader target group. For example, while discount apparel stores (e.g. *KIK* in Germany or the Dutch *Zeeman*) focus on the low-quality segment, clothing boutiques focus on the high-quality segment and department stores usually cover different quality levels.

Breadth and Depth of the Assortment

The breadth (or width) and depth of the assortment are the most commonly used criteria for structuring the merchandise mix (Ogden/Ogden 2005, pp. 263-264):

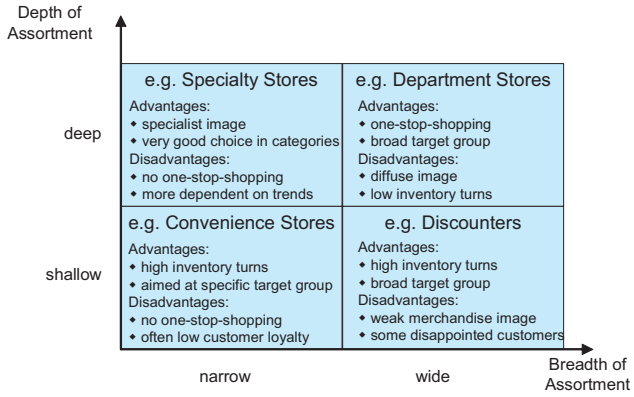
- The number of product lines (or categories) the retailer offers is referred to as the *breadth* (*width*) of the assortment. Breadth is generally depicted on a scale between narrow and wide; and retailers as specialists or generalists. A wide assortment usually has the advantage of appealing to many customers, and it makes one-stop-shopping possible, i.e. the customer finds most of the merchandise he wants "under one roof". A drawback is that very wide assortments often result in a diffuse, unspecific store image.
- The number of SKUs in a particular category (e.g. brands, colours, tastes, sizes) is called the *depth* of the assortment. Depth is mostly measured on a scale ranging between shallow and deep. Deep assortments have the advantage of giving the consumer a good choice within the categories, but often, a shallow assortment can focus better on the fast-selling items in a category. Deep assortments often lead to many items with low inven-

tory turns. When a category assortment is deep, it usually covers different quality and price levels, while shallow assortments usually focus on specific quality levels.

Using these two dimensions, most stores can be classified into one of four groups (see Figure 8.1).

The Merchandise Mix: Depth and Breadth of Assortment

Figure 8.1



Source: Adapted from Berman/Evans 2007, p. 423; Ogden/Ogden 2004, p. 264.

Complementary Demand

For the assortment decision, demand interrelationships have to be considered in merchandise planning. The consumer usually buys a shopping basket. The demand for certain items is interrelated. This can be the case simply because it is more convenient to do all the food shopping for the week in one store. However, complementary effects within the assortment can also arise, because products are consumed together and it has advantages to purchase them together because they can be matched. Shirt and tie, or paint-brush and paint, are typical examples of complementary goods.

One major challenge for retailers is that many stores have to accommodate the preferences of different consumer segments (Mulhern 1997, p. 109). Since the stores usually have only a limited geographic catchment area and the population in this catchment area is usually heterogeneous, many retailers cannot afford not to appeal to certain customer groups. This is especially the case for food retailers. General merchandise retailers, where consumers often travel further to the store of their choice (due to less frequent shopping

trips) and stores in large city centres where customer frequency is generally high, can focus more easily on certain specific customer groups.

Category Migration as Trend

Merchandise Diversification

An increasing number of retailers use a combination of specialist and generalist approaches within their product offer. They are specialist in one or a few categories, but add other categories, in which they only offer a shallow assortment (Varley 2006, p. 10). Temporarily or permanently, retailers diversify by adding new products to their assortment, which do not belong to their traditional merchandise (Zentes/Morschett 2004b). Supermarkets sell non-food products, DIY stores offer furniture, sports stores offer travel packages and food, to list just a few examples. This development results in a blurring of retail sector boundaries (Zentes/Swoboda 1998, p. 125). There are a number of reasons for this trend. The average store size has increased continuously over the last decades, giving retailers more space to enter new categories. Many product categories have stagnated, making a move into new fields attractive. And some retailers wish to exploit their high customer frequency by selling new product ranges (Zentes/Schramm-Klein/Neidhart 2005, pp. 52-57).

Successful Brand Extension

This strategy is sometimes called *product scrambling*, because it bears the risk of diluting the retailer's image (Varley 2006, p. 10). The concept of category migration can be compared to *brand extension* by a branded goods manufacturer. New categories that are related to existing ones therefore offer more potential with less image risk. Accordingly, successful category migration usually follows one of two diversification routes (Zentes/Morschett 2004b, p. 163):

- Either new categories and services are offered that are closely related to the core assortment. Examples would be furniture stores that offer accessories, DIY stores offering garden furniture as well as sport stores offering skiing trips or sports nutrition.
- Another strategy is to diversify the assortment into new categories that appeal to the core target group of the retailer. Clothing retailers for young fashion that add cosmetics or music CDs to their assortment are good examples.

Reduction of Variety as Trend

Adding new items to the assortment or eliminating items from the assortment is a fundamental and ongoing process for retailers. Studies of retail patronage have found repeatedly that the variety of assortment is an impor-

tant determinant of attitude towards the store and store choice, ranking only behind location and price. Shoppers are often looking for very specific items. A greater variety and larger assortment increases the probability of finding what they really want. Consumers may also like variety, because of a simple desire to purchase different alternatives rather than the same thing each time (Zentes/Morschett 2004b).

Disadvantages of Variety

This has led to continuously increasing product assortments at many retailers. On the other hand, one of the most valuable assets of a retailer, which poses a severe resource limitation, is selling space. Thus, the retailer has to make choices. Furthermore, too much variety in the assortment also has some disadvantages (Hoch/Bradlow/Wansink 1999, p. 528):

- From the perspective of retail operations, an increasing number of SKUs usually increases retailing costs. Assortment complexity raises various costs, including those of sales, shelf space, planning, advertising, inventory and logistics. Discounters, for example, are very successful with a strictly limited assortment.
- From the consumer perspective, a large number of alternatives within a category can lead to confusion and make the shopping process more complicated. Often, consumers prefer "mental convenience".

Recent studies have shown that even radical reductions of the assortment do not necessarily reduce customer visits to the store and sales may remain stable (see the overview by Boatwright/Nunes 2001). It is not the actual number of different products in a category that matters, but the consumers' perception of variety that is relevant for store choice behaviour. The elimination of different, but similar versions of the same product in the assortment is often not perceived or evaluated negatively by the consumer. Therefore, many retailers are currently analysing their assortment and pursue the general strategy of rationalising each category by consequently eliminating the under-performing items and brands (Zentes/Morschett 2004a, p. 2739).

Manufacturer Brands and Store Brands

In defining their merchandise mix, retailers also have to decide on the mix of manufacturer brands (e.g. *Ariel, Nestlé, Philips, Ferrero*) and their own brands, the so-called *store brands*.

While manufacturer brands (in the older literature often referred to as *national brands*) are owned, produced, managed and marketed by manufacturers, store brands (also called *private labels* or *own brands*) encompass all product brands that are owned, managed and marketed by retailers. The property rights for the brand in this case, are held by the retailer.

Functions of Manufacturer Brands in the Assortment

For many retailers, manufacturer brands comprise the main part of their merchandise. *Danone* in food retailing, *Bosch* and *Black & Decker* in DIY retailing, *Adidas* in shoes retailing and *Sony* in consumer electronics are just a few examples. Retailers include manufacturer brands in their assortment for several reasons. The two most important ones are the pull effects and image effects exerted by the manufacturer brands (Zentes/Morschett 2004a, pp. 2725-2731):

Pull Effect

- Strong manufacturer brands often enhance customer frequency in stores, because strong brands have loyal customers and their store choice is influenced by the availability of brands. Manufacturer brands are often heavily advertised in the media, so that consumers have clear images of these brands. Brand equity has been built up from which retailers can benefit. Strong manufacturer brands are said to pull customers into the store, so that other selling efforts by the retailer can be reduced.

Image Transfer

- The image of manufacturer brands in the assortment influences the retailer's image. A retailer's store image can be improved when it is associated with manufacturer brands that are evaluated positively. The number of available manufacturer brands as well as a strong anchor brand in the assortment can affect the retail brand positively (Mulhern 1997, p. 110). Positive effects can be expected to raise the perceived quality level and enhance certain intangible brand features such as brand character. A store carrying a good range of *Camel Active* clothing, *Levi's* and *Timberland* will be associated with other characteristics than a store carrying mainly *Prada* and *Gucci*.

However, the suppliers of strong brands are well aware of these benefits and their heavy advertising investment has to pay off. They have a strong negotiation position with retailers, which often results in unfavourable procurement prices for the latter. Therefore, manufacturer brands usually yield low profit margins for the retailer (Ogden/Ogden 2005, p. 265).

Functions of Store Brands in the Assortment

The proliferation of store brands in many product categories is one of the major developments in retail merchandising strategy (Burt/Davis 1999; Mulhern 1997, pp. 109-110). Once viewed with scepticism by consumers in terms of quality, in most countries store brands are now widely accepted substitutes for manufacturer brands and regarded as being of comparable quality (Varley 2006, p. 82). According to the *Private Label Manufacturers Association* (PLMA), in 2005, the store brand market share (by volume) reached almost

50 % in Switzerland, about 42 % in the United Kingdom and in Germany, and about 33 % in Spain and France (www.plmainternational.com).

In addition to profit margins, one of the most important disadvantages of a manufacturer brand for a retailer is *ubiquity*, meaning, that many retailers offer these brands.

Differentiation

Store brands, on the other side, provide an opportunity for differentiation. They are available at one retailer only, and can, therefore, be used to distinguish the retailer from its competitors. The brand image of a store brand must be established by the retailer himself and communication expenses paid by the retailer, but the brand can match the retail brand image of the retail company perfectly. The positive effects of store brands on retail image and retail profits have been proven in many studies (see, for example, Corstjens/Lal 2000; Dhar/Hoch 1997).

Customer Loyalty

Customer loyalty can more easily be built on store brands than on manufacturer brands. If a customer is satisfied with a store brand and intends to repurchase it, he needs to revisit the retailer. Conversely, if he is satisfied with a manufacturer brand, he can still switch stores and buy the product elsewhere. At the same time, store brands are not easily comparable across retailers. Therefore, price competition may be less severe. This factor, combined with lower procurement or production and marketing costs, often results in better profit margins for store brands (Corstjens/Lal 2000, p. 281).

Table 8.1

Examples of Differently Positioned Store Brands

Positioning	Examples for Store Brands
Value/Budget	M-Budget (Migros), ASDA Smart Price, Tesco Value, ja! (Rewe), Coop Prix Garantie, Gut & Günstig (Edeka), Euroshopper (e.g. Albert Heijn), Tandil (Aldi), clever! (Billa)
Standard	Carrefour, OBI Classic, Sephora Piiink, B&Q, The Body Shop, Tesco, Casino, Mibell (Edeka), Erlenhof (Rewe), BALEA (dm-Drogeriemarkt), Anna's Best (Migros), Castorama
Premium Store Brands	Tesco Finest, Sainsbury's Taste the Difference, Carrefour Selection, Coop Fine Food, Casino Saveur Gourmande, Lafayette Gourmet, ah excellent (Albert Heijn)
Organic/Health Oriented Store Brands (mostly premium)	Coop Naturaplan, Carrefour Agir, Tesco Organic, Coop FreeFrom, Safeway Healthy Choice, Rewe Füllhorn, Casino Terre et Savour, Casino Bio, ah biologisch (Albert Heijn)

Positioning of Store Brands

The first store brands were *generics*, that is, very low cost commodity products, with no brand-like labelling, but plain white packages that contained only the name of the product ("sugar" or "milk"). Currently, there are store brands in all price and quality segments (see Table 8.1 for examples). Store brands also cover different segments with different attributes, for example,

organic food or healthy eating. For budget store brands and standard store brands, price still plays a dominant role. The standard store brands are usually positioned as being of as good a quality as the manufacturer brand, but for a lesser price, and are targeted at the price-conscious customer segment (Dhar/Hoch 1997, p. 211). Premium store brands, on the other hand, are often positioned even above the manufacturer brand. Currently, many retailers are establishing a premium store brand segment. While all store brands have an impact on the retail brand, the premium store brands in particular, are introduced to improve the profile of the retailer and shape the retail brand image.

As part of the branding strategy, it also has to be decided how closely the store brand should be associated with the retail brand. In Table 8.1, the examples show that sometimes, the retail brand is used as an umbrella brand for the store brand products (for example, *Tesco* uses *Tesco Finest*, *Tesco Organic*, *Tesco Value,* among others, as store brands), while in other cases, the store brand is not directly connected to the retail brand. *Anna's Best*, the store brand for pasta at the Swiss retailer *Migros*, or *Mibell*, the store brand for German *Edeka*'s dairy products are examples. *Aldi*'s store brands are all of this type. For those retailers which carry manufacturer brands and store brands, a general trend can be observed towards reducing the brand selection in order to avoid consumer confusion and enhance efficiency. Only the best manufacturer brands are kept in the assortment, while the others are systematically eliminated or replaced by store brands.

Category Management

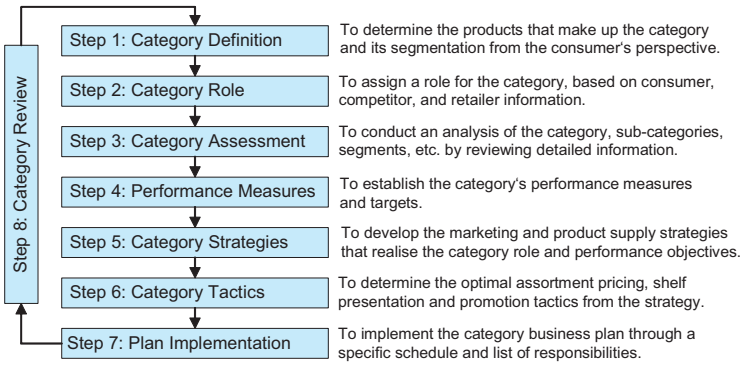
In recent years, the merchandising process is often integrated into a more holistic management approach to retailing, so-called *category management* (see e.g. A.C. Nielsen 2006; ECR Europe 1997). *ECR Europe* (1997) defines category management as a retailer/supplier process of managing categories as strategic business units, producing enhanced business results by focussing on delivering consumer value (www.ecrnet.org). Each category follows a specific strategy, which is embedded in the retailer's overall strategy. The importance of working together with the suppliers of a category is emphasised. One reason is that manufacturers usually have a deeper knowledge of the peculiarities of their category, because they frequently offer only products in one category. By contrast, the retailer has knowledge of his customers' behaviour across categories, so that the two can merge their knowledge in the pursuit of mutual goals.

Category management has developed as a stepwise planning process for categories, and was first proposed by the consulting company *The Partnering Group* in the mid-1990s. Over the last decade, it has developed into a stan-

dard industry process, which has been promoted by national and international ECR initiatives. Standard processes support an easy knowledge transfer across different retailers and/or suppliers. However, over time, other simplified processes have also been developed. The basic process is shown in Figure 8.2.

The Category Management Process

Figure 8.2



Source: ECR Europe.

The first steps in the category management process are the most innovative, because they include formulating a clear strategic objective for each category. These first steps distinguish the new process of category management from the traditional, more operational way of merchandising, because they position the retailer by providing a clear profile in his merchandise mix.

Category Definition

Category definition involves determining the specific SKUs that constitute the category, based on which products consumers perceive to be interrelated and/or substitutable. The primary aim is to develop a category definition that is based less on the procurement perspective of the retailer and more on the consumer perspective. Within the category definition, the category is also segmented into subcategories. This segmentation should be based on the consumers' *decision tree*, when purchasing in the category, that is, the sequential consumer choice process. For example, the category "wine" could be segmented at the first level by price categories (premium wines, standard wines, budget wines), countries (French wines, Italian wines, German wines), colours (red wine, white wine, rosé) or brands.

Category Role

In the next step, a *role* is assigned to each category, that is, the purpose of this category for the retailer is identified. Then it is analysed how the category fits in the retailer's company strategy. This facilitates managing categories according to their importance and allocating resources (such as marketing budgets, shelf space and management capacity) optimally. The four roles in the category management approach are shown in Table 8.2, although many retailers create their own system of category roles. Before assigning a role to a category, the category's importance to the consumer, retailer, and competition, should be analysed (A.C. Nielsen 2006, pp. 79-93).

Table 8.2 *Category Roles*

Role	Share of Categories	Role Description
Destination	about 5 % of categories	To be *the primary* category provider and help define the retailer as the store of choice by delivering consistent, superior consumer value.
Routine	55-60 % of categories	To be *one of the preferred* category providers and help develop the retailer as the store of choice by delivering consistent, competitive consumer value.
Convenience	15-20 % of categories	To be *a* category provider and help reinforce the retailer as the full-service store of choice by delivering good consumer value (i.e. to support the customers wish for one-stop-shopping).
Occasional/ Seasonal	15-20 % of categories	To be *a major* category provider, help reinforce the retailer as the store of choice by delivering frequent, competitive value.

Source: The Partnering Group.

After a more thorough analysis of the category and subcategories (*category assessment*), the category targets are set and relevant performance indicators selected (*category performance measures*), because different roles lead to different target indicators. The so-called *fair share* is an important indicator. This is the market share of a retailer in the category, compared to his overall market share. It is an indicator of retailer performance in this category relative to overall performance.

Category Strategies

The next step is to decide on a marketing strategy for the category. Many different strategies are possible, including:

- *Traffic building*, attracting many consumers into the store, for example, by offering price promotions for frequently purchased products.
- *Transaction building*, enhancing the average size of the shopping basket, for example, by exploiting demand interrelationships in the space allocation in stores or encouraging impulse purchases.

- *Profit generating*, enhancing the profitability of customers' shopping baskets, by offering products with high margins and/or higher inventory turns.
- *Image creating*, improving the retailer's image, e.g. by offering products that are sold uniquely at the retailer or offering an outstanding choice in the category.

At the level of the *category tactics*, operational decisions on the assortment, pricing, space allocation, and other retail marketing instruments are derived from the strategy and the other steps in the process. The final steps of the process are *implementing* the plan and a regular *review* of the category's performance, including plan adaptation.

Conclusion and Outlook

As with many other facets of retail management, merchandising is becoming more strategic and more fact-based, because retail information systems provide the necessary data for analysing the effects of merchandise changes. Some trends have emerged in the last few years:

- Retailers are increasingly adding new categories to their merchandise (category migration).
- Retailers are reducing the depth of their assortments in each category, focussing on leading brands, and eliminating underperforming manufacturer brands.
- Retailers are increasingly adding store brands to their assortment and the store brand portfolios cover all segments, including the premium segment.
- In many cases, merchandising planning is integrated into a category management process, which supports the strategic retail positioning by assigning defined roles to a category and systematically deriving the subsequent marketing decisions from the role.

The merchandising process is determined by the retailer's most valuable and limited resource: shelf-space. For Internet shops, however, this constraint does not apply. Therefore, merchandise planning for e-commerce is different. Assortments can be larger and structured differently: products can be placed in more than one category, because this does not use shelf-space, and constitutes an alternative way of finding the right product. More than one consumer decision tree can be modelled.

Increasingly, Internet shops customise their product offer to the specific customer (e.g. *Amazon*). Even though Internet shopping still has not reached considerable market share in most retailing sectors up to now, these merchandising processes could also have an impact on store retailing. Consumer expectations are changed by the new technology. At the same time, multichannel retailers can use their Internet merchandising to gather knowledge about consumer behaviour (for example demand interrelationships) and subsequently use that knowledge to improve the merchandise management in their stores.

Further Reading

A.C. NIELSEN (Ed.) (2006): Consumer-Centric Category Management, Hoboken/NJ.

VARLEY, R. (2006): Retail Product Management, 2nd ed., London et al.

Case Study: Coop (Switzerland)[1]

Profile, History, and Status Quo

The following case study deals with the company *Coop* in Switzerland. The name *Coop* is used by different retail companies throughout the world, especially in Europe. Those consumer cooperatives are retail companies that are owned by their customer members. Examples of consumer cooperatives are the *Coop Norden AB* (in Scandinavia), the *Co-op* stores in the United Kingdom, and *Coop* in Switzerland. Even though these companies carry the same name, they are independent retail companies. This case study focuses on merchandise management at the Swiss *Coop*.

Coop is the second largest retail group in Switzerland. Its turnover of 14.1 billion SFR in 2005 (1 SFR is about 0.63 EUR) is about 10 % lower than that of the market leader *Migros*, but about five times higher than that of the no. 3 in the market, *Manor*. This indicates the very high level of concentration in the Swiss retail market, with *Coop* and *Migros* achieving a joint market share of over 34 % of the total retail market and an even higher figure in food retailing. The consumer cooperative *Coop* has more than 2.3 million members.

1 Sources used for this case study include the web site http://www.coop.ch, various annual reports, press releases and presentations from company managers. Data on the Swiss market in general are from IHA-GfK 2005.

While this is a very specific situation, it is not unique in Switzerland, because *Migros* is also a consumer cooperative.

Coop has a store network of more than 1,400 outlets in Switzerland. While the majority of *Coop*'s sales (about three quarters) come from its food stores, *Coop* also has stores focussing on specific non-food product groups. An overview is given in Figure 8.3. The case study focuses on the food stores of *Coop*. Here, *Coop* has a market share of 20.6 % of the Swiss market and is the undisputed market leader for environmental, socially responsible products, including organic food.

Retail Format and Retail Brand Portfolio of Coop (2006)

Figure 8.3

Category Management at Coop

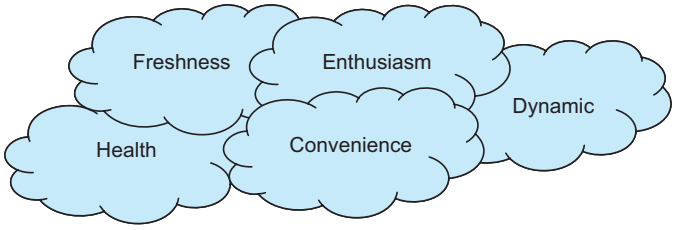
Coop follows the 8-step category management process proposed by *The Partnering Group* (see Figure 8.2). Shortly after the concepts of ECR and category management (CM) were introduced, *Coop* was among the first companies in Europe to adapt this approach to its own business. In 1997, preparations started with the establishment of a competence team and organisational changes. In 1998, training was carried out, including an extensive seminar of all involved *Coop* managers with the consulting company *The Partnering Group*. In 1999, the first CM business plans for seven pilot categories were completed, and, based on that experience, the CM process was rolled out sequentially to all categories. Today, the categories (i.e. the strategic business

units) are defined and specific business plans for the *approximately 130 categories* are developed and operational.

Coop Mission as Superordinate Marketing Objective

Since the category business plans must be embedded in the retailer's overall strategy, the pursued positioning of the retailer is the starting point of the CM process. At *Coop*, a so-called "mission" was defined (see Figure 8.4), as a set of values and benefits that represent the long-term strategic objective for the image of the retail brand *Coop*. The five components of this mission are the main brand messages of the company which represent the core of the brand. This mission (or positioning) serves as a guideline for all activities of *Coop*, at all levels of the company.

Figure 8.4 *The Coop Mission as the Core of Positioning*



Category Definitions

The assortment of *Coop* in the food channel is divided into 17 so-called "master categories", each managed by a specific CM team. Master categories are, for example, fruit/vegetables, bread/baked goods, breakfast/garnishes/baking ingredients, detergents and cleaning agents/hygiene, wine/sparkling wine, confectionary, or fresh convenience.

Each master category encompasses a number of categories. For example, the master category „fresh convenience" comprises the three categories fresh convenience "traiteur" (deli food items such as sandwiches, fresh pasta, fresh pizzas), fruits and vegetables convenience (e.g. prepared salads or fresh fruit cocktails), and chilled juices.

The master category "confectionary" consists of the three categories chocolate, sweet biscuits, and candy/chewing gum. Within each category, *Coop*

attempts to identify the consumer decision tree, i.e. what the consumer sees as the main classification criteria within the category and along which product characteristics his decision is taken. For example, the category "chocolate" is segmented into sub-categories such as:

- chocolate tablets
- chocolate bars in snack size (like *Twix*, *Snickers*, *Mars*)
- pralinés (boxed chocolate candy)
- touristic (chocolate products tailored to the tourist market) and
- seasonal products (e.g. Easter eggs).

Category Roles

The assignment of roles to categories is a crucial process, because it identifies the purpose of the category for *Coop*. The retailer's targeted positioning is translated into specific objectives for each category. The role is an important indicator of resource allocation, such as to shelf or advertising space.

While *Coop* applies the four roles suggested by *The Partnering Group*, they changed the labels for the roles, since the standard labels (destination, routine, convenience, seasonal) were considered misleading. Instead, *Coop* labels the four roles as: "profile role" (because the main purpose of those categories is to distinguish the retailer from its competitors), "leading role" (because those products form more than half of the merchandise mix, and the term "routine" might sound inadequate, considering their high importance), "supplementary role" (the term usually used in German-speaking countries for this role, possibly because the term "convenience" in a retail setting is already used for store formats and for certain products such as ready-to-eat food products).

Examples of Category Roles at Coop

Table 8.3

Role	Selected Categories with Role
Destination ("profile role")	fruits & vegetables convenience, fresh convenience "traiteur" (i.e. deli), fruit & vegetables, fresh bread, wine, baby, body care
Routine ("leading role")	milk, cheese, yogurts, prepared meals (frozen), soups and sauces, coffee, tea, chocolate, pet food, beverages
Convenience ("supplementary role")	tableware/cookware, kitchen appliances, electrical accessories, cut flowers
Seasonal	barbecue, camping, skiing

On average, about 60 % of *Coop*'s categories have a leading role, 10 % a profile role, 25 % a supplementary role and 5 % a seasonal role. Examples of role assignment are given in Table 8.3. Here, it becomes clear that the categories selected for "profile role" support the *Coop* mission, for example the simultaneous pursuit of convenience, health, and freshness. Other aspects that were considered when assigning roles to categories were the market (e.g. the sales volume of the categories, the household penetration, consumer trends, relevance of category for the consumer) and the competition. The strengths and weaknesses of a retailer relative to his main competitors are an important aspect of the decision as to whether the company can successfully strive for market leadership and a superior offer in a category.

Category Management at a Multi-Channel Retailer

CM is more complex for a multi-channel retailer. *Coop*, for example, offers its food customers convenience stores, small and large supermarkets, hypermarkets, and an Internet shop. Those stores all use the retail brand *Coop* (partly with an additional sub-brand), so that their general positioning is similar, but the specific characteristics of the retail formats differ and, therefore, so does their respective contribution to *Coop*'s mission. For example, a *Coop Pronto* focuses more on fill-in-need shopping by consumers and the convenience of the customer comes to the fore, while a *Coop* hypermarket is usually visited only for weekly or even monthly shopping, for the purpose of a large stock-up. *Coop* hypermarkets have a very substantial product offer, enabling a strong contribution to many components of the *Coop* mission. However, the mere size of the store may make the shopping process less convenient.

At *Coop*, each category– regardless of the retail format – is defined identically, but obviously, the specific products in the category differ, depending on the store format. For example, the number of SKUs in the category at a hypermarket is much larger than at a small supermarket. The specific challenge faced by a multi-channel retailer is solved by assigning different roles to categories, depending on the retail format, in the form of a retail format/category matrix. Therefore, while a few categories have a profile role across all *Coop* retail formats, most categories are assigned format-specific roles. For example, newspapers and magazines play a leading role in a *Coop Pronto,* while they have only a supplementary role in a *Coop* supermarket. In general, the share of categories with profile roles increases with store size, because a hypermarket has the space to display many categories effectively and prominently, while a small supermarket has to select more carefully which categories they use as profile categories.

Branding Strategies on the Level of the Assortment

The portfolio of brands, including the store brands, constitutes an important component of the merchandise mix of a retailer. Since the store brands are often used in many categories of a retailer, they are usually managed at a cross-category level for marketing in general, while the merchandise mix within each category is part of the CM process, usually as part of the *category tactics* process step.

Manufacturer Brands

Coop's main competitor, *Migros*, focuses very strongly on store brands. Its assortment consists almost exclusively of store brands and only a few manufacturer brands, which are the exception. Thus, *Coop* is in the comfortable position of being able to differentiate itself clearly from its main competitor by offering a good selection of manufacturer brands. *Coop* is the primary retailer for manufacturer brands in Switzerland. They currently account for 47 % of *Coop*'s sales. One important advantage of manufacturer brands is seen in their high level of innovativeness and the fact that strong manufacturer brands are perpetually popular with customers. *Coop* systematically analyses and reviews all ranges from the viewpoint of brand potential and provides brand manufacturers with a unique platform for positioning and marketing their brands and products. In Switzerland, *Coop* is therefore the main cooperation partner for brand suppliers. In addition to the manufacturer brands, *Coop* offers a great variety of store brands, which account for more than half of its sales. Each store brand meets a specific need and is positioned in one of three store brand price segments (see Table 8.4).

Table 8.4

Store Brands Portfolio of Coop

Positioning	Coop Store Brands
Value/Budget Store Brand	Coop Prix Garantie
Standard Store Brand	Coop
Segmented Standard Store Brands	Coop Betty Bossi, Coop Weight Watchers, Coop Delicorn, Coop Free From
Premium Store Brand	Coop Fine Food
Segmented Premium Store Brands	Coop Naturaplan, Coop Naturaline, Coop Oecoplan

Together with the store brands and the manufacturer brands, *Coop* attempts to offer its customers the broadest possible choice. A high level of product-range competence and range diversity gives *Coop* a highly distinctive profile in the competitive arena.

Standard Price Level Store Brands

The store brand *Coop* offers high-quality products with good value for money. Roughly *one third of Coop's sales* are achieved with this range that comprises a variety of products of a similar quality to that of a manufacturer brand. It covers the low-end price segment and is positioned as a lower-priced alternative to the manufacturer brand. Its design is similar to that of manufacturer brands in its appeal and the quality level implied by the packaging. It carries a uniform labelling with the *Coop* logo on a black, square background. In this way, the standard store brand, as an important pillar of the strategy, is assigned clearly to *Coop*.

Betty Bossi

At the beginning of 2002, *Coop* bought a 50 % interest in the *Betty Bossi Verlags AG*. This publishing house owned the now 50-year-old brand *Betty Bossi* and used it for cooking magazines and cookbooks as well as a few cookware articles. Its competence in developing cooking recipes was high. As a very strong brand, *Betty Bossi* stands for successful cooking in Switzerland and has a brand awareness of almost 100 %. By forming a partnership with the most competent partner in Switzerland, *Coop* aimed at market leadership in the field of fresh convenience goods. In mid-2002, *Coop* launched its first *Betty Bossi* products – convenience products that do not imply a loss of culinary standards. Thanks to the launch of *Betty Bossi*, *Coop* has become the market leader in fresh convenience food in just over a year.

Since then, the store brand has grown steadily with double-digit rates each year. It now comprises about 700 items, which are either for immediate consumption (ready-to-eat) or can be prepared quickly (ready-to-cook). They range from fruit juice and sandwiches to salads and complete ready-made meals. In 2005, sales amounted to about 400 million SFR. Working in cooperation with the *Coop* category management team, a competence team at the *Betty Bossi* company, which is still active in its former core business as well, continues to develop a wide range of innovative products each year.

In the last two years, *Coop* started a rapid further segmentation of its store brand, offering a number of store brands in the medium price segment. These are targeted at specific customer groups by offering a particular benefit.

Coop Weight Watchers

In June 2005, *Coop* launched the *Coop Weight Watchers* store brand with low-fat, low-sugar and low-calorie products. This was the first time that the dietary organisation *Weight Watchers* had entered into a cooperative venture with a retail company. *Coop* and *Weight Watchers* joined forces to meet the rapidly growing demand for low-calorie products. Products under the *Coop Weight Watchers* store brand include dairy products, salads and meat products, ready-to-eat meals, drinks, desserts, etc. The packaging indicates the respective fat and calorie content per portion and the number of *Weight*

Watchers points each portion represents. In terms of price, these products are comparable with the other *Coop* store brand items and are positioned to cost less than their manufacturer-brand counterparts. In the medium term, with this store brand, *Coop* will target sales of 300 million SFR from a range of 300 products and the leading position in the Swiss "low-calorie" market. *Coop* also emphasises that this store brand has pioneer status in Switzerland, contributing to *Coop*'s retail image as a dynamic, health-oriented retailer.

Coop Delicorn

In mid-2006, *Coop* launched the store brand *Coop Delicorn*, a range of vegetarian products. It is positioned as a healthy meat alternative. *Coop Delicorn* products include vegetarian sausages, ground, escalopes, veggie burgers, etc., that are made of soy, tofu, spelt, millet or other meat-free ingredients, and no supplementary vitamins or other additives. Just as *Coop Weight Watchers* targets the growing trend towards low-calorie consumption, *Coop Delicorn* targets the growing trend towards vegetarianism.

Coop Free From

More and more people suffer from food intolerances or allergies. In Switzerland, this applies to more than 10 % of the population, with lactosis-intolerance and gluten-intolerance as the most common forms. With the store brand range *Coop Free From*, introduced in mid-2006, *Coop* is the first Swiss retailer to offer an assortment of gluten- and lactosis-free products. The range currently comprises products like lactosis-free milk, yoghurts, cheeses, and gluten-free bread, baked products, pizzas, etc. An extension of the product range to address certain food allergies (e.g. eggs, peanuts) is planned.

Premium Store Brands

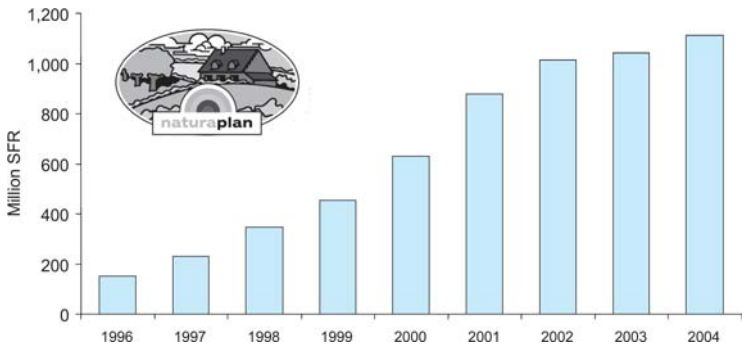
Coop Naturaplan

The most important of *Coop*'s store brands is probably *Coop Naturaplan*. This store-brand range of food products, sourced from organic farms and conforming to the rules of humane animal husbandry, was introduced in the market in 1993. Thus, *Coop* was very early to recognise a growing customer need: the need for well-being, based on healthy products produced with respect for the environment and animals.

With *Coop Naturaplan*, *Coop* is the clear market leader in the Swiss organics market, with a market share of about 50 %. The steady growth of the store brand's sales is illustrated in Figure 8.5.

Presently, *Coop Naturaplan* alone accounts for a turnover of more than 1 billion SFR, more than 10 % of *Coop*'s food sales. *Naturaplan* has made a strong contribution to the increasing market share of *Coop* in the last decade and it exerts a strong influence on *Coop*'s image in the market. *Coop Naturaplan* was at the centre of a number of large marketing campaigns, including heavy advertising on TV.

Figure 8.5 *Development of Coop Naturaplan Sales*



The early introduction of the brand made it possible for *Coop* to become the primary provider of organic food in Switzerland. The claims in the *Coop* mission are clearly connected to *Coop Naturaplan*. *Coop* itself therefore calls *Naturaplan* one of its *"flagship labels"*.

Coop Naturaline

Coop uses a number of other environmental, socially responsible store brands in other product categories. *Coop Naturaline* is a store brand focussing on textiles sourced from organic cultivation and fair trade, and cosmetic products made from natural raw materials. Through this brand, *Coop* is the world's largest supplier of organically grown and fair-traded cotton-based textiles with sales of more than 50 million SFR. The *Coop Naturaline* range of textiles was recently expanded substantially, and a shop-in-shop concept was implemented in the *Coop City* department stores, grouping all *Naturaline*-branded products together (see also Chapter 10).

Coop Oecoplan

The store brand *Coop Oecoplan* comprises over 1,300 non-food and near-food items and has a sales level of almost 100 million SFR. All *Oecoplan* products are manufactured in accordance with strict ecological criteria, are biodegradable and do not contain unhealthy ingredients such as formaldehyde or toxic heavy metals.

Max Havelaar

In addition, many *Coop* products are labelled with *Max Havelaar*. Here, *Coop* uses a quality label from an independent foundation which guarantees that the products are sourced according to principles of fair trade. With sales of more than 100 million SFR, *Coop* is the worldwide no. 1 for products from fair trade and for specific products like bananas, almost 100 % of all products sold at *Coop* are *Max Havelaar* products.

Coop Fine Food

In 2004, *Coop* launched another premium store brand. In some respects, this store brand is unlike all other *Coop* store brands. Those others focus on niches which *Coop* detected early, before the real market trend had emerged. This facilitated the introduction of a store brand, but *Coop Fine Food* is different. Here, the value added in the product range is purely the premium quality of the products, formerly a unique characteristic of manufacturer brands. The development of *Coop* as a strong and trusted retail brand with a positioning as pictured in Figure 8.4, is probably a prerequisite for the successful introduction of such a store brand.

With its *Fine Food* line, *Coop* markets an attractive selection of excellent-quality specialities which are not only delicious, but also have something special about them, such as the ingredients, their origin, the way they are prepared, or their producers. Products in the *Coop Fine Food* range include tuna carpaccio, buffalo mozzarella, quail eggs, goose liver pate, and also certain hams, honey and pasta items. *Fine Food* products are not positioned as true luxury items. They are delicacies that customers can treat themselves to for special occasions. The silver and black design of their packaging communicates their high culinary aspirations. Each item is provided with a small leaflet describing the product's history or what makes it special. The medium-term target is about 200 items and sales of about 50 million SFR.

Budget Store Brand "Coop Prix Garantie"

While Swiss consumers are generally less price sensitive than their counterparts in other European countries, which helped the early introduction of value-added store brands by *Coop*, a general consumer trend towards a price-orientation has also emerged in Switzerland. *Coop* had to react to this trend not only by improving its general price performance, but also with clear communication measures. The store brand *Coop Prix Garantie* was introduced in January 2005, in order to communicate clearly under one label the price-value of the products in *Coop*'s bargain-price segment. *Prix Garantie*'s product range comprises products that were previously offered under the *Coop* standard store brand and are now offered at guaranteed prices that were cut by 25 % on average and with no loss of quality. According to *Coop*, the fact that the *Coop Prix Garantie* products have the corresponding *Coop* store brand's accustomed quality, makes the products stand out clearly against the budget-price products of other retailers.

The product range now includes almost 400 products. Particularly popular articles for everyday use that sell in large amounts are sold under the *Prix Garantie* brand. Their attractive prices are recognised by consumers as substantially lowering the price of a total shopping basket, and include such items as milk, ham, flour, pasta, detergents, shampoo, etc. The product de-

sign clearly signals its budget character, with mainly plain white packages with a flashy pink label. All in all, in late 2004 and early 2005, Coop invested 280 million SFR in improving its price performance. A large part of this amount was spent on the new budget store brand.

In marketing *Coop Prix Garantie*, *Coop* makes a threefold promise: guaranteed low price, guaranteed permanent bargain prices rather than temporary special offers, and guaranteed quality. The latter means that *Coop* consciously excludes low-quality products from the *Prix Garantie* line. For instance, *Coop* makes a point of not including cheap eggs from battery hens.

Summary and Outlook

Coop successfully used a top-down approach to position itself in the Swiss retail market and to grow steadily over the last few years. A clear company positioning was developed and subsequent decisions were derived from that positioning. In addition, internal company processes and structures, an aspect that has not been mentioned in this case study, have been radically changed and re-engineering projects were carried out.

Coop category management plays an important role in this development, because it provides clear guidelines for the management of product categories, in marketing communication and in store operations, which are based on a clear business plan for each category. A stringent CM process is followed and CM was implemented very successfully into *Coop*'s business procedures within only a few years. Category managers now run their own categories as strategic business units, and roles are assigned to each category and for each retail format.

Store brands are an important part of the retail marketing at *Coop*. *Coop* introduced its flagship labels *Coop Naturaplan*, *Coop Naturaline*, *Coop Oecoplan* (and in addition, it started to use the fair-trade label *Max Havelaar*) in the early 1990s, when the trend towards such values was just emerging. This demonstrated a remarkable sense of c*orporate social responsibility*, a concept that became en vogue in the management literature about a decade later. With these brands, *Coop* has taken organic food and environmentally and socially responsible products out of their niches and made them attractive to a broad public. They have been an important cornerstone of *Coop*'s success in the last decade.

But *Coop* also used a mix of manufacturer brands and – as a lower-priced alternative – the *Coop* store brand in order to offer diversity and choice to consumers. New trends were identified early, and store brands were used to satisfy consumer needs in emerging market segments, such as the culinary convenience segment with the brand *Betty Bossi*.

Coop itself clearly is a strong brand now, standing for the values and consumer benefits that the *Coop* mission conveys. This is a strong foundation to differentiate the retailer further from its competitors. Strong store brands that help to enhance *Coop*'s image by connecting it with positive brand messages, such as *Coop Fine Food*, are among the measures that will certainly support this process in the coming years.

Questions

1. *Coop* introduced the budget store brand *Coop Prix Garantie* and thereby clearly connected those products with the retail brand *Coop*. Discuss the advantages and disadvantages of this strategy.
2. Even though *Coop* has very strong store brands, about half of its sales come from manufacturer brands. Discuss the benefits and drawbacks of an extensive range of manufacturer brands in this specific case.
3. As mentioned, *Coop* also has a chain of DIY stores. Develop two different positioning strategies for a DIY retailer and suggest what products the retailers should carry in their assortment and how the roles should be assigned to different categories which support the respective positioning.

Hints

2. Remember that *Coop*'s main competitor in the Swiss market focuses its strategy on store brands.
3. Consider, for example, that "do-it-yourself" covers very different activities, from soft furnishing and decoration in a house, or arts and crafts as a hobby, up to a complete house construction project. To get an idea of potentially relevant categories for a DIY retailer, visit the web sites of *B&Q* (www.diy.com) or *Home Depot* (www.homedepot.com).

Chapter 9

Pricing

The purpose of this Chapter is to discuss the main aspects of pricing in retailing. The Chapter describes the basic methods of calculating a retail price, the structure of a retailer's prices, and the dynamics and psychology of pricing. The Chapter concludes with some Internet-related aspects of pricing.

The Importance of Retail Pricing

Pricing in general and price promotions in particular have always been an important marketing instrument in retailing and, up to the present, price has played a very important role in retail marketing. However, it is precisely this focus on price reductions, often based more on belief and intuition on the part of the retailer, than on facts and knowledge about its effects, that makes pricing a field of considerable strategic importance today. In many countries, retailer *profit margins* are very low. In food retailing, it is about 1 % of sales, so that a product that is sold for 1.00 EUR leaves the retailer with an average profit of 1 cent. This means that by increasing this price by only 1 %, profits could double – if consumers continue to purchase roughly the same amount of this product. Consequently, the profitability potential of pricing is considered to be substantial (Bolton/Shankar/Montoya 2006, p. 255).

Methods of Price Setting

There are three major methods for setting product prices in retailing: cost-oriented, competition-oriented, and demand-oriented.

Cost-Oriented Pricing

Markups

The most commonly used method for determining retail prices is the cost-oriented method, also called *cost-plus pricing*. Here, a fixed percentage (the *markup*) is added to the cost of products in order to determine the final retail price:

$$(1)\ markup\ in\ \%\ (at\ cost) = \frac{retail\ \ price - merchandise\ costs}{merchandise\ costs}$$

The percentage markup is similar to the percentage gross margin of the retailer (see Chapter 15). Generally, the costs used in the formula are the variable costs per unit (purchasing price for the retailer), while fixed costs are estimated in order to calculate the markup percentage necessary to cover them. The markup percentage also includes the planned profit per unit. Since different product categories lead to different expenses, the markup is usually different between categories.

Direct Product Profitability

Direct product profitability (DPP) is a sophisticated method for planning variable markups. This technique enables a retailer to find the profitability of each product by computing adjusted per-unit gross margins and assigning direct product costs for such expense categories as warehousing, transportation, handling, and selling. Based on exact costs per product, appropriate markups can be set (Berman/Evans 2007, p. 514). The major problem, however, is the complexity of assigning costs to specific products, since it is very difficult for retailers to allocate overhead expenses with a high degree of accuracy.

While cost-oriented pricing usually does not determine the optimal price, it is the most simplistic method of calculating a price. A retailer has the task of setting prices for merchandise assortments of 10,000 products in a supermarket or more than 100,000 products in a department store. For some items in a supermarket, prices are changed weekly. Obviously, this makes it almost impossible to calculate optimal prices, based on estimated price sensitivity, for all products (Simon/Gathen/Daus 2006, p. 274). Therefore, the cost-oriented method for setting prices is a very cost-efficient method concerning the retailer's planning costs.

Competition-Oriented Pricing

In competition-oriented pricing, the retailer identifies his main competitors and sets his prices accordingly. Many retailers systematically monitor prices in their competitors' outlets. Depending on the pricing strategy, prices for certain products are then established at or below the competitors' price.

Competition must be considered in many retailing industries, because retailing is often characterised by oligopolistic competition. In many countries, a few large retailers combine a very high market share. In this situation, a company has to anticipate the potential reaction of a competitor to its own moves, before setting or changing prices. *Game theory* has developed a framework for this kind of analysis, which retailers have applied implicitly for a long time. In Germany, for example, food retailers know that they should not set prices below *Aldi*'s price level for a particular product – or *Aldi* will react strongly in order to defend its image as the absolute price

leader in the market. Such price wars can result in a generally lower price level in a country, which reduces profits for all retailers.

Demand-Oriented Pricing

With demand-oriented pricing, the retailer bases his prices on consumer demand. The sensitivity of consumers to price changes is an important coefficient for setting a demand-oriented price. The *price elasticity* (more precisely: own-price elasticity) of demand is a measure of consumer sensitivity to price (see for example Ogden/Ogden 2005, pp. 328-331). It measures the responsiveness of quantity demanded to a change in price:

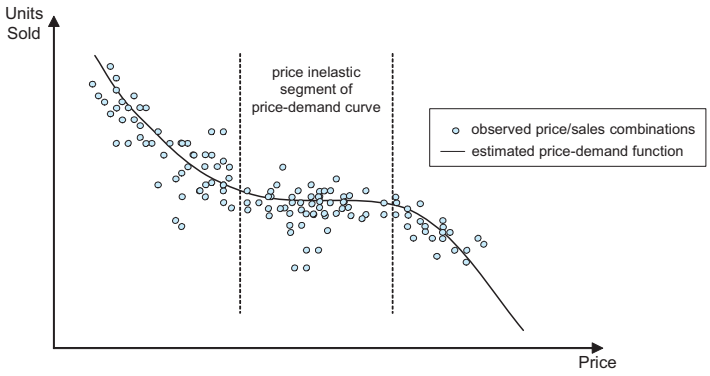
Price Elasticity

$$(2)\ \text{price elasticity } \varepsilon = \frac{\text{relative change in quantity demanded}}{\text{relative change in price}} = \frac{\Delta q / q}{\Delta p / p}$$

With a price elasticity of $|\varepsilon| > 1$, if the retailer raises prices, total revenue decreases. This is likely, when there are many substitute products available. If price elasticity $|\varepsilon| < 1$, that is, demand is relatively price inelastic, a price increase results in a smaller relative reduction in purchasing volume and total revenue increases. For example, at 11 p.m., a convenience store usually experiences a relatively price inelastic consumer demand.

Example of the Estimation of a Price-Demand Function from Scanner Data (Fictitious Example)

Figure 9.1



Information on price elasticity can be obtained in different ways. Customers can be surveyed to determine whether they would buy a certain product at a certain price. Experts can estimate sales levels at a certain price, based on

Estimating the Price-Demand Function

their knowledge of similar products. For products that have been in the assortment for a longer period of time, historical data from the retailer's information system (price-volume combinations) can be used and both price elasticity and price-demand functions estimated from this data (see Figure 9.1 for a fictitious example). Another method would be to undertake experiments by using a sample of stores, varying the price systematically while leaving it unchanged for a control group of stores, and observe the changes in demand resulting from the price changes.

The two other methods can be included in demand-oriented pricing. Competitors' prices can be integrated as an influence factor on consumer demand. Since the objective is generally not to maximise sales, but to maximise profit, cost information can be added in order to determine the optimal level of demand and, subsequently, price.

Interdependence of Price-Demand Functions within Assortment

Cross-Product Price Elasticity

Retailers simultaneously offer a large variety of products to consumers, so that retail pricing is really a multiple-product pricing activity. The demand functions of different products are interrelated and not only the own-price elasticity of demand is relevant, but also the various *cross-product price elasticities*. Demand interrelationships can have *complementary effects*. For example, customers are drawn into a store by some product offers and then also buy additional products while in the store. On the other hand, cross-product relations may also comprise *substitution effects* (cannibalisation), when reducing the price of one product leads to purchases on the expense of another product. Retail pricing must incorporate such demand interdependencies in order to maximise store profitability (Simon/Gathen/Daus 2006, p. 283).

Mixed Calculation and Loss Leaders

A *mixed calculation*, in which certain products are used to draw customers into the store and to establish a positive price image, while other products are used to make the customers' total purchase profitable for the retailer, is therefore a common strategy. Within such a strategy, *loss leaders* are very often used by retailers. Here, a retailer sells selected items in his assortment at less than the usual profit margins or even below marginal costs. Usually these items are heavily advertised. The goal is to increase customer traffic so as to sell regularly-priced goods in addition to the specially priced items. Loss leaders are often frequently purchased products from known brand manufacturers, so that customers are aware of the low prices and can compare them with other stores (Levy/Weitz 2007, p. 420). Selling below costs is regulated in many countries by minimum price laws. However, calculating the true purchasing costs is difficult, even for the retailer himself.

Technology and Retail Pricing

Due to its complexity, while retail pricing has often been based on intuition and simple rules (such as fixed markups), new technology is being developed constantly (see for example Bolton/Shandar/Montoya 2006, p. 259; Russ/Stahmer/Schwaiger 2004). Price optimisation software can predict demand for individual products at a certain price level, based on historical price and sales data, competitors' prices, local demographics, inventory and other data.

The complexity of the decision and the intense interdependence of influence factors, as well as the fact that the prices of many other products influence the sale of one specific product, makes new technology necessary. Price optimisation software can be used by retail managers to test and forecast the expected reactions of consumers to changing pricing and promotion tactics in "what-if" scenarios.

Price Positioning and Price Structure

The price image of a retailer is the result of a generalisation process, in which separate price-value impressions created by different products, departments, and stores of a retailer are aggregated into a total impression of the price level of that retailer in the mind of the consumer. Price images are the result of the fact that consumers are unable and often unwilling to carry out a full and current price comparison for all products offered by a particular retailer (Diller/Anselstetter 2006, pp. 599-600).

The price positioning of a retailer, that is his price image in relation to his competitors, is determined largely by the general positioning of the company (see Chapter 6). This, in turn, is closely connected to the retail format selected by the company (see Chapters 1 and 2).

The retail format influences the general price image of the retail outlet, since customers expect certain price levels at certain retail formats. From the perspective of the retailer, the retail format plays an important role in determining the cost structure of a retailer and thereby limits the potential pricing strategies.

Price Structure

With respect to the price structure of a retailer, a differentiation is often made between:

- a value (or budget) price segment,
- a medium (or standard) price segment and
- a premium price segment.

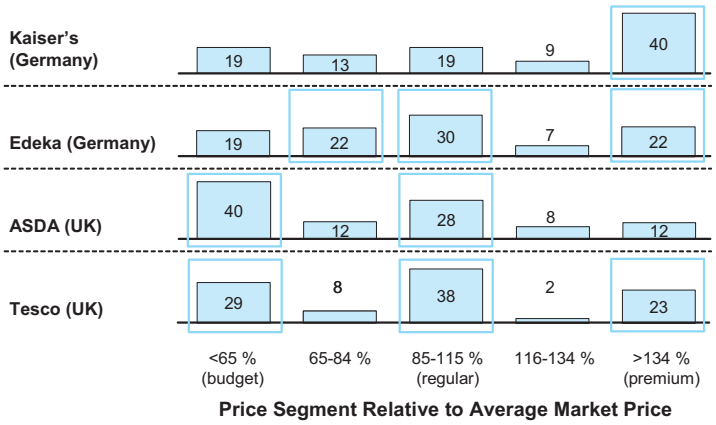
In the premium price segment, retailers attract customers who are less concerned with price than with service, merchandise quality, prestige, and other store attributes. It does not usually maximise sales, but does achieve high profits per unit. With an aggressive pricing strategy in the budget price segment, a retailer seeks to earn high revenues by setting low prices and selling many units. Profit per unit is low, but total profit may still be high.

Many successful retailers focus on the budget price segment. The hard discounters, *Wal-Mart*, many of the category killers, the dollar stores in the USA, *Hennes & Mauritz* or *IKEA* and many more, have gained tremendous market shares with a low or even aggressive pricing strategy.

Price Lining

However, offering different price levels (within a merchandise category) allows a retailer to target consumers with a differing willingness to pay for a product. In economic terms, with different price levels, the retailer is able to obtain a larger share of total consumer rent. Rather than offering merchandise in a category evenly distributed over a continuous price range, many retailers employ *price lining*. This means that they sell merchandise at a limited number of price points. Price lining helps consumers avoid confusion about product differences. Distinct price levels within a category simplify the buying process for customers. Figure 9.2 shows an example of the very clear pricing structure of *Tesco* compared to some competitors.

Figure 9.2 *Examples of Price Lining of Different European Food Retailers – Percentage of SKUs in 5 Price Segments (Example: Toothpaste)*



Source: McKinsey.

Price Differentiation

Price differentiation means charging different customers different prices for the same product. The extreme case is negotiating the price with each customer individually. In some retailing industries, such as automobiles, such flexible pricing based on negotiations is standard and the prices actually paid vary greatly.

While in the service industry (for example, movie theatres), prices for students or senior citizens are often lower, this is not usually implemented by retailers. Here, geographic price differentiation is the most commonly applied approach. Loyalty programmes, another way of price differentiation, are discussed in Chapter 11.

Geographic Price Differentiation

The price sensitivity of a store's customers is – among other factors – a function of the spending power of the clientele and the density and aggressiveness of the competition in the store's catchment area. A store in a poor region next door to a hard discounter might therefore use lower prices than another store of the same chain that is located in a rich city with no nearby competitors.

Price Zones

Retailers often use *price zones* as areas (or groups of stores) in which consumers pay uniform prices, while the prices between the zones differ. Such price zones help retailers to adapt pricing more effectively to the distinctiveness and competitive environment of a local market area. In large cities, sometimes retailers even have different pricing zones within the same city (Levy/Weitz 2007, p. 417).

One-Price Policy

While geographic price differentiation usually enhances profits, some retailers follow a *one-price policy*, charging all customers the same price for a certain item, irrespective of the store location (Berman/Evans 2007, p. 519).

This policy, implemented, for example, by *Coop* in Switzerland, is directed towards consumer trust in the retailer and is often based on a company mission with a strong corporate social responsibility element.

Dynamics of Pricing: HiLo vs. EDLP

Two different dynamic pricing strategies can be observed for retailers: EDLP and HiLo (e.g. Hoch/Drèze/Purk 1994; Levy/Weitz 2007, pp. 417-418; Bolton/Shankar/Montoya 2006, pp. 261-264).

HiLo (High-Low) Policy

With a HiLo pricing strategy, retailers have relatively high regular prices, but use substantial temporary price reductions to advertise their products and draw customers into the stores. Many supermarkets use this strategy. Price promotions can be regarded as a method of price differentiation through customer self-selection (Gedenk/Neslin/Ailawadi 2006, pp. 356-357). The promotion is offered to all customers, who then decide whether or not to use it. Less price-sensitive customers buy at regular prices, while more price-sensitive customers wait for a sale and buy then. Price promotions can influence the retailer's price image. Proponents of a HiLo strategy also argue that price promotions create excitement in the store.

However, price reductions pose the danger that they change the customers' *reference price*. While a short, one-time reduction is considered a bargain, frequent or longer-time reductions of a product price reduce the reference price, making it difficult to sell the product at normal price in the future (Diller/Anselstetter 2006, p. 618). Heavy price promotion activity can erode consumer confidence in regular prices (Hoch/Drèze/Purk 1994, p. 16). Over time, the customer can buy larger quantities of a product at reduced prices and stock them, thus reducing the amount purchased at normal prices.

HiLo pricing is often criticised for encouraging customer disloyalty and appeal to smart shoppers who only buy items on special prices. Especially for intensive HiLo strategies, this can lead to reduced profits of the retailer.

EDLP (Every-Day-Low-Price) Policy

The alternative is an EDLP strategy, for which prices remain stable over a long period of time. It involves offering consistently low prices. *Wal-Mart* is an important example of such a strategy (see case study *Wal-Mart* in this Chapter).

EDLP makes the shopping process easier for the customer, and the price continuity enhances his trust in the retailer. Disappointment that consumers of a HiLo store can experience if they see certain products being sold this week at a much lower price than they paid last week, can be avoided. Simple and consistent pricing is expected to lead to *price credibility*.

The real advantages of EDLP for the retailer, however, often lie in improving the efficiency of internal processes, in operating costs. While price promotions result in short-time volume volatility, which leads to increased logistics costs, EDLP results in stable sales. Therefore, sales forecasting becomes more reliable. Out-of-stocks can be avoided and warehousing and transport costs reduced.

On the other hand, EDLP has high price transparency, and thus can only be implemented successfully if the retailer has a very low cost structure. EDLP makes price comparisons much easier for consumers (and competitors) than a HiLo policy. An EDLP retailer must, therefore, have a very low retail price for most of his products and only the most efficient retailers will be able to sustain this in the long run (Morschett 2002, p. 249).

EDLP and HiLo both have their advantages. In a survey conducted in the USA, 78 % of the customers claimed to prefer EDLP. At the same time, more than one-third stated they would hold out for a price promotion or shop around to get the best deals. This shows why HiLo pricing remains a viable pricing policy, despite the supply chain and trust drawbacks (LeHong 2004).

Price Reduction Options

Adjustments of product prices are very common in retailing, usually in the form of price reductions.

Markdowns

Markdowns are a permanent reduction of the initial retail price. They are a very common pricing tool, for example, in clothing and textiles, in order to sell off merchandise. In the USA, it is estimated that more than 30 % of sales in department and specialty stores are of marked down goods, up from less than 10 % in the 1970s. The main reason is the seasonal character of certain merchandise, which often leads to overstocking at the end of the season, often with products that cannot be sold successfully in future seasons. Markdowns are planned ahead and calculated into the initial markup in order to be able to reduce prices as part of a *temporal price differentiation strategy*. Those customers with a higher willingness to pay for new fashion early in the season, pay higher prices than customers who buy later in the season. However, markdowns are expensive and often after the first, planned markdown, others have to follow to clear off the merchandise. Substantial markdowns are often a signal of poor demand planning or pricing during normal selling phases.

Temporary Price Reductions

The options for temporary price reductions are manifold (see Diller/Anselstetter 2006, p. 615; Levy/Weitz 2007, pp. 416-417), for example:

- *Promotion packs* have some extra content and the price per volume is lower (e.g. “10 % extra for the same price”).
- With *BOGOFs* (“buy one, get one free”), a customer receives one unit of a product free of charge, if he buys another one for full price.

- In *multipacks*, several units of the same products are tied together (to a simple price bundle), usually at a lower price than the sum of the individual units.
- With *coupons*, consumers have to show the coupons at the store checkout in order to get a discount. Coupons can be distributed together with the retailer's advertising or through direct mailings. They can also be distributed by manufacturers' advertising (and be accepted by the retailer, but refunded by the manufacturer), or they can be distributed at the shelf.
- *Store-wide reductions* are another option which applies to the whole assortment. The German DIY chain *Praktiker* regularly offers "20 % on everything in the store" for a few days. As these events show, customer traffic in the stores increases dramatically during the price promotion.

The short-term effects of price promotions are often very strong. Such promotions can lift sales by several hundred per cent for a short time, depending on the category and promotion instrument used. On the other hand, a certain share of such increased sales derives only from purchase acceleration. This can lead to a below-normal sales volume of the same product for some time after the price promotion (Gedenk/Neslin/Ailawadi 2006, pp. 350-352). This is, in fact, a typical reaction to retail promotions.

Psychological Pricing

In setting prices, it is not just purely rational economics, but also the psychological aspects of prices that have to be considered.

Price-Quality Relationship

Especially when it is difficult for consumers to evaluate a product's quality, price may be used as an indicator of quality. Studies regularly show this influence of price on quality perception and for many retail products, such as clothing, certain food items, or technology, consumers often lack the necessary information and ability to judge the merchandise quality accurately.

Price Communication

Even though the price seems to be objective, price perception is often largely subjective (Hurth 2006, pp. 63-94). Depending on the way a price is communicated to consumers, they evaluate price-value differently. A red or yellow colour of price stickers, large price signs, crossed-out "old" prices, comparisons with recommended retail price by the manufacturers, and many other communicative measures can lead to perceptions of lower prices. Presenting the price as a major feature in retail communication (i.e. the German retailer *Media Markt*), combined with a heavy advertising budget, often influences the price image. Price communication can therefore be an important facet of a retailer's pricing strategy.

Odd Prices

Another frequently used approach is that of odd prices, i.e. prices on products that end on an odd number, mostly 9. Consumers are expected to perceive prices slightly below certain thresholds as substantially lower than prices at the threshold. So a product that is priced at 1.99 EUR is perceived to be much less expensive than a product for 2.00 EUR. Research on the effect of odd prices shows ambiguous results; a positive effect is not really proven. Even so, in most retail sectors, it is a common practice.

Pricing and the Internet

All the traditional pricing instruments are also used in e-commerce. In addition, price differentiation is heavily used in the Internet. While store-based retailers usually set fixed prices within one store, auctions, a very traditional form of finding the optimal selling price based on customers' exact willingness to pay, have regained popularity through the Internet, especially in the form of *eBay*.

Another important development is increased price transparency. Comparing prices through the Internet is far simpler and faster than through visiting different store outlets. It is therefore done more intensively. Certain web sites specialise in price comparison, such as *www.kelkoo.com, www.pricerunner.com, www.guenstiger.de*.

Since Internet shops often price their products aggressively, these prices are used by consumers as reference prices, even when shopping at bricks-and-mortar stores. Since store retailers have to invest in facilities, employees and stock, they have a different cost structure to that of Internet players and matching their prices is not always easy. This is a real problem for multi-channel retailers (see case study *Media Markt* in Chapter 2), but also for traditional store retailers.

Conclusion and Outlook

Pricing is a major marketing instrument for retailers. It is an important element of consumer buying decisions and the right pricing may be a decisive determinant of profit or loss for a retailer. Certain trends can be observed in retail pricing:

- Increasingly, retailers are setting their prices based on consumer demand and on what the market is willing to pay.
- Many companies now introduce every-day-low-prices (EDLP). The main reason is to improve efficiency in the supply chain, forecast demand more reliably and achieve more consistent sales patterns.

- Even so, many retailers prefer to reduce their prices as part of a price promotion, with promotional strategies becoming more varied and increasingly complex.
- Price differentiation between regions or based on other factors is likely to become even more widespread in the future. Prices not only differ from region to region, but also on the basis of different customer profiles. With loyalty programmes, coupons, price promotions, temporal and regional price differentiation, two customers are becoming increasingly unlikely to pay the same price for the identical shopping basket.

On the whole, pricing is becoming more analytical. In the past, pricing decisions were often based on intuition and rough rules of thumb. Today, retailers have far more sophisticated tools at their disposal and can increasingly analyse how price changes affect the buying behaviour of individual customers, including cross-product price sensitivity and the competitors' prices in the calculation. Pricing software also enables retailers to consider more and more the influence factors that determine an optimal price. Revenue benefits from more flexible pricing can be expected, but price pressure is likely to remain strong over the ensuing years.

Further Reading

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Case Study: Wal-Mart[1]

Introduction

Wal-Mart, Inc. is the world's largest retailer and, since 2002, has been the largest company in the United States, as evidenced by the no. 1 position in the *Fortune 500* list for four consecutive years. This global company, with its headquarters in Bentonville (in the North-Western part of Arkansans) was named America's "most admired company" by *Fortune Magazine* in March

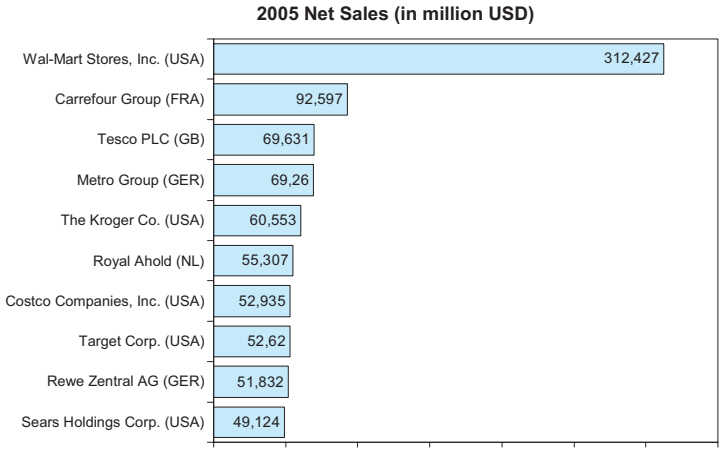
1 Sources used for this case study include the web site http://www.walmartstores.com as well as explicitly cited sources.

2003. With its current number of about 1.8 million employees worldwide, *Wal-Mart* constitutes the largest private-sector employer in the world (Wal-Mart 2006). It operates about 6,150 stores and wholesale clubs in numerous countries. The company is the most prominent example of a "big box discount retailer" applying the principle of *every-day-low-prices* (EDLP), holding leading positions in virtually all consumer goods categories, i.e. clothes, shoes, toys, home appliances, consumer electronics, sporting goods, bicycles, groceries, and food in the USA (Smith 2004).

Wal-Mart is likewise known for its "cutting-edge technology, distribution proficiency, and data mining capabilities" (Discount Store News 1999, p. 107). *Wal-Mart's* worldwide competitors in the food retail industry are *Carrefour* from France, *Tesco* from the United Kingdom and the German *Metro Group*. *Wal-Mart's* unchallenged position as the world's leading retail company, which is illustrated by Figure 9.3, is also confirmed by the fact that the joint net sales of the world's second through fifth largest food retailers together are still less than those of *Wal-Mart.*

Top 10 Retailers Worldwide

Figure 9.3



Source: Adapted from M+M Planet Retail Ltd.

Since Sam Walton opened the first *Wal-Mart* store (short for *Walton's Mart*) in Rogers (Arkansas) in 1962, the company has been characterised by unprecedented growth rates with respect to sales, the number of stores, the number of employees as well as the numbers of US states and international

markets entered. *Wal-Mart's* pace of growth was accelerated by the initial public offering (IPO) in 1970, which provided the capital needed to make several acquisitions. Table 9.1 summarises the key growth figures.

Table 9.1 *History of Growth*

Year*	Sales (in million USD)	Number of Stores	Number of U.S. States	Number of Foreign Markets	Number of Employees
1970	44	38	3	0	1,500
1979	1,248	276	11	0	21,000
1987	11,909	1,198	23	0	200,000
1995	82,494	2,784	50	4	675,000
2005	312,427	6,141	50	15	1,800,000
* Fiscal year starts on 01 February and ends on 31 January of the following year.					

Source: www.walmartstores.com.

Currently (in 2006), the company is divided into three business segments, the *Wal-Mart Stores* segment with a threefold portfolio of retail formats in the USA (*Discount Stores*, *Supercenters*, and *Neighborhood Markets*), which accounted for about two-thirds of overall sales in 2005 (209.9 billion USD), the *SAM'S CLUB* segment, containing the US-based warehouse clubs (12.7 % sales contribution, 39.8 billion USD in absolute terms), and the *Wal-Mart* international segment (20.1 %, 62.7 billion USD), which consists of all retail formats outside the USA. Next to global sales, which amounted to 312.4 billion USD in 2005 and hence exceeded the estimated GDP of nations such as Switzerland or Austria (World Bank 2005), the company topped 11 billion USD in net income for the first time in its history and grew its earnings per share by more than 11 %.

Discount Retailing & Diversification of Retail Formats

Big Box Discount Stores as Initial Retail Format

Discount Stores, which emerged in the USA in the mid-1950s, gave rise to the general retail format of discounters, which is growing rapidly in the USA today (see Hilt/Scheer 2006) (US-based discount stores, which today usually take the form of *big box discount stores*, are not to be confused with German-based hard discounters such as *Aldi* or *Lidl*). Based on the example of supermarkets, which sell food at very low margins, this approach was extended to non-food and general merchandise by charging lower margins than conventional department stores. Deep cost cuts were necessary to compensate for lower margins: "Fixtures were distinctly unluxurious, instore

selling was limited, and ancilliary services, such as delivery and credit, were scarce" (Bradley/Ghemawat/Foley 1994, p. 138). *Wal-Mart's* discount strategy involved locating its stores in rural areas and small towns, which were largely ignored by competitors, and charging the same or lower prices than competitors, which were located in the closest bigger cities (Walton 1992). Although one third of *Wal-Mart's Discount Stores* were operated in regions not served by competitors in the mid-1980s, the company's growth was accompanied by increased competition from other retailers (Bradley/Ghemawat/Foley 1994). Therefore, *Wal-Mart* diversified its retail activities throughout the 1980s, by establishing warehouse clubs named *SAM'S CLUB* which started in 1983 and by opening so-called *Supercenters* in 1988. Ten years later, another, smaller-sized retail format was introduced: the *Neighborhood Market*. In addition to the traditional retail formats, the company operates two online retail formats (www.walmart.com and www.samsclub.com). A break-down of *Wal-Mart's* traditional retail formats looks as follows:

- *Discount Stores* represent the company's classic format. It is characterised by an assortment which is non-food dominated and resembles that of a department store including toys, clothing, leisure and sporting goods, car components and furniture. Food items are reduced to a small range of sweets and beverages (Gotterbarm 2004). *Discount Stores* average approximately 9,500 m² in size (Wal-Mart 2006).

- A *Supercenter* can be described as a combination of supermarket and discount store with an average size of 17,400 m² (Wal-Mart 2006). It features a complete grocery department along with 36 departments with general merchandise. The number of brands and package sizes, however, is more limited – in comparison to a supermarket – in order to achieve a cost advantage. Additionally, *Supercenters*, whose stores open 24/7, usually contain "bakeries, delis, and convenience shops such as portrait studios, photo labs, dry cleaners, optical shops, and hair salons" (Bradley/Ghemawat/Foley 1994, p. 148).

- *Neighborhood Markets* range from 4,000 to 5,000 m² in size, have about 80 to 100 employees and offer an assortment of goods consisting of approximately 28,000 items, with a two-thirds non-food and a one-third food assortment. The former focuses on freshness and the latter includes dairy products, pharmaceuticals and a selection of general merchandise. *Neighborhood Markets* are generally located within a radius of three to seven miles of *Supercenters,* in order to supplement the existing food distribution network and provide added convenience (Gotterbarm 2004).

- *SAM'S CLUB* is a members-only warehouse club. The first *SAM'S CLUB* opened its doors in Midwest City, Oklahoma, in 1983. The warehouse

club represents the fastest growing sector of the retailing industry – approximately 30 % of the US adult population has a warehouse club membership. *SAM'S CLUB* has over 46 million members (Wal-Mart 2005).

Table 9.2 gives an overview of the relevance of the different retail formats with respect to store numbers (on a national as well as on an international scale) and sales contributions.

Table 9.2 *Configuration of Wal-Mart's Retail Formats*

Country	Discount Stores	Supercenters	SAM'S CLUBS	Neighborhood Markets
US Totals (50 states)	1,209	1,980	567	100
Argentina	0	11	0	0
Brazil	255	23	15	2
Canada	272	0	6	0
China	0	51	3	2
Germany	0	88**	0	0
Japan	2	96	0	300
South Korea	0	16*	0	0
Mexico	599	105	70	0
Puerto Rico	9	5	9	31
United Kingdom	294	21	0	0
International Totals	1,431	416	103	335
Grand Totals	2,640	2,396	670	435

* Sale of Supercenters to market leader Shinsegae was announced on 22 May 2006.
** Sale of Supercenters to Metro was announced on 26 July 2006.

Company Philosophy

Wal-Mart's corporate philosophy continues to be based on the thinking of its founder, Sam Walton, who formulated the following three basic guidelines (www.walmartstores.com):

- respect for the individual
- service to the customer
- striving for excellence.

Respect for the Individual

The first guideline refers essentially to the company's desired way of treating human beings and it shows that employees are highly valued. The fact that employees are called "associates" at *Wal-Mart* also suggests respectful and

motivating treatment. Employees' contribution to successful company operations is inherent in the slogan "Our people make the difference". *Wal-Mart* also aims at providing a sense of belonging by singing the *Wal-Mart-Cheer* every morning.

Service to the Customer

The second guideline reflects *Wal-Mart's* customer orientation, which is manifested in several ways. Customers are, for example, greeted at the entrance of the store by an employee, who offers them a shopping cart, and whose clothes, like those of all other employees, carry the slogan "How can I help YOU?" As a general rule, which is part of the company's proclaimed "aggressive hospitality", *Wal-Mart* employees have to address and offer help to every customer within an area of ten feet, known as the *ten-foot-rule*. Another rule, which aims at achieving customer satisfaction, is the *sundown rule*, which states that all employees should respond to calls from customers, suppliers or other employees by sundown of the day they are received. This is intended to demonstrate that they take care of the respective issues, even if they are unable to solve every problem or complete every task before sundown.

Striving for Excellence

Striving for excellence, the third guideline, has consequences for many value-adding activities at *Wal-Mart*. It refers to excellence in supply chain management, logistics, IT processes and, most importantly, it refers to constantly lowering costs and prices in accordance with the company's credo of *every-day-low-prices*, which is analysed below in greater depth.

Every-Day-Low-Prices (EDLP) & Every-Day-Low-Costs (EDLC)

Pricing Philosophy

Discounting

Wal-Mart's successful retailing activities are deeply rooted in the company's discount pricing philosophy, which was developed by Sam Walton, the company's founder. It states that by cutting prices, sales can be boosted to a point where far more can be earned than from selling items at higher prices, i.e. earnings can be maximised by lowering the markup, because of the increased volume of merchandise sold (Walton 1992). In its external communications, *Wal-Mart* emphasises that, thanks to this pricing philosophy, low prices can be passed on to customers, who receive the best possible value for money.

The overall pricing philosophy contains the sub-elements *EDLP*, *rollback* and *special buy* (www.walmartstores.com). Rollback refers to the ongoing com-

mitment to pass on even more savings to customers by lowering the every-day-low-prices whenever possible, i.e. if *Wal-Mart's* costs get rolled back on a permanent basis. Lowered prices, due to such a cost rollback, can be traced by customers with the help of *rollback smiley faces*, which are used in the stores. A *special buy item* may be one carried every day that includes an additional amount of the same product or another product for a limited time, or it could be an item carried at a special price while supplies last. Such items, which can be recognised by a "special buy logo", represent elements of a high-low (HiLo) pricing policy.

Opening Price Point Items

As additional features of *Wal-Mart's* exceptional pricing concept, the company introduced *opening price point items*, i.e. one super-low priced item in each category (Hornblower 2004a) and it introduced the volume producing item (VPI) contest, which is a powerful tool in combination with EDLP. Management selects specific items, usually those that "can be stacked out, case cut, single-price point features that are priced to generate large sales" (Discount Store News 1999, p. 1) and encourages employees to develop creative ways to merchandise and sell these items.

Moreover, customers are given a price guarantee that they can purchase products offered at a lower price by competitors within a certain radius from the *Wal-Mart* store, at the same (lower) price. However, it has become evident that customers mostly did not make use of this option, because the effort involved was perceived as too high (Gotterbarm 2004).

EDLP

Until now, the great strength of *Wal-Mart* has been the strong commitment to EDLP, which is the basis for all marketing and advertising campaigns. Since *Wal-Mart* largely avoids one-off sales, it also largely avoids out-of-stock situations that retailers applying HiLo pricing frequently have to face. Studies in the USA (e.g. by *Goldman Sachs*, see Discount Store News 1999, p. 2) have revealed that *Wal-Mart* indeed beats their supermarket competition on prices in nearly all grocery product categories, supporting the company's claim of "Always Low Prices. Always."

Apart from substantial investments in advertising when entering a new location, the overall advertising activities, and hence costs, are kept at fairly low levels. Although the company uses TV advertising in order to enhance its image, it launches only twelve promotional circulars per year, which is far below the figures for competitors such as *Kmart* and *Target* (Kalish 1999; Arnold/Fernie 2000).

In order to ensure EDLP, *Wal-Mart* aims at constantly lowering its costs, another basic rule, which (in analogy to EDLP) is expressed as achieving *Every-Day-Low-Costs* (EDLC). It basically involves all functions of the value chain, meaning that cost efficiencies are expected of the company's suppliers, its employees and executives.

Low Wages and Thriftiness

An important part of the EDLC policy is ensuring low labour costs. With hourly wages as low as eight USD per hour, *Wal-Mart* employees might earn about 20-30 % less than workers at rival supermarkets, which are unionised. Besides the potentially steep cuts in pay, *Wal-Mart* employees might also lack union members' further benefits in terms of pensions, health-care insurance, and job security (Public Broadcasting Services 2006; The Economist 2004).

Extreme Cost-Consciousness

At *Wal-Mart*, thriftiness is valued highly and carried to extremes. Employees and executives have to control their expenses and be extremely cost-conscious in their day-to-day business. This implies that they fly economy class, share offices and hotel rooms, drive affordable cars, empty their own trash, and pay for their coffee at work. They are even encouraged to bring free pens from conferences.

Wal-Mart's strict opposition towards worker rights and unionisation, however, has started to backfire, which is reflected in the company's rather high employee turnover rate and the growing number of lawsuits on labour issues. The legal allegations raised by existing and former employees relate to working conditions, pay and discrimination, to name but a few areas of conflict.

Supply Chain Management and Global Sourcing

With respect to suppliers, *Wal-Mart's* buyers have to negotiate continually lower prices. Due to its volume power, *Wal-Mart* can often force the integration of suppliers' operations into its supply chain. This might imply the implementation of a joint business plan with contracts specifying price, volume, delivery schedule, packaging and quality. It might also involve a subsequent close monitoring of their suppliers' production and gaining access to their books and accounts (Smith 2004). *Wal-Mart* grades its suppliers on weekly, quarterly and annual report cards, sets price points and monitors whether they meet their targets. *Wal-Mart* has established a close partnership with its key suppliers such as *General Electric* and *Procter & Gamble* (Bradley/Ghemawat/Foley 1994). The company can also be regarded as a pioneer with respect to the early adoption and subsequent development of trendsetting methods involving retailer-manufacturer interaction such as ECR, VMI or CPFR (see Chapter 14).

Low-Cost Imports

Another key measure for achieving EDLC involves importing goods at the lowest possible prices. The desire to buy cheap import goods was stressed by Ortega (1998): "From the beginning, Walton had bought goods wherever he could get them cheapest, with any other considerations secondary." From

1989 to 2002, *Wal-Mart* performed its global sourcing activities via an Asian-based exclusive global buying agency called *Pacific Resources Exports, Ltd.* (PREL). While competing retailers had entered Asian procurement markets long before *Wal-Mart*, it deliberately favoured a second-mover strategy. *Wal-Mart* wanted its competitors to lay the groundwork, before it stepped in and achieved a rapid expansion, choosing those Asian countries without major tariffs (Hornblower 2004b). In 2002, *Wal-Mart* set up its own global procurement centre in Shenzhen (China) by acquiring PREL and merging it with its local buying offices. The new global sourcing headquarters coordinates a network of more than 6,000 global manufacturers/suppliers (a list which will be subject to a further consolidation process in due course), 80 % of which are located in China (Hornblower 2004b). *Wal-Mart* sends US managers to Shenzhen to train suppliers, who have to use *Wal-Mart's* computer software (Smith 2004). Due to the huge annual import volume of Chinese goods, which is estimated to be worth about 15 billion USD and is equally split between direct imports and indirect imports via suppliers located in the USA, *Wal-Mart* and China have been labelled a joint venture with massive economies of scale in purchasing (Hornblower 2004b). Some economists even credit *Wal-Mart* with lowering the US rate of inflation because of the high amount of imported goods at lowest possible prices (Global Insight 2005).

IT and Logistics

Wal-Mart's ability to keep prices down is further enhanced by innovative uses of information & communication technologies. The company started to take advantage of these technologies by transmitting real time point-of-sale information from bar codes to manufacturers. According to a *Wal-Mart* manager, this enabled the company to "track sales on specific items specific weeks, specific days, specific hours of the day, when [they] sell merchandise the most" (Lewallen 2004). On the basis of this consumer tracking software, an extranet called *Retail Link* was developed and shared with suppliers at no cost (Hornblower 2004a). A data warehouse storage capacity of over 570 terabytes gives *Wal-Mart* real-time visibility into merchandise planning (Wal-Mart 2005). In 2003, *Wal-Mart* announced that, as of January 2005, it requires its top 100 suppliers to put RFID tags on all pallets and cases they deliver to *Wal-Mart's* distribution centres and stores, and consequently, to install RFID readers in their own manufacturing facilities, warehouses and distribution centres (Roberti 2003).

Data Collection and Analysis

According to research estimates, a full deployment of RFID throughout *Wal-Mart's* supply chain and its stores could lead to annual savings of 8.4 billion USD (Roberti 2003).

Likewise, the improvement of logistical processes has enabled *Wal-Mart* to maintain its EDLP policy. This involves a restructuring of the supply chain in such a way as to eliminate the traditional dependence on wholesalers, by building its own infrastructure and distribution network instead. *Wal-Mart* has fine-tuned its supply chain from factory floor to store shelf, lowering inventory costs and insisting on just-in-time deliveries from its suppliers in order to cut waste and down-time in warehouses (Smith 2004). Inventory turnover at *Wal-Mart* is approximately twice as high as the industry average (The Economist 2001). The efficiencies that *Wal-Mart* has achieved in its supply chain are even estimated to contribute overall US productivity (Global Insight 2005; Fishman 2003).

The positive relationship between EDLP and efficient supply chain management also works the other way around. Constantly low prices imply steady and predictable demand patterns with minimal fluctuation. This renders supply more stable and contributes substantially to easier logistical planning.

Questions

1. How did *Wal-Mart* facilitate the adoption of an EDLP policy, i.e. what are the prerequisites for adopting such a policy?
2. What are the drawbacks of *Wal-Mart's* EDLP and EDLC policies that might ultimately erode its cost advantage?
3. How could competitors potentially gain a competitive advantage over *Wal-Mart*?

Hints

1. Areas to be analysed could include labour costs, corporate overheads, and supply chain efficiencies, etc.
2. You could consider aspects relating to, for example, labour costs, employee turnover, and lawsuit involvements.
3. Dimensions such as quality, service, product selection, store locations, convenience, customer segmentation, and possibly even price competition could be involved in the analysis.

Chapter 10

Instore Marketing

The purpose of this Chapter is to highlight the importance of the store environment as part of the retail marketing mix. Options for store layout, the determinants and influence of store atmosphere and the allocation of space to merchandise are described.

Relevance of Instore Marketing

For all forms of retailing – store retailing as well as non-store retailing such as Internet shops – the store environment is among the most important determinants of store choice by buyers. It also exerts a very strong influence on shopping behaviour in the store. Many buying decisions are made at the point-of-sale, so that professional marketing in the store can increase sales tremendously, for example, by pushing impulse purchases. *Instore marketing* refers to the use of information and communication-related retail marketing instruments within the outlets of a retailer. It includes the structure of the store and its basic layout, the presentation of goods and allocation of space to the merchandise, and all measures for influencing the store atmosphere, including instore events (Gröppel-Klein 2006, p. 673). *Visual merchandising* is a term frequently used in the context of instore marketing. It refers to the way products are presented in a retail outlet. While this expression has been used with a focus on merchandise display (e.g. the choice of fixtures to be used and the method of product presentation), it relates to overall store design, store layout and other facets of the store environment (Varley 2006, pp. 182-183). Therefore, it is often used synonymously with the design component of instore marketing.

Visual Merchandising

Two basic objectives of instore marketing are

Objectives of Instore Marketing

- to facilitate the search process for customers, i.e. to design the store for *easy internal orientation*, and
- to create a positive *store atmosphere*, i.e. to evoke a positive emotional state of mind in consumers while visiting the store.

Both aspects are important to different degrees in different stores and for different consumer segments. Basically, a distinction can be made between two different types of shopping processes and motives (Levy/Weitz 2007, p. 512):

- *task completion*, i.e. the motive to buy items that are needed (utilitarian motives)
- *recreational shopping*, i.e. spending leisure time shopping and browsing through stores (hedonic motives).

When targeting task completion, the retailer's focus is mainly on easy orientation and supporting the consumer search process. When approaching recreational shoppers, however, the efforts are shifted towards store atmosphere. Instore marketing always has to consider both aspects. Even in everyday routine shopping for task completion, store atmosphere is important, because it can positively influence the customer's mood. Also, in recreational shopping, easy orientation plays a role, because consumers should not be confused, but feel secure and self-confident in the shopping situation.

Instore Marketing and Consumer Behaviour

Environmental Psychology

The model most frequently used to explain the influence of store environment on customer behaviour was developed by Donovan and Rossiter (1982), based on earlier contributions on *environmental psychology*. They conclude that the stimuli presented in the store and the personality variables of the customers act together to influence the affective and cognitive response of customers to the store environment. They found that two main dimensions have to be considered as intermediating variables when evaluating the effects of store environment:

- *pleasure* (which refers to the level of positive emotions)
- *arousal* (which refers to the feelings of excitement and stimulation).

Together, these two dimensions affect the response behaviour of the customer, that is, the degree of *approach behaviour* or *avoidance behaviour*. Studies have frequently shown that with increasing *pleasure*, the duration of a store visit, amount of unplanned purchasing, willingness to talk to store employees as well as the re-visit intentions rise. *Arousal* is a construct with optimal levels. Very low levels of arousal result in a lack of interest, very high levels of arousal can lead to "panic" and lead a consumer to avoid a store or to leave a store as fast as possible. While this seldom occurs in marketing, crowded situations as in summer-end sales or on opening days may create this level of arousal. Thus, the interior design of the store environment should evoke an optimum level of customer arousal. It has frequently been shown that moderate levels of arousal (if the store environment is perceived as pleasant) correspond positively with *approaching behaviour*, i.e. a positive response of the customer to the environment (Gröppel-Klein/Baun 2001, pp. 412-413).

The level of arousal is determined largely by the *information rate* of the store, that is, the novelty (the unexpected, surprising, unfamiliar in an environment) and complexity (the number of elements, changes in the setting, etc.) (Mehrabian/Russel 1974) of the total store environment. Arousal theory implies that optimal information rates contain some novelty and some complexity which activate the consumer, but also include calming elements. In other words, complexity and novelty are attenuated by giving the consumer familiar cues and signs.

Store Design and Store Layout

A store should be planned so as to (consciously or unconsciously) direct the customer flow in specific patterns which will ensure that they visit certain important merchandise areas. This should achieve optimum sales-space productivity, and stimulate impulse purchases. With respect to the consumer orientation process, the retail layout must be easily comprehensible so that customers quickly understand and assimilate the route through the merchandise (Gilbert 2003, p. 129).

Mental Maps

One core component of the store-environment design is the macro structure of elements in the store, i.e. the *store layout*. This layout is represented internally in consumers' minds in so-called *mental maps* of a store. Clear and well-arranged mental maps of a store, and knowledge of the location of specific products, categories, check-outs, etc., have been found to positively influence the customer's perceived shopping convenience (Gröppel-Klein 2006, pp. 680-681; Foxall/Hackett 1992, pp. 313-314). For the creation of strong mental maps, i.e. the extent to which a store is easily cognitively organised by a consumer, use is made of orientation points and areas in the store. The design of paths and crossings of paths, appropriate signage, different colours for different sections, escalators, floor material, etc. can act as clues for customers. Some retailers (e.g. *Toys 'R' Us* or *XXXLutz*) support the development of cognitive maps by the provision of real store maps in which departments and paths are represented visually.

Basic Types of Store Layout

In designing the store layout, the retailer has two basic options, which can also be mixed (see Figure 10.1; Gilbert 2003, pp. 124-125; Varley 2006, pp. 189-190; Levy/Weitz 2007, pp. 495-497):

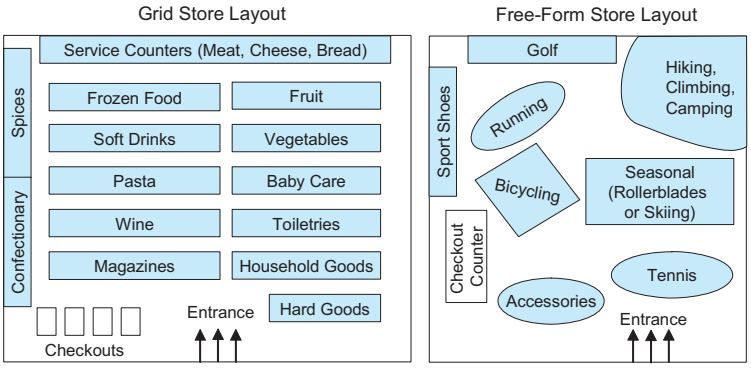
- A *grid store layout* is characterised by long parallel aisles, with merchandise on shelves on both sides. This layout channels customer flow and it is often not very stimulating, but it is well suited for shopping trips in which customers need to easily locate certain products and basically move through the entire store. Self-service is rather easy, and the shopping process for customers often fast and efficient. Space is utilised to a

large extent. Supermarkets, drugstores and other retailers of fast-moving consumer goods normally adopt this layout.

- A *free-form layout* (also called *free-flow layout*) follows an irregular pattern which allows customers a free choice of movement in certain areas of the store and along certain paths. It allows for more relaxed and unregimented shopping. However, it may require salespersons to aid the customer to find certain products. This style is found in many clothing stores.

There are a number of variations of these basic types. For example, a *loop layout* (also called *racetrack layout*) provides a major aisle that loops around the store to guide customer traffic around different departments (Levy/Weitz 2007, p. 496). Within the departments, there is usually a free-form pattern. In an extreme case, a racetrack layout can force a *fully guided customer flow*. This principle is often applied by *IKEA*, where customers have to follow one major path through the entire store, with few possibilities for short-cuts.

Figure 10.1 *Two Basic Types of Store Layouts*



Source: Adapted from Gilbert 2003, pp. 125-127.

Fixture Types

In combination with certain store layouts, the fixtures used also vary. The most important fixture types are gondolas (shelves), round fixtures (e.g. for hanging clothes), tables (for stacked clothes), dump bins, baskets (for vegetables) and closed counters (e.g. for jewellery). While the grid layout employs mainly gondolas, free-form layouts usually have a mix of many different types of fixtures.

Grouping of Store Offerings

Within the store layout, merchandise is grouped together in sections, departments or aisles. Three principle types of groupings are commonly used by retailers:

- With a *item-oriented presentation*, the most traditional way of displaying merchandise, products are organised by types of items, such as, for a fashion retailer, one area for shoes, one area for trousers and one area for shirts. A DIY retailer might have a shelf for paint-brushes, one for paint, one for wallpapers and so on. While products are easily found with such a concept, demand interrelationships are not considered and therefore not exploited fully.
- With a *theme-oriented presentation*, merchandise is displayed together according to a specific theme, such as "living in your home" (e.g. furniture, lamps, rugs, and accessories), "outdoor" (e.g. backpacks, outdoor clothes, tents, barbecue grills and special food products), "office" (e.g. suits, shirts, and executive briefcases). Sometimes, a theme-orientation can follow a certain *lifestyle* and display all the fashion in one area that is associated with a common lifestyle such as hip hop, sophisticated career women, casual and denim style. Short-term or seasonal themes like Halloween, Christmas, Olympic Games or the Soccer World Cup can influence the decoration in all parts of the store but also be used to group certain merchandise together temporarily, often in a special feature area. Theme-based presentations promote cross-selling and can support the *solution selling* of retailers in which products and services are bundled to provide a full problem solution for customers. Examples are tools, materials, delivery service and even craftsmen's services in a DIY store. Skis, ski shoes, services like waxing and edge sharpening, skiing lessons, skiing clothes and travel arrangements in a sports store, are another good example.

Solution Selling

- With a *brand-oriented* presentation, products from a certain (manufacturer) brand are merchandised together in *mono-brand* store areas. In a fashion store, different products such as shoes, suits, shirts, neckties from *Boss* could be grouped together in one area and the equivalent items from *Armani* in another. Often, a brand-oriented presentation takes the form of a *shop-in-shop* (or *store-in-the-store*), a concept in which merchandise of one brand is clearly separated from the rest of the store in a boutique-like manner. This type of *boutique layout* is sometimes considered a variation of the free-form store layout (McGoldrick 2002, p. 468). Frequently, this takes the form of *leased space* or a so-called *concession store*, in which an external company (often the brand manufacturer) operates this dedicated selling space, including the coordination of merchandise mix

and inventory, with separate check-out and specialist staff (see also Chapter 3). Brand manufacturers often design their entire product range to match. Brand loyal customers buy different products from the same brand to wear or consume together. A brand-oriented grouping facilitates such buying behaviour. Large department stores, such as *Saks Fifth Avenue* or *Selfridges*, have traditionally employed concession stores for such products as cosmetics, fashion, and other brand-dominated categories. In this way, they act as a *house of brands*. The concept of a shop-in-shop has recently expanded into other retail sectors, such as *Tchibo* stores in supermarkets, *T-Mobile* concession stores in electronics stores, *Starbucks* in bookstores or *Bosch* stores within DIY stores.

Store Design and Store Atmosphere

The store atmosphere refers to the emotional response of customers to the store interior. It is this emotional state of mind which influences shopping enjoyment and subsequent shopping behaviour (Berman/Evans 2007, p. 544; Varley 2006, p. 166).

While the layout of the store and the arrangement type for the goods are the core components, store atmosphere is created by many more elements. The atmosphere created by the store environment is influenced by all modalities; the consumer perceives the store environment through all his senses. These include (Gilbert 2003, p. 128; McGoldrick 2002, pp. 460-467):

The Five Senses

- *visual* elements (such as colour, brightness, sizes and shapes of fixtures and goods, floors, look of salespeople, etc.)
- *aural* elements (such as background music, audio advertising in instore radio or noises from other people)
- *olfactory* elements (i.e. the scent in the store, e.g. perfumes used in clothing stores or the smell of a bakery department in a supermarket)
- *tactile* elements (such as the material used for floors or the sensation of touching products)
- *gustatory* elements (such as food samples in a supermarket, coffee served in a bookstore or champagne served in an elite boutique).

Colours

Visual elements, in particular, have been used systematically for influencing consumers, and especially colours.

Colour psychology is applied to the store design. Examples of different psychological effects of colour include (Varley 2006, pp. 166-167; Hurth 2006, pp. 140-141):

- White and blue appear calm, cool and clean.
- Red (similar orange and yellow) has been shown to be very stimulating and arousing and to evoke sensations of warmth, action, sometimes even aggression.
- Green is regarded as restful and stimulates associations with life and nature.

Some retailers use a specific colour in their branding that they also use extensively in the store. For instance, *The Body Shop* uses green (which emphasises its environmental claim), *Saturn* uses a blue and orange combination (to stress its price-aggressive positioning), *Boots* has blue and white (which strengthens its image as a chemist), and *Douglas* uses turquoise (to communicate a luxury image). On the other hand, many retailers prefer to use colours only sparsely in the store, because they could conflict with the colour of the goods sold, which often change with seasons and fashions, as in the case of a clothing retailer.

Other sensual modalities are planned to some extent, but their effect is seldom considered systematically. However, *sound* and aromas have been shown to influence customer behaviour and mood, thereby exerting an influence on purchasing behaviour. Slow music, for instance, encourages people to move slowly and spend more time in the store (Berman/Evans 2007, p. 550), while fast music causes more arousal and feelings of excitement, which might lead to more vivid memories of the store and a more active shopping behaviour.

Experiential Retailing

Store atmosphere becomes even more important with the trend towards *experiential retailing*. This refers to creating a retail environment which offers a unique and memorable sensory experience, in order to convert shopping into an interactive, enjoyable and exciting experience for the customer (Schmitt 1999), and provides a coherent overall emotional profile of the store. The atmosphere is intended to appeal to the consumer trends of seeking exciting events, pursuing stimulation in shopping and spending leisure time going shopping. While *Disney Store* or *Warner Brothers' Store*, department stores such as *Galeries Lafayette* (see case study in this Chapter), and urban entertainment centres might be considered prototypes of experiential retailing, elements of this trend are important for every retailer.

Retail Theatre

These trends show that the retail store's potential to provide pleasure is not only achieved through the static physical facilities of the store, but also through events in the store that can be used as an "experience stage". The store is thus transformed into an interactive "retail theatre"(McGoldrick 2002, p. 453). Possible events that contribute to pleasant and entertaining instore marketing include cooking lessons in supermarkets, beauty treat-

ments in department stores, fashion shows at apparel retailers, live appearances of artists in music stores, or soccer tournaments in front of a sports store.

Store Design and Retail Branding

Direct Brand Experience

Store design can be an important element of a retail branding strategy, since it exerts an all-embracing influence on the customer. The memory associations of consumers that comprise the *store image*, can be influenced by a direct brand experience (during a store visit), in addition to indirect experiences, such as advertising (Krishnan 1996, p. 394). Because he can offer customers a more extensive and direct physical experience than the manufacturer of a product, a retailer is better able to relate directly to consumers, trigger off intensive emotions and build vivid memories.

This effect on the retail brand is especially strong when store design is aimed at not only evoking unspecific positive emotions and an appealing store atmosphere, leading to a pleasant shopping experience, but when the store design represents the core of the retail brand and is used to differentiate the retailer from its competitors (Morschett 2006, pp. 537-538). The application of colour has already been discussed, and the concept can be developed further. The unique store designs of *REI* in the USA, *The Body Shop*, *Sephora*, *Old Navy*, *Boots*, and *Lush* can serve as conventional examples, but the flagship stores of manufacturers (see Chapter 3), such as *NikeTown*, *Nokia* stores, *Apple* stores, *The House of Villeroy & Boch*, the prime objective of which is to strengthen the brand, illustrate the effective use of this strategy even more cogently.

However, not only stores following the approach of experiential retailing can use their store design to convey a brand message to their customers. Hard discounters such as *Aldi* and *Lidl* or wholesale clubs such as *Costco*, follow the same principle. Simple, basic stores, reduced to the bare essentials, floors and shelves with an inexpensive appeal, presenting the goods in cut cardboard boxes and on pallets, no unnecessary decoration elements as well as the modest and pragmatic exterior design communicate these retailers' main competitive advantage very clearly to the customer.

Space Allocation

Space within stores and on the shelves and fixtures is a scarce resource. The allocation of store space to merchandise categories as well as allocating shelf-space to different products is therefore a crucial process for retailers. Store space requires heavy investment. Appropriately allocated merchandise

Space Productivity

is an important determinant of the productivity of the relevant assets. *Space productivity* is a coefficient that is thus measured by most retailers as part of their operational controlling (see Chapter 15). It is typically measured in *sales per square metre* or *sales per linear metre*. Retailers that display most of their merchandise on free-standing fixtures usually use square metres, while retailers that display most of their merchandise on shelves prefer to use length, i.e. sales per linear metre, to assess space productivity (Levy/Weitz 2007, p. 503).

The decision on how much space to allocate to a certain product or category is influenced by a number of variables. A very simple rule of thumb is that share of space is allocated according to share of sales. However, other determinants, such as product profitability, potential to enhance store traffic, demand interrelationships, retail brand positioning, category role (e.g. destination categories vs. routine categories), display needs (e.g. physical characteristics of the products, such as watches vs. bicycles), and inventory turnover (due to restocking considerations), are also considered frequently.

Space Elasticity of Demand

An important coefficient for determining space allocation is *space elasticity of demand* (similar to the frequently used coefficient price elasticity; see Chapter 9). Space elasticity of demand measures the responsiveness of quantity demanded to a change in sales space and is defined as the ratio of relative change in unit sales (or change in the turnover) to relative change in shelf space. Average space elasticity has been found to be about 0.2, so that doubling the space allocated to a product would increase sales by 20 %. However, the rate of change is very different for different products. Figures between 0.6 at the high end (e.g. for fruit and vegetables) and close to zero at the low end (for many fashion products, maybe due to a negative impact on the exclusiveness with increasing sales space) are reported from studies. As with many output/input ratios, a declining marginal return on additional space is likely (McGoldrick 2002, pp. 478-479).

Space Elasticity of Profit

However, not sales but profit is to be maximised, hence, space elasticity of profit, defined as the relative change in profit in relation to a relative change in space allocated, could serve as an efficiency-enhancing coefficient. In order to obtain an optimum, the space allocated to all products or categories must lead to the same marginal space elasticity of profits. Otherwise, allocating more space to a product with higher marginal space elasticity of profits at the expense of a product with a lower coefficient would increase total store profits. On the other hand, with category management (see Chapter 8), the consumer perspective is emphasised more and allocating space only with short-term profit maximisation in mind might not influence customer satisfaction and customer loyalty positively, i.e. the needs of the customer also have to be considered (Varley 2006, p. 152).

Highly Valuable Store Areas

Space allocation also needs to be based on the quality of space. Areas in a store are not trafficked equally by customers, the speed with which customers pass through different areas varies, and certain areas of the store (or on a shelf) draw more attention than others. Accordingly, placement has a profound impact on sales success. Some examples of valuable store and shelf areas are (Varley 2006, p. 185, p. 191, pp. 147-148; Levy/Weitz 2007, pp. 501-504; Berman/Evans 2007, p. 555; Hurth 2006, pp. 122-129):

- areas at the entrance of the store, especially the first shelf or other fixtures that customers face immediately after entering the store
- ground-level space as compared to other floors, which even results in very different levels of rent for different floors
- end caps of gondolas, which are usually highly visible – even for people who do not enter into an aisle
- feature displays/special displays (e.g. *off-shelf displays* in a supermarket), which exert an additional impact and are employed to highlight certain products, and new product introductions
- the check-out area, since all customers have to pass through it and may have to queue at the till (which makes this a preferred space for impulse items)
- eye-level on shelves, the centre of the shelf and - since customers in Western cultures usually look at items from the left to the right - shelf-space at the right side of the shelf compared to that on the left.

Space Allocation Software

The task of space allocation is often based on simple rules of thumb and experience. Yet, the complexity of influence factors has made it a field in which optimisation software was already developed decades ago. With the rise of retail information systems, scanner data at check-outs and even personalised loyalty card data, these systems can now store an immense amount of data.

Space optimisation software uses information on the specific products (e.g. product costs, size of product, variations), general information on space productivity in different areas of the store and on the shelf, or the specific market (e.g. demographics in the catchment area). It calculates effect metrics (such as space elasticity) and demand interdependencies from past sales data or the tools integrate estimations (e.g. from experiments). Company strategy (such as category role or inventory targets) is also considered and all variables are applied in a multivariate model to generate suggestions for

an optimal store-space and shelf-space allocation. Two of the most commonly used software tools for the optimisation of space allocation are *Spaceman* from *A.C. Nielsen* and *Apollo* from *Information Resources Inc.* (*IRI*). Typically, the optimisation results are displayed in a *planogram*, which is a visual representation of a store or a shelf which illustrates how many products of a specific SKU should be put on the shelf and where they should be placed. Planograms are also useful for store employees setting up and restocking the shelves, because they help store employees to comply with the planned space allocation.

Planograms

Conclusion and Outlook

Most of the various aspects of store design, store layout and space allocation discussed in this Chapter apply not only to store retailing, but – at least to some degree – to all types of retailers, including mail-order retailers and Internet stores. Space is also precious in the mail-order business, because square metres in stores are analogous to space on the pages of catalogues. While catalogues cannot offer all that "instore" marketing can achieve, because they only display two-dimensional, static pictures, Internet shops can now employ methods and approaches that are very similar to store marketing. Even though products cannot be touched in Internet shops, the medium has other benefits. Internet stores can be customised for specific users, space is only limited by the duration of the customer's visit and virtual reality means that consumers can be provided with different paths to find the same product and the grouping of store offerings can follow several types of groupings simultaneously (e.g. brand-oriented *and* theme-oriented). With digital salespersons (potentially customised), three-dimensional views on products, virtual try-ons, sound effects and modern monitors, Internet shops have many instruments available for creating an exciting and pleasant store atmosphere.

On the other hand, one main motive for shopping in the Internet is ease and convenience. Therefore, Internet shops should not be designed purely from a technical perspective, but from the consumer perspective. The aim should not be to employ all technical possibilities to excite the customer, but rather to reduce the effort of buying products (e.g. by providing shopping lists from prior purchases), and support the customer. In other words, technology should be used to facilitate shopping.

If a retailer employs different retail channels, coherence between the store atmospheres in all channels is important. Similarity within the appearance of a *multi-channel retailer* has been found to have a positive influence on consumer attitudes towards the retailer (Schramm-Klein 2003, pp. 227-245). Considering the influence of store atmosphere on the retail brand, similari-

ties between different retail formats of one retailer seem to be an important factor.

Further Reading

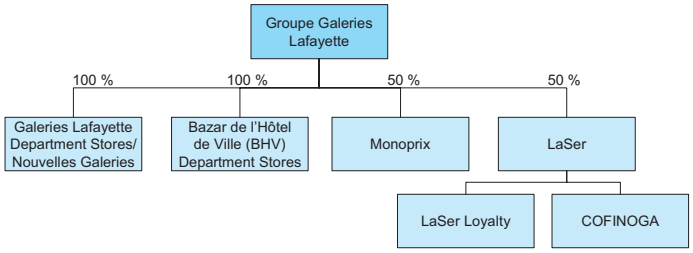
SCHMITT, B. (1999): Experiential Marketing: How to Get Customers to Sense, Feel, Think, Act, New York.

Case Study: Galeries Lafayette[1]

Profile, History, and Status Quo

In 1893, Théophile Bader founded *Galeries Lafayette* and in 1912, the famous flagship department store ("grand magasin") on Boulevard Haussmann in Paris was opened. It is the largest of the twelve major department stores in Paris. The *Galeries Lafayette* group presently operates in four business segments (see Figure 10.2).

Figure 10.2 *Galeries Lafayette Group*



In 2005, group turnover totalled 4,493 million EUR, up 0.7 % from the previous year. Around 35,000 employees work in the group's 422 stores and 56 affiliates. *Galeries Lafayette's* total surface area of nearly 500,000 m² includes a

1 Sources used for this case study include the web sites http://www.galerieslafayette.fr, http//www.groupgalerieslafayette.fr, http://www.laser.fr, http://www.galeries-lafayette.de, various press releases, presentations and annual reports as well as explicitly cited sources.

number of outstanding features, such as the famous neo-Byzantine dome built in the 19th century atop the building on Boulevard Haussmann.

The stores outside Paris are centrally located in major cities across the country. A breakdown of the group's turnover by business segment is as follows: *Galeries Lafayette:* 31.8 %, *Bazar de l'Hôtel de Ville:* 10.2 %, *Monoprix:* 31.4 %, *LaSer:* 22.6 %, and others: 4 %.

In accordance with its former advertising slogan "Il se passe toujours quelque chose aux Galeries Lafayette!" ("Something is always happening at Galeries Lafayette!"), a number of *Galeries Lafayette* sub-brands have been created in Paris, which harness the strength of the original brand:

- *Lafayette Homme* (2001) – men's apparel
- *Lafayette Gourmet* (2002) – food
- *Lafayette Maison* (2004) – decoration and home improvement
- *Lafayette V.O.* (2004) – kids and teenagers.

In Paris, the so-called *Haussmann*, *Homme*, *Gourmet,* and *Maison* stores cover a combined total of 68,000 m^2—the Western world's largest retail outlet and Europe's biggest store in terms of sales.

After the withdrawal from operations in Tokyo, Moscow, Singapore, Bangkok and New York, currently the only international activity is the *Galeries Lafayette* department store in Berlin, with its famous glass-front architecture on Berlin Friedrichstraße. The store was opened in 1996 and ten years after its foundation, about 250 employees work at *Galeries Lafayette Berlin*, the "secret embassy of France", as it is sometimes called. The sales area comprises 8,000 m^2 on five floors. However, since the launch in 1996, the *Galeries Lafayette Berlin* has only recently been able to operate profitably.

After quarrels between the former major shareholder families Meyer and Moulin, the latter and the French bank *BNP Paribas* bought all remaining public shares of the group. As a result, *Galeries Lafayette* shares have no longer been traded on the Paris stock exchange since July 2005.

Despite this new ownership structure, the group's strategy remains based on the following foundations:

- department stores (*Galeries Lafayette, BHV)*
- city centre supermarkets (*Monoprix*)
- consumer credits and customer loyalty programmes (*LaSer*).

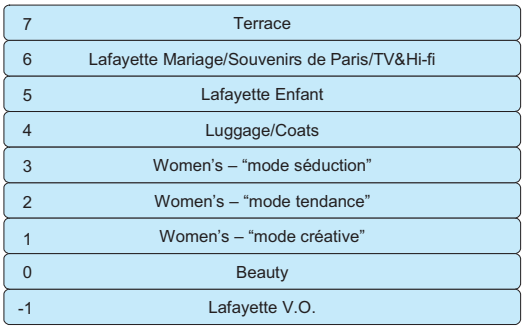
Instore Marketing Strategy at Galeries Lafayette – "Theme Worlds"

Distinct Shopping Worlds Since 2001

When *Marks & Spencer* closed its Paris store in 2001, *Galeries Lafayette* bought the site and built its home furnishings department store *Lafayette Maison* there. This left the basement, the former home furnishings floor at the *Haussmann* empty, where *Lafayette V.O.* (for "version originale"), a shopping world for 12-25 year-olds, was established. *Lafayette V.O.* has led to a major rethink in the way the rest of the store is merchandised. *Galeries Lafayette* has always been a "house of brands" and a "temple of fashion", but has also always been perceived as a place for the high-end shopper. To an extent, this is reinforced by the flagship store's belle époque architecture with its stained-glass dome, which has led to the impression of *Galeries Lafayette* being the "grande dame of Paris retailing" (Ryan 2005). Since 2001, however, the "retail renaissance" (Costello 2005, p. 21) of *Galeries Lafayette* has been implemented, aiming to create different shopping worlds in a real-life experience instead of traditional departments. *Galeries Lafayette* is trying to evolve from a department store into a multi-concept store, with different specialised concepts under one single roof (Roulleau 2006, p. 9). This holistic instore marketing concept is based on the following pillars:

- offering comprehensive "shopping worlds" revolving around a central theme including a large number of brands, instead of conventional departments
- events to enhance the shopping experience
- high level of dynamics in terms of new products and short-term offers.

Figure 10.3 *„Shopping Worlds" at the Haussmann*



Since this metamorphosis, customers no longer really enter a shop, but several distinct worlds that allow them to experience real-life sensations. This is what the company calls its "new spaces". It is a world customers visit not only to buy goods, but one in which they can take part in a real-life experience.

On its seven floors (including the patio on the seventh floor), the *Haussmann* store presents its so-called "universes" of fashion, beauty, food, and leisure. In 2005, after four years of work, the flagship store's facelift worth 96.5 million USD was completed. Figure 10.3 shows the store's current divisions.

Apart from the three floors covering an entire world of women's apparel for different income levels and for different shopping occasions, examples of other theme worlds include *Lafayette Enfant,* the store's baby and kids world, the *Beauty* world and the fourth floor, which is home to raincoats, luggage, furs and leathers and thus provides "everything you need for your holiday in England" (Ryan 2005). These worlds are characterised by the grouping of a large variety of complementary products, often contradicting conventional department store divisions. In the course of the store's remodelling, the walkways have been widened, something that characterises each of the floors and creates the impression of more space, which improves the shopping atmosphere. Instore navigational signage, other than at the escalators, is largely redundant, owing to the clarity of the shopping worlds' layout which groups logically complementary products together (Ryan 2005).

Fashion-Oriented

In the 1970s, *Galeries Lafayette* evolved from a general merchandise department store into a department store specialising in fashion. This vocation for fashion has been demonstrated regularly since 1980, when the first "Festival de la Mode", a runway fashion show free of charge and a renowned tourist attraction, was held. This successful event has also been replicated at the Berlin store (Gebauer 2003, pp. 43-44).

Long-Term Instore Marketing: Basic Layout

Holistic Approach

The bases of *Galeries Lafayette's* holistic approach of instore marketing are the different shopping worlds, whether integrated in the different floors, such as *Lafayette Enfant* or *Lafayette V.O.*, or in the case of free-standing buildings, such as *Lafayette Maison* or *Lafayette Homme*. Designed for a longer time frame to indulge customers in, they are nonetheless subject to change in order to respond to current trends. The basis for this specialised approach is a detailed analysis of customer lifestyles. The focal point is no longer the product, but the customer and the full variety of his potential needs with respect to a particular aspect of his life. Examples of the current status quo are described below.

Lafayette V.O.

Lafayette V.O., situated in the basement at the Haussmann store, offers a complete shopping universe for 12-25 year-olds. It mixes fashion, music and interior decoration into a permanent happening according to the motto: "All the store's a stage" (Faithfull 2005). Before the official opening in 2004, the group created a faux web site (www.street-challenge.com) seemingly dealing with urban fashion battles, without revealing its identity in order to communicate with the clientele. This viral marketing strategy was necessary, because the young customer segment had not so far been attracted to the department store of their parent's generation (Leveque 2004). The concept has proven a great success with its clientele. Filled with music and marketed for the tastes of the teenage generation, *Lafayette V.O.* and its salespeople, who are of the same age and dressed like their customers, "could make you almost forget you're in a department store" (Faithfull 2005).

Ultra Customised

Throughout its 4,000 m² space, the assortment is ultra customised to meet the taste of 12-25 year olds. Colour-coded walls divide up the floor space into four sections themed around youth lifestyle. Besides fashion, which accounts for 80 % of the assortment, *V.O.* sells cosmetics, cell phones, video games, CDs, vinyl, books, Manga art, and stationery. About 150 international brands are sold, appealing to teenagers from all cultural backgrounds. The real-life experience is also conveyed via a multi-functional area devoted to emerging product lines such as those using sustainable materials, and also including small exhibitions, installations by local associations and a nearby D.J. booth where rotating musicians perform live and contribute to the club-like atmosphere (Faithfull 2005). Other attractions include XXL fitting rooms equipped with soft-drink vending machines, displays that whirl clothing around on conveyor belts, impromptu shows for up-and-coming artists and graphic designers, as well as a restaurant and recreation area (Marsh 2004, p. 29). The concept is ever changing in order to adapt to the fast-moving lifestyle of its clientele and aims to provide constant novelty, lively emotions, and surprise.

Lafayette Enfant

First Concept Store for Children

On the fifth floor of *Galeries Lafayette's* flagship store, an entire concept store dedicated to children from ages 0-12 was created in 2005, shortly after the realisation of *Lafayette V.O.* Thus, *Lafayette Enfant,* which celebrated its first anniversary in March 2006, fills what had been an age gap. It was also the first concept store of its kind dedicated entirely to children.

The 5,000 m² space offers an assortment covering all customer needs, appealing and appropriate visual merchandising as well as different activities, all

aiming at creating a strong real-life experience. The assortment includes the following product categories: apparel for newborns, trendy fashion for boys and girls, apparel for pregnant women, decorative items for the children's room, "boutique naissance" (equipment for newborns) and toys.

Since *Lafayette Enfant* strongly emphasises the variety of its assortment, more than 85 brands can be purchased, ranging from classic baby and kids brands (e.g. *Petit Bateau*) to trendy fashion labels, to luxury brands such as *Dior* or *Lacroix*. At the "boutique naissance", shoppers can also create a gift list, for example, for a baptism. The list is comparable to a wedding list and can also be accessed and managed online.

In order to keep the customers' shopping experience up-to-date, the assortment is revised constantly and new brands are added. Furthermore, at "le labo" (short for laboratory), children's apparel created by young designers is sold exclusively at *Lafayette Enfant*.

The shopping ambiance is designed to be fun and lively, in order to please the specific target group. The three metres high giant rocket right at the entrance is especially appealing to young children. Since *Lafayette Enfant* seeks to please not only the offspring, but their parents as well, facilities are provided to occupy the children for a limited period of time under the supervision of qualified employees, e.g. a *Lego* atelier (Mottez 2005).

On the occasion of *Lafayette Enfant's* first anniversary, which was celebrated through February and March 2006, new apparel brands were introduced to stress the newness of the concept store and a number of special events were held to complete the shopping experience. Examples of the special anniversary events included: treasure hunts organised at *Lafayette Enfant,* makeup and customised T-shirt workshops and a children's menu formulated so that kids can create their own sandwiches. Additionally, items for children's birthday parties, such as garlands, party favours, and balloons have been added to the basic assortment.

Souvenirs Boutique

In 2006, *Galeries Lafayette* launched a new 400 m^2 space, located on the sixth floor and dedicated entirely to souvenirs. Each year, the *Haussmann* store sells more than 320,000 souvenir products (including 10,000 Eiffel Tower models, 8,000 fridge magnets, 5,000 snowstorm globes, etc.) In reaction to this enormous demand for souvenir items, *Galeries Lafayette* has created a whole world of souvenirs for the tourist to indulge in, including detailed visual merchandising to create the desired atmosphere. All the windows are wide open to the dome. A panoramic cloth, showing the roofs of Paris, covers a wall on which shelves are suspended. The roofs-of-Paris scenery is also

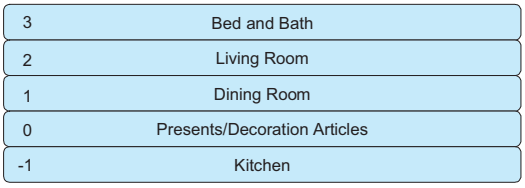
used as a theme throughout the boutique. After climbing the stairs, customers discover the amazing panoramic view from the terrace and have lunch at the restaurant, enjoying the outstanding 360° view. In order to satisfy the many customer demands and requirements, and to offer the best visibility possible, the following eight large product categories share the boutique: *Galeries Lafayette* Paris (e.g. a *Galeries Lafayette* collection of classical tourist souvenirs such as T-shirts or caps), Paris Mode, (e.g. textile products branded with various Paris themes), Paris Patrimoine (products reflecting the French way of life ("savoir vivre"), e.g. soap from Marseille or *Perrier* and *Orangina* bottles), Paris Collector (e.g. mugs, flag shaped key rings, or pens), Paris Metro (e.g. plates printed with Metro stations or street names), Paris Luxe (e.g. Limoges porcelain), Paris Culturel (e.g. typically French books, music, cards), and Paris Gourmand (e.g. wine or foie gras).

Lafayette Maison

World for Home Fashions

Just as teenagers have their own shopping world at *Lafayette V.O.*, the equivalent for their parents is *Lafayette Maison*, which used to be integrated in the Haussmann store's basement. As trends like *cocooning* have emerged, it grew in importance and it was outsourced into its own building. The 10,000 m², five-level annex dedicated to home fashions was opened in March 2004 and is also situated on Boulevard Haussmann, across from the main store. It was the first department store to open on Boulevard Haussmann in more than 30 years. The concept underlying *Lafayette Maison* is that when entering, customers do not feel like going into a retail store, but into a huge house instead. Accordingly, the selling floors are arranged according to residential activity, by "living space" (Sloan 2004, p. 6). Cooking is on the lower level, personal expression items and gifts on the ground floor, dining products on the first floor, relaxation products in the lounge on the second floor, and the sleep shop and bath shop are on the third floor (see Figure 10.4). The offer ranges from upscale lines to affordable gifts and accessories.

Figure 10.4 *Departments at Lafayette Maison*



Lafayette Maison offers the complete range of interior decoration and "art de vivre" under one roof in an exclusive atmosphere. Creating this required a 20 month-construction period. Only the façade of the former *Marks & Spencer* site remained unchanged. The building now has a central atrium containing eight escalators above which a glass ceiling was installed, allowing natural light to illuminate the interior.

Merchandising Through Living Space

The concept of merchandising through living space also implies a different arrangement of products than at conventional department stores. For instance, unlike traditional department stores, mattresses are offered on the bed and bath floor, which is a logical move in terms of the underlying concept (Sloan 2004, p. 6). This rearrangement of departments, along with clear signage, which is a key element in ensuring effectiveness, helps the customer to find the right products. However, it also ensures that customers linger and take their time, which encourages impulse purchases (Baum 2006, p. 67). Furthermore, so-called surprise elements are designed to stop and amuse the browsing customer. A huge candle-wax bathtub situated on the bed and bath floor is a good example (Sloan 2004, p. 6).

Brands and designer boutiques are considered essential for creating a holistic, upmarket shopping experience. Therefore, brands are highlighted throughout the store and in the same way in order to achieve a consistent layout.

In order to enhance the shopping experience and event-like character of shopping at *Lafayette Maison,* a number of instore exhibitions have been held, such as cooking courses, launches for several product collections, a designer's day, raising awareness for fair trade in cooperation with UMAE which works with craftsmen from African countries. There are also country themes, where a particular culture, Brazil, India, or Japan, for example, is represented across various areas including food (Baum 2006, p. 67).

Constant Newness

Furthermore, at the kitchen department, chefs regularly demonstrate their cooking skills in front of the clientele. Cocktail tasting is also offered on a regular basis. The aim of these initiatives is to provide an authentic, real-life experience for customers. In order to keep customers coming back, the store is keen to give shoppers something new every time they visit. New products are highlighted throughout the store with "nouveau" signs. Furthermore, in the middle of each floor area, there is a presentation of current trends in home furnishing, intended to inspire the customers (Stores and Shops 2004, p. 8). Since the one and a half year existence of *Lafayette Maison,* twelve major adaptations and changes have been implemented in order to achieve ongoing innovation and newness (Roulleau 2006, p. 10).

Lafayette Maison represents a 24.6 million USD investment for *Galeries Lafayette*, which allowed the retailer to reinvent itself as an event shopping desti-

nation and has also made a considerable contribution to the group's performance. In 2004, sales rose 7.4 %, thanks to *Lafayette Maison* (Baum 2006, p. 68). Two years after its launch, the concept has proven a success and been introduced in ten other French cities so far, as single floors in existing *Galeries Lafayette* stores (Baum 2006, p. 67). This success has been achieved mainly through the real-life experience concept which "dramatically breaks away from conventional retailing" (Sloan 2004, p. 1).

Lighting

As a major element of visual merchandising, lighting is crucial to creating the appropriate atmosphere for the respective clientele and is therefore used in all *Galeries Lafayette* stores. The flagship store on Boulevard Haussmann stands out as the prime example. When the lingerie department on the third floor was redesigned, the aim was to reinforce the Paris theme, as a courtesy to the foreigners shopping at *Galeries Lafayette* who strongly associate the store with the French capital. To accomplish this, a 20 metre stylised replica of the Eiffel Tower was suspended under the building's cupola. In order to achieve a dramatic effect, canvas was stretched between double rows of the open balconies at the top two levels, illuminated with projected images. The floors beneath *Galeries Lafayette's* dome are equipped with coloured lighting that continually shifts in tone and add to the visual effect.

At *Lafayette Maison,* light plays a critical role in creating the desired modern and sophisticated atmosphere (Sloan 2004, p. 1), including both natural light pouring through the glass ceiling as well as artificial lighting. Transparent panels which have been turned into a lighting design feature wrap around the staircase at each floor. Customers riding on the escalators and shopping in the departments facing the atrium can see vistas enhanced by colourful LED-illuminated visual creations. The daylight pouring into all the selling floors through 150 windows allows customers to examine their selections in both natural and artificial light. Feature lighting for displays is supplied by adjustable-head track and individual surface-mounted luminaries. Multi-head flush-mounted fixtures provide additional ambient illumination in such areas as store directories (Display and Design Ideas 2004).

Short-Term Instore Marketing: Regularly Varying Mottos

In order to continuously refresh the customer shopping experience at *Galeries Lafayette,* different shopping areas focussing on one central motto are introduced for a limited period of time. This approach stresses the event-like character of shopping at the department store and is expected to keep cus-

tomers coming back, because of their desire to indulge constantly in new shopping experiences. The installation of a new shopping theme is always accompanied by press releases and advertising in various media.

Los Angeles Fashion

An example of a short-term motto were the three weeks in April 2006 dedicated to the theme of *Los Angeles Fashion*. The entire store was dedicated and redecorated to fit the Los Angeles theme. This ranged from fake nails in the beauty department and typically American brands such as *Tupperware* or *Kitchen Aid* showcasing the "American Way of Life" at *Lafayette Maison* to the women's floors and *Lafayette Homme* offering a large variety of L.A. lifestyle brands like *Guess, American Apparel* or *Rock & Republic*. Furthermore, numerous activities supported the retailer's attempt to create a real-life Los Angeles atmosphere, such as:

- an exhibition of *Fender* guitars accompanied by free master class sessions
- a "Little White Wedding Chapel" at the wedding boutique
- beauty makeovers and a tanning centre
- a motorcycle tour on a *Harley Davidson*.

The event was rounded off by cheerleaders and marching bands in front of *Galeries Lafayette* announcing the Los Angeles Fashion weeks (Foreman 2006, p. 10).

Valentine's Day

Another example of short-term instore marketing is Valentine's Day, on which *Galeries Lafayette* regularly offers a number of related products and services in order to attract customers. Additionally, activities include creating Valentine's Day cards, beauty treatments, or a theme dinner "Casanova" at *Lafayette Gourmet*, accompanied by a theatre performance.

Summary and Outlook

In 2004, *Galeries Lafayette* defined its challenges for achieving the performance needed to play a dominant role in the expected consolidation process of Europe's department stores: clear positioning of retail brands and formats, proactive selling strategy, planned closure of structurally loss-making stores, strategies for improving cost structures, optimisation of capital employed and cohesive management. According to Philippe Houzé, the Chairman of the Executive Management Board of *Galeries Lafayette*, two conditions are necessary in order to guarantee a positive future development of department stores. In general, the stores have suffered severely as a result of customer price sensitivity and new formats such as category killers. These factors create the need for a critical mass and to reinvent and innovate constantly. That is why the group makes every effort to react constantly to the latest

market trends and adapt its concepts accordingly (Houzé 2006). To achieve growth in the future, *Galeries Lafayette* will continue its strategy of transforming itself into a specialised, multi-concept store under one roof. Possible new worlds include sports, leisure and accessories/jewellery.

The success of *Lafayette Maison* is generally regarded likely to be exported to other European countries and possibly also to the Far East (Baum 2006, p. 67). So far, the group has already begun and/or plans to transfer its *Lafayette Maison, Lafayette Gourmet* as well as *Lafayette V.O.* concepts to other major French cities. Further expansion plans include the opening of additional stores in the Paris region, with the long-term aim of establishing a total of ten stores in Paris. Other rumours include plans to open a store comparable to the *Galeries Lafayette Berlin* in Asia (TextilWirtschaft 2006, p. 54).

Questions

1. In the case study, numerous examples of holistic instore marketing were discussed. What elements exactly constitute a holistic instore marketing approach?
2. For a department store, there are three basic ways to organise its floors. It can be structured either as a classic item-oriented area with traditional categories (such as trousers, books, or kitchenware), as a brand-oriented shop-in-shop concept or by means of different theme worlds such as at *Galeries Lafayette*. Describe the various advantages and disadvantages of these concepts.
3. Why may it be attractive for a retailer such as a department store to apply an upmarket and expensive holistic instore marketing approach, whereas discounters and category killers keep on gaining market share with an extremely simple and reduced store layout?

Hints

1. See Levy/Weitz 2007 for a detailed description of the various elements of store design.
2. See case study *Esprit* in Chapter 3 for shop-in-shop concepts, as well as the section "Grouping of Store Offerings" in this Chapter.
3. See Chapters 1 and 2 as well as Berman/Evans 2007 for a discussion of retail formats.

Chapter 11

Customer Relationship Management

Building enduring relationships with customers has become a prime strategic objective of retail marketing. The purpose of this Chapter is to explain the new paradigm of relationship marketing and to introduce the underlying principles of customer value, the relationship lifecycle and the constructs of customer loyalty and customer satisfaction. In retailing, loyalty programmes are manifestations of customer relationship management.

Relationship Marketing as New Paradigm

Traditionally, marketing has focussed on attracting new customers for a company. Today, however, companies recognise the importance of retaining current customers by forming relationships with them (Kotler et al. 2002, p. 405). This focus on relationships builds on the premise that it is less expensive to market to existing customers than to acquire new ones (Reichheld/Sasser 1990). *Relationship marketing*, a term usually used synonymously with *customer relationship management* (CRM), involves establishing, maintaining and enhancing long-term relationships with customers (Morgan/Hunt 1994).

Relationship Marketing

With this perspective, the manager's primary task is to identify profitable and non-profitable customers, focus efforts on the former and balance the cost of acquiring and retaining customers with current and potential revenue from those customers (Bechwati/Eshghi 2005, p. 88).

In retailing, advances in IT and the spread of loyalty cards have provided a means for retailers to identify a particular customer and to collect customer-specific data, thus enabling individualised marketing.

Compared to other industries, retailing has tremendous advantages in CRM, since it is in direct contact with the consumer (Hansiota/Rukstales 2002, p. 260).

Even though the methods proposed for CRM are very heterogeneous, some common and underlying principles have emerged (Homburg/Sieben 2005, p. 437-438):

Principles of CRM

- *Customer information*: Companies must gather reliable and detailed information on their existing and potential customers, usually stored in an IT-based customer data base.
- *Individualisation/segmentation*: A strong customer orientation leads to a targeted approach to individual customers or customer segments, instead of a standardised mass market approach to retail marketing.
- *Profit orientation*: Not all customers are treated equally. Rather, they are classified and prioritised in terms of their profit potential for the company. Investment in customers is undertaken on the basis of their profitability.
- *Customer interaction and integration*: Instead of one-directional communication (such as traditional advertising), the aim is to achieve a two-directional interaction with the customer, including a stronger integration in the value-added process.

Customer Lifetime Value and Relationship Lifecycle

Customers as Assets

In the context of long-term customer relationships, loyal customers can be seen as an enduring *asset* for the retailer (Shugan 2005, p. 191). Customers spend money on certain product categories not just once, but generally regularly (weekly, monthly, yearly) for the rest of their lives. Since the purchasing relationship might extend over many years, the future revenue stream should be discounted to arrive at the net present value of future cash flow. If a single customer spends 400 EUR on clothing each 6 months, the net present value accrues to about 15,000 EUR between the ages of 15 and 75 (at a discount rate of 5 %).

Customer Lifetime Value

Customer lifetime value (CLV), the quantified value of a customer, has become a prominent concept with the rise of CRM. CLV is the difference between what it costs to acquire, service, and retain a customer and the revenue generated by that customer over the total duration of the relationship with him (Bechwati/Eshghi 2005, p. 88). The formula for CLV in its simplest form is:

$$(1)\ CLV = \sum_{t=1}^{n} \frac{(R_t - C_t)}{(1+i)^t},$$

with R_t = revenue earned from a particular customer in the year t, C_t = customer-specific cost in the year t, i = discount rate and n = duration of relationship.

However, the most challenging aspect of estimating CLV is not applying a formula, but projecting future revenue and cost. While this was very complicated in the past, it has since become a more manageable task, because his-

torical purchasing data for a specific customer, based on loyalty card data, is available and can form a better base for projection.

Application of Customer Lifetime Value

CLV can be used to develop a *profile of high-value customers,* which can then be applied to focus customer acquisition efforts on similar consumers. CLV can also be employed to *categorise the existing customer base* into high-, medium-, and low-value customers, which allows a differentiation of product offers and services according to expected customer value and also provides an objective basis for directing retention efforts toward higher-value customers. If, for example, handling a customer complaint costs 500 EUR and the lifetime revenue value of this customer is 5,000 EUR, it may be worth investing the money, while for a customer with a value of 300 EUR, it might not be (Bechwati/Eshghi 2005, p. 89).

Monetary Effects of Loyalty

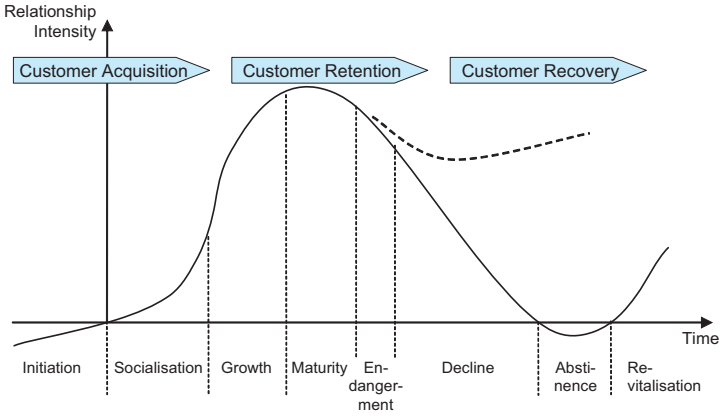
The monetary value of customer loyalty originates from different components. Higher commitment to a company often leads to enhanced *purchasing frequency* (i.e. more frequent store visits), *larger shopping baskets*, *lower customer price sensitivity*, and a stronger *resistance to counter offers* from competitors. Loyal customers search less for competing product and service offers. Lower marketing costs are also assumed, since targeted marketing is possible and the company acquires substantial knowledge about the consumer, making marketing more efficient. *Cross-selling*, where the customer buys additional products from the company, and *up-selling*, where the company manages to sell higher-value products to the customer, are usually also achieved. Accordingly, the marketing focus is shifted from market share in specific product categories to increased *share-of-wallet* for a particular customer (Uncles/Dowling/Hammond 2003). In addition, *non-monetary benefits* also accrue. More loyal customers are expected to recommend the retailer to friends and relatives and this *word-of-mouth* constitutes effective and efficient marketing communication. Loyal customers also have an *information value* for the company, since they more often complain when the performance of a company deteriorates. They communicate with the retailer, thereby contributing to maintaining and enhancing the overall quality of the company (Reichheld/Sasser 1990, p. 108).

Non-Monetary Effects of Loyalty

Customer Relationship Lifecycle

Pursuing the notion that customers are potential sources of profit over their entire lifetime, the relationship between customer and retailer can also be regarded as a lifecycle. The relationship therefore has a clear beginning, a growth stage and a maturity stage, after which a decline and a potential termination could occur (see Figure 11.1). The customer relationship lifecycle describes regularly observed patterns in the longitudinal development of customer relationships with a company. However, the model is *not deterministic*, i.e. not all stages have to occur in a relationship, the duration of stages differ and a retailer can influence the shape of the curve, by, for example, effective counter-measures in the endangerment stage.

Figure 11.1 *Stages in the Customer Relationship Lifecycle*



Source: Adapted from Bruhn 2001, pp. 46-52.

Marketing in the Relationship Lifecycle

Different stages in the relationship require different marketing approaches (Bruhn 2001, pp. 47-51). In the early stages, the emphasis is on *customer acquisition*. In the growth stage and through maturity, the company needs to strengthen the relationship and exploit the full sales potential (*customer retention)*. In the later stages of the relationship cycle, it is important to know which customers are at risk of defecting and to employ *customer recovery* measures.

After customers are lost, it may be possible to reactivate them. Identifying the causes of such defection can help to win particular customers back, but also to avoid the same mistakes with others. Sending lost customers a special offer or calling them in order to allow them to complain about mistakes, might bring them back into the relationship. Through data analysis, defection behaviour might be predicted and those customers with the highest propensity to discontinue the relationship with the retailer, targeted proactively (Brown/Gulycz 2002, p. 124).

Customer Loyalty and Customer Satisfaction

While loyalty has become more important as a marketing objective with CRM, there is no universally agreed definition of loyalty. Two basic approaches to conceptionalise loyalty can be identified (Dick/Basu 1994, pp. 99-100; Uncles/Dowling/Hammonds 2003):

- Often, loyalty is defined with reference to a pattern of purchases. *Behavioural loyalty* is measured in terms of repeat patronage, percentage of budget allocation in a category to a store, amount of switching, or purchase likelihood.

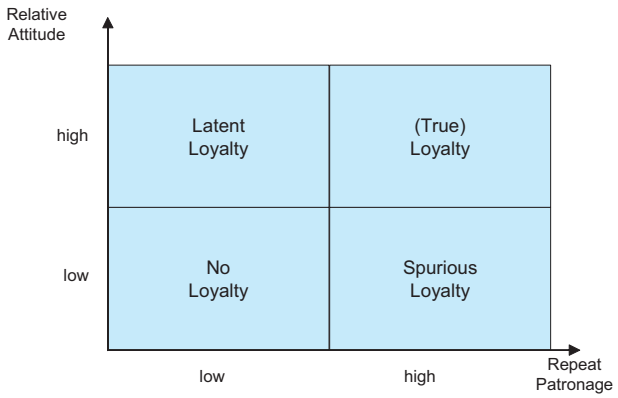
Behavioural Loyalty

- Many researchers argue that there must be strong commitment to a company for true loyalty to exist. Commitment refers to an emotional or psychological attachment to a company. Trust, which entails the confidence in the retailer's reliability and integrity, is often seen as closely connected to it (Morgan/Hunt 1994). This *attitudinal loyalty* can be measured by asking consumers if they like and trust the store, whether they feel committed to it, and whether they would recommend it to others.

Attitudinal Loyalty

Types of Loyalty

Figure 11.2



Source: Dick/Basu 1994, p. 101.

Both dimensions are important for true loyalty (see Figure 11.2). *Spurious loyalty* refers to a situation, where repeat patronage is observed, but is not based on a strong positive attitude towards the retailer. For example, a lack of alternatives in the area can result in store patronage without having anything to do with positive attitudes. Habitual purchasing behaviour might have the same effect.

Spurious Loyalty

Therefore, behavioural loyalty may merely reflect situational influences, but it is permanently at risk, if situational conditions change, such as rivals entering the market (McGoldrick 2002, p. 114).

Latent Loyalty

While a positive attitude is an important objective, attitude does not necessarily correspond with behaviour and *latent loyalty* can occur. Situational influences can form a barrier between attitude and behaviour. For example, people can have a very positive attitude towards *Tiffany's*, but not be able to buy there. Alternatively, they may feel very positively towards *Harrods* in London, but live hundreds of miles away. Ultimately, however, retailers do not wish to foster a positive attitude of consumers, but aim at increasing their sales.

True Loyalty

True loyalty, the most favourable position, is signified by repeat patronage based on a strong relative attitude towards the retailer (Dick/Basu 1994, p. 102). Most definitions of loyalty now include both dimensions, i.e. behavioural loyalty corresponding with attitudinal loyalty.

Customer Satisfaction

Satisfaction is considered to be a primary prerequisite for loyalty, and loyalty is expected to rise with increasing levels of satisfaction. Satisfaction (or dissatisfaction) is a consumer's post-purchase response to a product which results from a comparison of (pre-purchase) expectations and perceived performance (Dick/Basu 1994, p. 104). It should be noted, though, that the association between satisfaction and loyalty is moderated by a large number of variables. If, for example, the customer is a variety seeker, or social pressure acts against purchasing at a particular store, satisfaction might only be weakly linked to loyalty. However, dissatisfaction usually leads to a substantial decline in loyalty.

Satisfaction in the Buying Cycle

A customer's satisfaction with a retailer derives from the overall evaluation of all prior experience with this retailer, and not only with respect to a specific transaction. Increasing customer satisfaction is therefore important in all stages of the customer purchasing process, while traditionally, marketing has emphasised *pre-sale* and *sale activities* (Kotler et al. 2002, p. 405). With the perspective of CRM, the *post-sale stage* is simultaneously a pre-sale stage, since the customer is regarded as being in a continuous buying cycle. Retailers providing their customers with friendly and courteous customer service departments, fair and above regulation reactions to complaints, etc., try to enhance customer satisfaction after a purchase, with the intention of increasing the repurchase likelihood.

Increasing Expectations

One challenge associated with customer satisfaction, is that results derive from a comparison of performance with expectations – and expectations change over time. Consequently, constantly meeting or even exceeding customer expectations leads to increasing expectations over time. Service levels that enthused the customer when he first experienced them can become standard and form a new minimum expectation level. Thus, maintaining stable levels of customer satisfaction is only possible with steadily increasing levels of service quality.

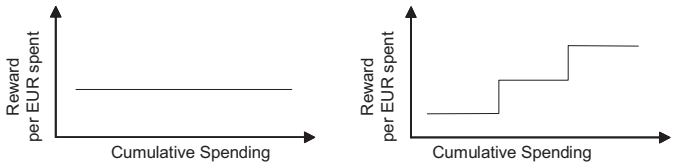
Loyalty Marketing of Retailers

In retailing, CRM is closely connected to the *loyalty schemes* that are usually based on *loyalty cards*. Pioneers in Europe were *Tesco* in the United Kingdom (see case study *Tesco* in this Chapter) and *Albert Heijn* in Holland (Ziliani/Bellini 2004, p. 9). Many retailers now employ some form of loyalty scheme. Typically, loyalty programmes offer delayed, accumulated economic benefits to consumers on the basis of repeat purchases. Usually, this takes the form of points that can be exchanged for gifts, or vouchers. The discount value of points generally ranges between 1 and 4 % of sales. The option of giving discounts in different "currencies" (e.g. cash, stamps, miles, reward points) can also offer perceptual advantages, e.g. for the retailer's price image (Shugan 2005, p. 190; Cuthbertson/Laine 2004, p. 296). In so-called *affinity programmes*, the focus is more on the emotional bond between customer and retailer. With club memberships, preferred service, newsletters, Internet chat groups, telephone help lines and other measures, two-way communication is established so that customers can interact with the company and get to know it better (Rowley 2004, pp. 126-127).

Most frequently, the ability to accrue benefits in the form of discounts on purchases, as well as the promotional offers connected to the loyalty programme, are the principal motivation for consumers for joining a loyalty scheme. However, emotional bonding and psychological relationship awards might also be important. *Self-actualisation* is considered a basic human need and loyalty programmes can provide recognition to selected customers by giving them an evaluated status and the feeling of being special. In some loyalty programmes, the sense of being a member of a community is considered more important than financial rewards (Shugan 2005, p. 190; Reinartz 2006, pp. 363-364).

Basic Types of Reward Accumulation Functions

Figure 11.3



Source: Reinartz 2006, p. 365.

Reward Accumulation Functions

Loyalty programme rewards depend on the cumulative spending by customers at the retailer. There are two basic reward-accumulation functions (see Figure 11.3). If the same share of spending is given as reward (e.g. 1 point per EUR spent), regardless of accumulated spending, this linear function might lead a consumer to distribute his spending between different retailers (without a loss for the customer). If only the *relative* rewards count as cumulative spending level increases (e.g. 1 point per EUR when spending is below 100 EUR, 3 points when spending is above 100 EUR), the programme becomes relatively more attractive for customers who spend more with one retailer and when concentrated spending at one retailer is rewarded. This supports a company strategy that aims to focus retention efforts on a small group of high-value customers (Reinartz 2006, p. 365). Sometimes this is implemented with different types of loyalty cards, e.g. "normal" cards, gold cards, platinum cards. *Switching costs* for customers are increased, since accumulated assets can be seen as customer investment in the relationship with the retailer, which should in turn enhance loyalty.

In terms of sponsorship, two types of loyalty programme exist:

- single-company loyalty programmes
- multi-partner programmes (or coalition schemes).

Single-Company Loyalty Programmes

Single-company loyalty programmes are run by an individual retailer. Examples are the programmes of *Boots*, *Auchan*, *Coop (Switzerland)*, *Peek & Cloppenburg*. Usually, the loyalty card carries the retail brand, and points can be accumulated at this retailer only.

Multi-Partner Loyalty Programmes

A benefit of *multi-partner programmes* is that customers can use their loyalty card more often, collect points faster, and qualify for certain premiums or prizes faster (Zentes/Morschett/Schramm-Klein 2006, pp. 615-616). Penetration of the programme in the population is often higher than for single-company programmes. Especially for retailers with a low purchasing frequency (e.g. DIY stores or consumer electronics retailers), for whom attracting customers in a proprietary programme would be difficult, participating in a coalition programme can be beneficial. While single-company programmes only have data on the current customers of a particular retailer, multi-partner programmes have access to far more data about shopping habits, so that the retailer can also target profitable consumers who are not yet part of his own customer basis (Cuthbertson/Laine 2004, p. 302). This facilitates analysing customer behaviour on a much broader base (within the limits of privacy regulations and customer acceptance). At the same time, the high cost of a loyalty programme can be distributed among the participating retailers. The disadvantages of a multi-partner programme are that loyalty is often focussed on the coalition programme, rather than any particular retailer (Cuthbertson/Laine 2004, p. 298). Also, the loyalty scheme (e.g. re-

wards, accumulation function) is not designed to meet a specific retailer's strategy, but has to appeal to a group of retailers as a whole. One of the most successful multi-partner programmes in Europe is the German *Payback* system with more than 30 million customer members, in which many large retail companies, such as *Real*, *OBI*, *dm-drogerie markt*, *Aral*, *Apollo Optik*, participate. The British multi-partner programme *Nectar* has companies such as *Sainsbury's*, *Debenhams*, *BP* and *Hertz* as partners. In France, *S'Miles* offers bonus points for purchases with *Géant*, *Monoprix*, *Galeries Lafayette*, *Shell*, *BHV*, and others.

Analysing Customer Data

In CRM, data mining techniques are used to analyse customer information. Since the results of the analysis and the forecasting of customer response can be used to develop marketing measures and the subsequent behaviour of specific customers can be tracked and evaluated, a learning system can be created that studies the specific behaviour of each customer and can also detect changes in behaviour over time (Zentes/Morschett/Schramm-Klein 2006, p. 600). An important potential advantage of CRM is that the success and the profitability of marketing measures can be evaluated in an experimental approach, by comparing the purchasing behaviour of the targeted customer group with a control group, based on incremental sales or contribution margin (Hansiota/Rukstales 2002, pp. 262-263). However, up to the present, the huge amount of data collected through loyalty cards (often millions of data sets daily) results in an inadequate usage of the data, because IT capacity and methods of data analysis develop at a slower pace than data availability.

Customer Segmentation

Customer segmentation is a core task of data analysis. In theory, retailers employing loyalty programmes could segment their customer base down to individual customers, but in practice, the number of segments used is generally limited to between 10 and 30. Segmentation criteria include purchasing volumes, demographic characteristics, geographical aspects, shopping motives, attitudes and lifestyles.

Value-Based Segmentation

The options start with very simple segmentation criteria. *ABC analysis* is used to categorise customers by their annual purchases. Very often, a 20-80 rule is used that 20 % of the customers (*"A" customers*) account for about 80 % of retail sales volume. Even if the ratio is often not that extreme, it has frequently been shown that the relevance of different customers for a retailer varies considerably (Cuthbertson/Laine 2004, p. 295). While customer purchase behaviour is a backwards-oriented criterion, total *customer lifetime value* can serve as a very sophisticated basis for segmentation. Such cus-

tomer-value-oriented segmentation shows what customer groups a retailer should focus on, but it does not show *how* to approach the customers.

Consumer Behaviour-Based Segmentation

Segmentations based on such consumer behaviour as shopping motives or attitudes are better suited to develop tailored marketing. Many different customer clusters have been proposed in the literature. For instance, customers can be clustered into "price-oriented", "quality-oriented", and "service-oriented", or fashion customers into "fashion enthusiast", "style seekers", "classics" and "timids and uninvolved" (McGoldrick 2002, p. 112). The customers' stage in the family cycle (e.g. young singles, young couples, couples with young children, older, retired couples) is usually a good predictor of purchasing behaviour. Based on their own customer data, retailers can, however, use a combination of methods to establish customer segments that are tailored to the retailer's specific needs.

Using Customer Data

Micro-Macro Approach

Individual customer information provides insights into consumer behaviour that can be used to bring about a general change in a retailer's marketing. In such a case, the customer data is used to change macro variables of retail marketing, such as the merchandise mix, pricing, promotion, or location decisions (*micro-macro approach*; Zilliani/Bellini 2004, pp. 12-13). For example, before a product is de-listed due to low sales, an analysis can be conducted to determine who still buys it. If, for example, only 20 % of customers purchase the product, but those are most valuable customers in the store, keeping this product in stock is important for retaining these profitable customers (Cuthbertson/Laine 2004, p. 301).

CRM, on the other hand, focuses on *micro-marketing* (or one-to-one-marketing) which targets specific consumers or consumer segments based on knowledge of their behaviour. The retail service (such as the merchandise offered in advertising, promotions, services offered) is tailored to certain segments or (seldom) individual customers. Since the store itself is still standardised for all visitors, CRM often does not take place in the store offer, but through marketing communication with specific customers. Measures include the following (Zentes/Morschett/Schramm-Klein 2006, pp. 604-609):

- *Addressed direct mailings*: Customised direct mailings to customers' homes are used in almost all retailer loyalty programmes. The prime communication channel in loyalty programmes is some kind of (tailored or segmented) product catalogue, often with targeted promotions.
- *E-mail marketing*: Direct customer mailings have increased tremendously with the advent of e-mail, which is used to distribute customised adver-

tising and newsletters to customers. Distribution costs are much lower and customising more flexible and cheaper.

- *Instore multimedia kiosks*: Similar to the Internet, multimedia kiosks in retail stores can be used to communicate with each customer individually (Swoboda 1996). At electronic point-of-sale terminals, loyalty card holders can (among other functions) check their point account, order rewards or print out value checks with which they can pay their next purchase.
- *Mobile marketing*: Some retailers already use the customers' mobile phones as communication devices, for example for providing coupons by SMS or MMS.
- *Personal shopping assistants*: Digital shopping assistants that a customer can carry or attach to the shopping cart are still in the testing stage. Based on his loyalty card, such a device can guide the customer interactively through the shopping process in real time. Shopping lists can be displayed, the customer led to certain products, or recipes recommended, including the necessary ingredients and their location in the store.

Loyalty Marketing on the Internet

A higher level of CRM and one-to-one marketing can be employed in Internet shopping. In addition to the purchases, total purchasing behaviour can be observed with *web usage mining*. Over and above the data that can be collected with loyalty cards in store retailing, an electronic retailer can track the date and duration of each visit to his web site, the time a customer spends looking at a specific product, products viewed but not purchased, the sequence in which products were viewed or web sites browsed (Hansiota/Rukstales 2002, p. 261; Hertel/Zentes/Schramm-Klein 2005, pp. 401-403). In contrast to stores, the individual data can be employed to tailor the entire retail marketing process to a specific customer, from the basic merchandise offer, prices and promotions, to the store design.

The most successful example, *Amazon*, shows how individualised product recommendations are derived from connecting the profile of an individual customer (established from his purchase history) to the profiles of other customers. Demand interrelationships are detected systematically. Even the recency of purchases is considered, because purchasing behaviour can change over time. Cookies are placed or the customers log in with a password and the customer is addressed with a *personal store*.

Conclusion and Outlook

Over the last decade, many retailers have shifted their focus to CRM and introduced loyalty card programmes as a tool. The costs of such a programme are often substantial, including those of incentives, IT systems and administration of the programme (McGoldrick 2002, p. 120). Some researchers are critical of the success of such programmes, claiming that "loyalty programs do not create loyalty" (Reinartz 2006, p. 362). This points to the fact that loyalty programmes have to be monitored closely and that loyalty cards alone, are not enough to establish loyalty, but have to be employed as part of the overall retail marketing approach. While some researchers also state that it is difficult to judge the ultimate profitability of a loyalty programme, this is true for marketing in general. Furthermore, the success of loyalty marketing campaigns can usually be measured more accurately than that of traditional marketing campaigns (Cuthbertson/Laine 2004, p. 299).

CRM must be compatible with the company's broader strategy. If a primary goal is, to achieve market leadership by gaining customers from its main competitors and grow rapidly, the maximum number of customers should be attracted. A focus on only the most profitable customers will not be appropriate for the company's strategic objectives (Bechwati/Eshghi 2005, p. 96). This example illustrates that customer relationship marketing is an increasingly relevant marketing approach in retailing. However, as with all functional strategies, alignment with the overall company strategy is crucial. Some retailers, such as *ASDA*, *Aldi* or *Lidl*, believe that adhering to their core strategy is more important to establish and build loyal customers, than creating a loyalty programme. While this is certainly true, for many other retailers, CRM offers a universe of options for interacting with their customers. All in all, the potential gains of analysing detailed customer data and targeting consumers, especially with new media which lower the communication costs of tailored marketing communication, still seems enormous.

Further Reading

REICHHELD, F.; SASSER, W. (1990): Zero Defections: Quality Comes to Services, in: Harvard Business Review, Vol. 68, No. 5, pp. 105-113.

GRÖNROOS, C. (1994): From Marketing Mix to Relationship Marketing: Towards a Paradigm Shift in Marketing, in: Management Decision, Vol. 32, No. 2, pp. 4-20.

Case Study: Tesco[1]

Profile, History, and Status Quo

The origins of *Tesco Plc* date back to 1919, when Sir Jack Cohen started to sell groceries in a market stall in the East End of London. The name *Tesco* is derived from TES (from *TE Stockell*, a tea supplier Jack Cohen used) and CO (Cohen). By the 1960s, the company had established its self-service model and developed a reputation as a value-for-money retailer, according to its founder's "pile it high and sell it cheap" motto. However, during the 1970s, the company constantly lost market share to the competitors, especially *Sainsbury's*. But by 1995, *Tesco* took over *Sainsbury's* and became the United Kingdom's market leader in food retailing, thanks to constantly pursuing a more up-market strategy since 1977 (Cooper/Browne/Peters 1992, p. 97). In 2005, with a market share of about 28 % in the United Kingdom, the company employs approximately 250,000 people in over 1,800 stores throughout the United Kingdom, where it operates four different store formats. Table 11.1 gives an overview of these formats.

Store Formats of Tesco in the UK

Table 11.1

Store Format	Square Feet	Number of SKUs	Location	Purpose
Express	<3,000	2,500	busy city centres/petrol stations	impulse
Metro	7,000-15,000	10,000	high streets/ large city centre shopping areas	top-up
Superstore	20,000-50,000	30,000	city suburbs	one-stop weekly shop
Extra	>60,000	50,000	city suburbs	destination shopping

Source: Adapted from Coriolis 2004, p. 37.

1 Sources used for this case study include the web sites http://www.tesco.com and http://www.tescocorporate.com as well as explicitly cited sources.

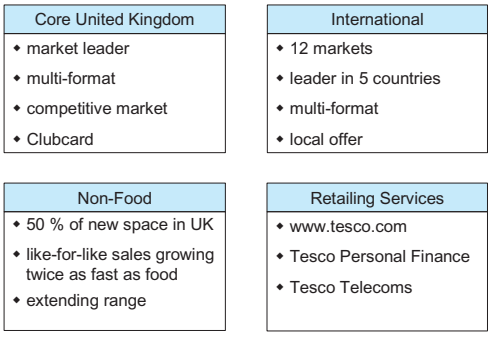
The company currently operates in 12 markets outside the United Kingdom, in Europe and Asia. Over 100,000 employees work in the international operations, serving over 15 million customers and generating 7,600 million GBP sales and 370 million GBP profit. Over half of group space is now outside the United Kingdom. Currently it is the world's third largest food retailer (see Figure 5.1 in Chapter 5). Table 11.2 shows the path of the company's internationalisation.

Table 11.2 *Internationalisation of Tesco*

Country	Year of Entry	Country	Year of Entry
Hungary	1994	Taiwan	2000-2005 (exit)
Poland	1995	Malaysia	2001
Czech Republic	1996	Turkey	2003
Slovakia	1996	Japan	2003
Rep. of Ireland	1997	China	2004
Thailand	1998	USA	planned for 2007
South Korea	1999		

The company pursues a long-term growth strategy based on four key features (see Figure 11.4).

Figure 11.4 *Key Features of Tesco's Growth Strategy*



Source: Adapted from Tesco 2006, pp. 5-6.

Tesco Clubcard

Market Conditions before the Introduction of Tesco Clubcard

Challenging Market Conditions

At the beginning of the 1990s, *Tesco* faced a number of difficult market conditions. Population growth was low and so was food market growth; the supermarket segment in the United Kingdom was already well developed and relatively saturated; getting planning permission for large greenfield sites was becoming increasingly difficult; there were three strong competitors (*Sainsbury's*, *Asda* and *Safeway*) in the national market; *Tesco* was the no. 2 in the market with a share of 16.7 %; traditional supermarkets were challenged by the arrival of new formats such as hard discounters like *Aldi* (see case study *Aldi* in Chapter 5) (Coriolis 2004, p. 3). In order to tackle these difficulties, *Tesco* decided to implement an entirely customer-focused CRM initiative based on the customer loyalty card *Tesco Clubcard*. In a saturated market like the United Kingdom, the goal of the initiative was not only to gain new customers in order to increase market share, but also to enhance existing customers' loyalty in order to secure a greater share of their total shopping basket.

Implementation

This programme was developed and implemented with the help of the agency *dunnhumby* which joined *Tesco* in their marketing efforts. In a test and learn approach, the loyalty scheme was tried out in twelve selected stores in 1994.

In February 1995, the *Tesco Clubcard* was launched nationwide. The core purpose of the CRM strategy was "to create value for customers to earn their lifetime loyalty" which is expressed in two key values "No one tries harder for customers" and "Treating people how we like to be treated" (Tesco 2006, p. 1). Thus, the *Clubcard* is more than an "average" loyalty card, and constitutes a central part of the company's philosophy. The explicit goal of *Tesco*'s CRM strategy is to reward individual customers for their loyalty (Beckett/Nayak 2005, p. 8). Consequently, the focus was shifted away from the average or typical to the individual customer. By using the individual customer as the focus, the aim was to create a modern "corner store" (Wylie 2005). This customer-centric strategy is also reflected in the pivotal role of *Tesco* employees who deliver the brand promise and customer experience and thus become "brand ambassadors" (Seiler 2005, p. 21) for the company. To ensure the initiative's success, staff training, which included an educational video informing the employee's of the functioning and goal of the programme, was crucial.

Focus on the Individual Customer

Even though *Tesco* had been testing the loyalty scheme in a limited number of stores since 1994, the United Kingdom's first supermarket loyalty programme took the grocery industry by surprise (Rafiq 1997, p. 43). Furthermore, it was not taken seriously by many competitors. Between 1963 and 1977, *Tesco*, among other UK retailers, had used a trading stamps scheme, the Greenshield trading stamps. These stamps were given to customers when purchasing groceries or other items (in proportion to expenditure), collected in books and could be redeemed for cash or gifts (Rafiq 1997, p. 44). Thus, when *Tesco* launched the *Clubcard* in 1995, Lord Sainsbury famously dismissed the idea as nothing more than "electronic Greenshield Stamps" (Humby/Hunt/Phillips 2003, p. 65). However, *Tesco Clubcard* has proven a roaring success since its introduction, despite the cost of about 300 million GBP over the first three years, which was the equivalent of 4.5 % of *Tesco*'s sales. These costs included an update in point-of-sale technology, the supporting computer system needed to handle the *Clubcard* data and a call centre which established a hotline. However, due to *Clubcard*'s success, *Tesco* has covered the costs of running its loyalty programme by a sales increase "directly attributable to the promotions that have been created by Clubcard" (Humby/Hunt/Phillips 2003, p. 5). According to many experts, the key ingredient which helped *Tesco* overtake *Sainsbury's* to become the United Kingdom's leading retailer, was the implementation of the CRM strategy based on *Tesco Clubcard* (Beckett/Nayak 2005, p. 8).

Greenshield Stamps

Mode of Function

The *Clubcard* scheme starts like other loyalty card schemes: customers pay a joining fee and receive their own card in exchange for personal details such as name, address, date of birth, family composition, dietary requirements and product preferences. *Clubcard* holders can then present their card at the check-out each time they go shopping and earn one *Clubcard* point (which is worth a penny) for every 1 GBP spent. Points can be earned either by shopping instore, at *Tesco petrol* or at *Tesco.com*. Furthermore, *Tesco* has acquired a number of so-called points partners since the launch of the loyalty scheme, so *Clubcard* holders can also earn points for their *Clubcard* while shopping at (or using the services of) the following partners: *Avis* car rentals, *Powergen*, *Marriott Hotels*, *Johnsons* dry cleaner, *Nationwide Autocentre*, *National Tyres and Autocare* and *The Nutri Centre*. Loyalty schemes like *Tesco Clubcard* are described as "single operator multi partner programmes" (Rowley 2004, p. 129). Once customers have purchased items worth at least 150 GBP, they can either cash them in at the next shopping trip or redeem them for numerous offers. Each quarter, the accumulated points are transferred into vouchers and mailed to the customers, as well as additional coupons which can be redeemed for specific products (Reynolds 2004a, p. 312). Apart from spend-

Single Operator Multi-Partner Programme

Vouchers

ing the vouchers at a *Tesco* store or for online purchases, the customer can also transfer them into *British Airways AirMiles.* For example, a 2.50 GBP *Clubcard* voucher is worth 60 *AirMiles*. Also, vouchers can be spent on so-called *Clubcard Deals* such as fun parks, museums, or restaurants. When used to order one of these *Deals*, the value of the voucher quadruples. Along with the customer's statement, the *Clubcard Magazine* is sent out four times a year. Even though delivering the vouchers and magazines by mail is more expensive for the company than e-mail, *Tesco* still uses postal service because of the "bigger uplift" (Spethlift 2004, p. 34) it entails for the company.

The vouchers are valid through two years, which is considered long enough for customers not to feel coerced into spending the vouchers before they want to, but also short enough so that *Tesco* does not build up excessive financial exposure, as it is the case with many airlines, where millions of unredeemed flyer miles accumulate as a growing liability. Since *Tesco* tries to stress the characteristics of a club, vouchers represent the club membership dividend (Humby/Hunt/Phillips 2003, p. 76).

Above-Average Redemption Rate

Currently, about 14 million British shoppers receive a statement from *Tesco* every three months (this equals about 35 % of UK homes in every mailing). The annual nominal amount of vouchers redeemed by customers is about 200 million GBP which corresponds to a redemption rate of about 20 %. This is an extraordinarily high number, compared to the industry average of about 0.5 %. This success was achieved to a great extent through a detailed analysis of the data acquired via the *Clubcard* (Spethlift 2004, pp. 33-34).

Use of Data

Customer Segments

The *Clubcard* programme is not only a loyalty card, but a comprehensive corporate philosophy and a complete business system. The data the *Clubcard* scheme provides to *Tesco* is used to drive crucial business decisions. Furthermore, it is estimated to have made *Tesco* into the "most sophisticated marketer in the world" (Spethlift 2004, p. 34). In 1995, however, the company was faced with the limitations of the IT technology at that time. Merely transmitting the data between *Tesco*'s IT department, where it was used to run the points accounting database, to *dunnhumby*, where it was analysed for marketing and business information use, took 30 hours, using the highest bandwidth connection then available (Stone 2003, p. 186). In the first three months, the data from more than 50 million shopping trips, comprising more than 2,000 million purchased items by more than five million *Clubcard* members, was collected.

Whereas today, the capacity for taking the information from every single shopping basket processed through the check-outs and analysing it is read-

ily available, in 1995, only 10 % of the weekly data was analysed and the findings were extrapolated to the other 90 % (Humby/Hunt/Phillips 2003, p. 97). State of the art data mining techniques were used to manage and analyse the created database. This analysis enabled *Tesco* to accurately pinpoint the time when purchases were made, the amount that was spent and the kind of products purchased.

Rolling Ball Method

Tesco used the data to segment its customers via the so-called rolling ball method, which is based on the notion that a person's shopping basket reveals much about the person's characteristics: "You are what you eat" (Reynolds 2004a, p. 317). In order to understand why customers purchase certain products, interpretating these goods through a "psychological lens" is necessary to reveal "hidden" desires, aspirations and fears expressed in the purchase of products (Beckett/Nayak 2005, p. 9). For this purpose, about 50 products were classified by rating about 20 characteristics on a two-tailed Likert scale. These product attributes included "low fat" against "high fat", "needs preparation" vs. "ready to eat" or "low price" against "high price", but also "adventurous", "exotic" or "fresh" (Humby/Hunt/Phillips 2003, pp. 153-154). This profiling method generates a map of the connotations for the goods. Since rating every product in the store by hand is an almost impossible task, 50 "obvious" products which clearly possessed the attribute or quality *Tesco* wanted to measure, such as pineapple for "exotic" or extra virgin olive oil for "adventurous", were chosen as a basis and a computer algorithm programme then took over.

Map of Connotations

The next step was looking at what other items customers who purchased these products bought, discarding common items such as eggs or milk. Based on the customer's behaviour, different consumer clusters could be identified. The combination of the rated product provides information about the customer's lifestyle and thus helps segment all customers. These groupings must be large enough to be cost-efficient, but "with a richness of common interest to be truly meaningful" (Spethman 2004, p. 34).

Store Brands According to Segmentation

Accordingly, *Tesco* was able to segment its customers into the categories of *Finer Foods*, *Healthy*, *Traditional*, *Mainstream*, *Convenience*, and *Price Sensitive* (see Table 11.3). The company then launched store brands targeting the identified segments. Currently, these store brands account for about 45 % of the company's total assortment.

The potential to use and exploit data from the *Clubcard* programme are substantial. By comparing an individual's shopping behaviour with the norm for that specific customer segment, variances can be identified. This analysis highlights not only undershopped departments, but also shows which products the individual is likely to want in the future, in order to exploit *cancelling* opportunities (Beckett/Nayak 2005, p. 10).

Customer Segmentation

Table 11.3

Category	Classification	Characteristics	Store Brands
Up-Market	Finer Foods	time poor, money rich, everyday luxury items	Tesco Finest, Tesco Fair Trade
	Healthy	fruits and vegetables, weight watchers, diabetic etc.	Tesco Organic, Tesco Healthy Living, Tesco Free From
Mid-Market	Convenience	people on the go, no time or inclination for cooking	Tesco
	Traditional	time to buy and prepare meals	Tesco
Cost Conscious	Mainstream	family type meals, kids products, popular brands	Tesco Kids, Tesco
	Price Sensitive	less affluent, tend to buy cheapest or display	Tesco Value

Source: Adapted from Coriolis 2004, pp. 13-14.

Marketing activities, and most importantly vouchers and coupons, are therefore a mixture of gifts and rewards for past and continued behaviour and also enticements for future behaviour (Reynolds 2004a, p. 315).

Mass Customisation

Tesco's data warehouse allows for considerable mass customisation. Whereas there are *150,000 variations of the Clubcard magazine* alone, based on life stages such as young families, empty nesters, etc. (Spethmann 2004, p. 39) the complete quarterly statement, with personalised letter, vouchers and coupons, is so carefully tailored for each recipient, that *Tesco* sends out around *four million variations* (Spethmann 2004, p. 33). For example, a significantly decreased amount of grocery shopping is a strong indicator of a forthcoming holiday; *Tesco* can now send the customer coupons for sunscreen lotions. The identified 5,000 "customer needs" subgroups allow the personalised "rifle shot" approach. *Tesco* strives to make its personalised customer communication as relevant for the individual as possible. Another finding from the analysis was that in every single store, the top-spending 100 customers were as valuable as the bottom 4,000. This led to the decision to run *invitation-only Clubcard events* in major stores as a way of thanking the most loyal customers (Stone 2003, p. 186). A number of clubs have also been created based on *Tesco*'s unique insight into the shopping habits of its customers:

Clubcard Clubs

- *Food Club*
- *Baby & Toddler Club*

- *Wine Club* as well as
- *Healthy Living Club*.

These clubs are free to all *Clubcard* holders and provide benefits such as free magazines, advice, coupons and special offers. Currently, about 800,000 people have become members and voluntarily offer more personal data and preferences.

Retailing Services

The *Clubcard* data has also helped *Tesco* to identify areas where customers are positively inclined towards online shopping and launched *Tesco.com* in 1997. Today, it is the world's leading grocery internet retailer with an average of 150,000 orders per week and a leap in profit of more than 50 % from 2004 to 2005 (Tesco 2006, p. 28). Since 2006, *Clubcard* vouchers can also be used for online shopping at *Tesco.com*.

Furthermore, the company has leveraged customer data obtained from its loyalty programme to diversify into non-food service offers (in a *micro-macro approach*):

- financial and banking services *Tesco Personal Finance* (TPF)
- *Tesco Telecoms*.

TPF is a 50/50 joint venture between *Tesco* and the *Royal Bank of Scotland* created in 1997 (Coriolis 2004, p. 28). Using information derived from *Tesco*'s loyalty card programme and blending it with externally-generated demographic data, the company conducted targeted research and developed profiles of customers who would be most interested in basic banking services or other options. *Tesco* found that it can acquire a financial-services customer for less than half of what it costs a bank. Currently, *Tesco* offers 17 financial products and services, such as a credit card, loans, mortgages, car breakdown cover, savings, travel money, car insurance, travel insurance, life insurance or pet insurance (Tesco 2006, p. 30). Since 2001, TPF is highly profitable and currently generates over 200 million GBP in profits with almost 5 million customers (Tesco 2006, p. 6). It is also the biggest online car insurer in the United Kingdom. Since 2003, the retailer also offers a wide range of telecommunication services, such as mobile (in a 50/50 joint venture with *O2*), home phone, broadband, dial-up internet access and internet phone. Around one million customers use these services (Tesco 2006, p. 6). These retailing services are a key feature of *Tesco*'s growth strategy (see Figure 11.4) and their successful implementation was achieved through *Clubcard* data. Customers can also collect *Clubcard* points from selected services, e.g. when paying with TPF Credit Card, on mobile, home phone, and broadband.

Outcome

For many experts, *Tesco Clubcard* has been the driving force behind the company's transformation from its "pile it high and sell it cheap" to a customer value strategy which helped the company to become the world's fifth largest retailer (McKelvey 2005, p. 13). Only two months after the introduction of the loyalty scheme, *Tesco* became the UK market leader. One year after the launch of the loyalty scheme, *Clubcard* holders were spending 28 % more at *Tesco* and 16 % less at *Tesco*'s arch rival *Sainsbury's*. In 1998, *Tesco* and its agency *dunnhumby* received the silver IDM Business Performance Award for the *Tesco Clubcard* campaign (Marketing Week 1998, p. 77). Currently, half of all British households are *Clubcard* holders.

However, a main characteristic of the *Clubcard* loyalty scheme is its dynamic nature. As customer habits change, so do *Tesco*'s business decisions which are based on ongoing *Clubcard* data. This implies the need for constant innovations such as the *Christmas Savers Club*, which was launched in 2005 and allows customers to save their *Clubcard* vouchers to help with their Christmas shopping. Due to a decline in *Clubcard* use of two per cent at the end of 2003, *Tesco* decided to relaunch its loyalty scheme in May 2004 (Marketing Week 2005, p. 89). The company introduced smaller, personalised *Clubcards* which can be attached to a keying, making it easier for customers to remember their cards. Furthermore, the new cards have a bar-code in order to provide customers with a quicker and more convenient way of collecting their points (Tesco 2006, p. 8). Reportedly, the bar-coded cards allow for quicker scanning by the check-out staff; the resulting increase in productivity is supposed to be worth nine million GBP a year (Marketing Week 2005, p. 89).

Summary and Outlook

Even though many competitors have tried to copy or introduced similar customer loyalty schemes, such as *Sainsbury's Nectar-Card* (introduced in 2002 as the *Reward Card* successor), *Safeway Added Bonus Card* (which was abandoned by the company in 2000), *Asda Style Card* and, most recently, *Boots Advantage Card*, *Tesco Clubcard* remains the one which has set the pace for followers (McKelvey 2005, p. 13). Numerous indicators illustrate *Clubcard*'s success. One of the most impressive is that, while *Tesco*'s floor space in the United Kingdom has only been rising by 15 % since the introduction of the loyalty scheme in 1995, market share is up by 52 % (Reinartz 2006, p. 372). The strong customer focus has proven a very successful concept in creating value for the customer and profit for *Tesco*. Currently, the company is estimated to retain "a seemingly unbeatable position at the top of the market" (Datamonitor 2005c, p. 12). However, *Tesco* lost its position once as UK market leader to *Sainsbury's* in the 1970s. By withstanding the challenge

of the numerous followers in loyalty schemes, *Tesco* must now prove that it indeed offers more value to its clientele and in a sustainable manner.

In February 2006, *Tesco* announced its plans for an entry into the US market in 2007. The retailer will operate on the West Coast, not using the brand name *Tesco*, however, and expects to break even within three years. It remains to be seen whether *Tesco* will be able to replicate its home market success in the very competitive US market and whether it will also use its loyalty scheme.

Questions

1. How could data be gathered via the *Clubcard* and then be used? Give some detailed examples.
2. Do you think it is possible for *Tesco* to replicate the success of its customer loyalty programme in the home market to other countries? Discuss critically.
3. Compare *Tesco*'s *Clubcard* programme with another CRM tool such as a stamps scheme, e.g. the one *Tesco* used in the 1960s and 1970s.

Hints

1. See Humby/Hunt/Phillips 2003, pp. 95-112, for details of the exploitation of *Clubcard* data for marketing purposes.
2. See, for example, Alexander 1997, pp. 29-37, on the limits of the internationalisation of retailing.
3. See Humby/Hunt/Phillips 2003, pp. 40-42.

Part IV

Buying, Logistics and Performance Measurement

Chapter 12

Buying - Strategy and Concepts

The objectives of this Chapter are to look at the characteristics and instruments of retail buying, to discuss traditional and non-traditional forms of buying and to contrast different buying situations. The last part of this Chapter describes a multi-channel sourcing approach.

Merchandising Philosophy, Changing Buyer-Seller Relationships, and Buying Strategy

The buying strategy of retailers is influenced by the merchandising philosophy and target relationship between the retail company and manufacturers (suppliers). "A merchandising philosophy sets the guiding principles for all the merchandise decisions that a retailer makes. It must reflect target market desires, the retailer's institutional type, the marketplace positioning, the defined value chain, supplier capabilities, costs, competitors, product trends, and other factors. The retail merchandising philosophy drives every product decision, from what product lines to carry to the shelf space allotted to different products to inventory turnover to pricing – and more" (Berman/Evans 2007, p. 408). The merchandising philosophy determines the breadth of the assortment (narrow or wide) and the depth of the assortment (deep or shallow) within each category. In addition, retailers "must select the quality of the items within the assortment – high or low, national brands or store brands. They need to decide on their pricing policies, across categories and within. Finally, retailers must decide if assortments should generally be stable over time or whether there should be surprises, specials, or customization in assortments" (Kahn 1999, p. 289). These issues are all discussed in Chapter 8.

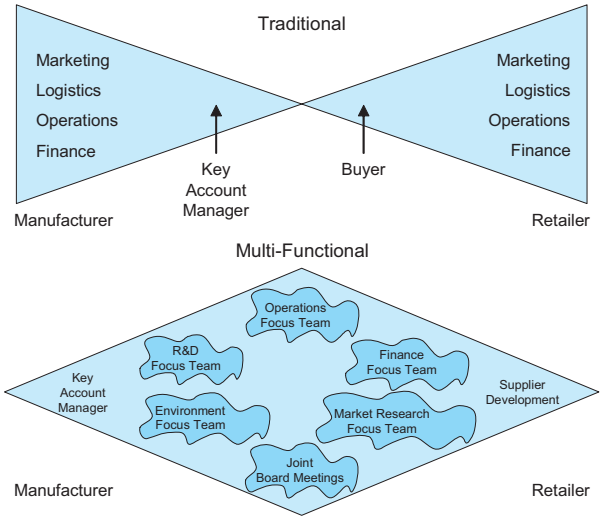
Driving Forces

The nature of relationships in the supply chain is another important factor for buying or *sourcing decisions*. The relationships between retailers and manufacturers are changing: from adversarial to *collaborative relationships* (Bartsch 2004). This leads to a shift from short-term buying to long-term buying, from a price focus to a total-cost focus, including all costs within the buying process. This represents a major paradigm shift in buying, away from the traditional transactional view of exchange (Fernie 2004b, p. 26). This collaborative relationship approach is discussed in Chapters 13 and 14 in the context of *efficient consumer response* (ECR) initiatives.

Supplier Relationship Management

The changing relationships in the supply chain have also transformed the interface between manufacturers and retailers (see Figure 12.1; Hertel/Zentes/Schramm-Klein 2005). Traditionally, there has been a bilateral interaction between the buyer from the retail side and the key account manager from the manufacturer side. Currently, multi-functional teams from both sides interact with one another. Key account managers and category managers, responsible for *supplier development*, also coordinate or orchestrate these activities.

Figure 12.1 *Transformation of the Interface Between Manufacturer and Retailer*



Source: Fernie 2004b, p. 39.

Electronic Marketplaces

In addition to this tendency, the traditional *transaction focus* still exists. Interestingly, the process of closely connecting with vendors and cooperation runs parallel with transactional exchanges, for example through *Internet exchanges* (Zentes/Bartsch 2002). "One of the most innovative and potentially useful developments stemming from retailers' growing level of sophistication with the Internet is retail exchanges. *Retail exchanges* are electronic marketplaces operated by organisations that facilitate the buying and selling of merchandise using the Internet. They provide an opportunity for vendors and retailers to interact electronically rather than meet face to face in a physical market" (Levy/Weitz 2004, p. 448).

Sourcing Toolbox

The buying decisions can be systematised by the so-called sourcing toolbox (see Table 12.1). This box describes the strategic options and concepts by eight dimensions.

Sourcing Toolbox

Table 12.1

Source	company-owned		outside supplier
Interacting with Merchandising Source	active		passive
Supplier Relationships	transactional		collaborative
Stocking Merchandise	stock	stock reduced	stockless
Geographical Market	local/national		international/global
Mode of Buying	individual		cooperative
Organisational Form	internal		external
Technological Form	traditional		electronic (web-based)

Source: Adapted from Arnold 1998.

Merchandise Sources

With regard to merchandise sources, there are two major options:

- company-owned suppliers
- outside suppliers.

Company-Owned and Outside Suppliers

Company-owned means that a retailer owns a manufacturing and/or wholesaling facility. *Outside suppliers* are not owned by the retailer. Two basic kinds of outside suppliers can be identified: regularly-used suppliers and new suppliers (Berman/Evans 2007, p. 442). In the case of a *regular supplier*, the retailer knows the quality of merchandise and the reliability of the supplier. In the case of a *new supplier*, the retailer is unfamiliar with the quality and reliability. The types of outside suppliers are described in Table 12.2.

Interacting with Merchandising Sources and Supplier Relationships

Through *active sourcing*, the retailer exerts an influence on outside sources with regard to product development and product improvement, including packaging, etc.

Passive sourcing means that the retailer buys goods from manufacturers and/or wholesalers that have been developed and produced independently. This situation is typical of the buying process for manufacturer brands (national brands or global brands).

Table 12.2 *Outside Sources of Supply*

Source	Characteristics
1. Manufacturer	Physically produces goods, may provide shipping and credit.
2. Full-Service Merchant Wholesaler	Buys goods from manufacturers, performs many services for retailer (shipping, storing, credit, information etc.).
a. General Merchandise	Carries a very wide assortment.
b. Specialty Merchandise	Carries a very deep assortment.
c. Rack Jobber	Brings and sets up own displays, usually deals with nonfood items in supermarkets and other stores, may be paid after merchandise is sold, convenient for store.
3. Limited-Service Merchant Wholesaler	Same as full service, except that fewer retailer services are provided and costs are lower.
a. Drop Shipper	Buys and sells via the telephone (never physically handles the merchandise), major task is connecting buyer and seller.
b. Mail Order	Catalog sales to small retailers.
c. Cash-and-Carry	Store where small retailers buy and take merchandise.
4. Agents and Brokers	Do not take title to goods (ownership remains with manufacturer), provide a variety of functions for a fee or commission, includes auction companies, salespeople, and selling agents.

Source: Adapted from Berman/Evans 2007, p. 443.

Store brands are products developed by a retailer and available for sale only from the retailer. The retailer exerts the greatest influence with respect to these products. The store brands are produced by company-owned manufacturing facilities or by outside manufacturers (store brand manufacturers or private label manufacturers).

Transactional Relationships

Transactional relations are typical in short-term buying, for example, in buying commodities, such as stationery (see section "Sourcing Cluster 2" in this Chapter).

Collaborative Relationships

In such a situation, the price (given a stipulated quality) is the dominant factor in selecting suppliers. *Collaborative relationships* exist with store brand manufacturers in terms of marketing and logistics and to a growing extent with brand manufacturers, and use is made of ECR concepts of category management and supply chain management.

Stocking Merchandise

Stock and Stockless

With regard to logistics and supply chain management, three types of sourcing options can be described. *Stockless* means that the manufacturer delivers to the outlets of a retailer and/or a transit terminal/cross-docking terminal of a retailer according to the *just-in-time* philosophy. This implies collaborative relationships using, for example, electronic data interchange (EDI) for replenishment (see Chapters 13 and 14). *Stock* characterises a kind of sourcing for which the products are stored in one central or in several regional warehouses. This situation is typical for commodities bought in foreign countries, for example (huge quantities with low prices).

Stock reduced lies in between the two extremes. Through the use of modern concepts of supply chain management, such as vendor-managed inventory (VMI), stock volume decreases, but the service level remains constant or even increases ("never out of stock").

Geographical Market

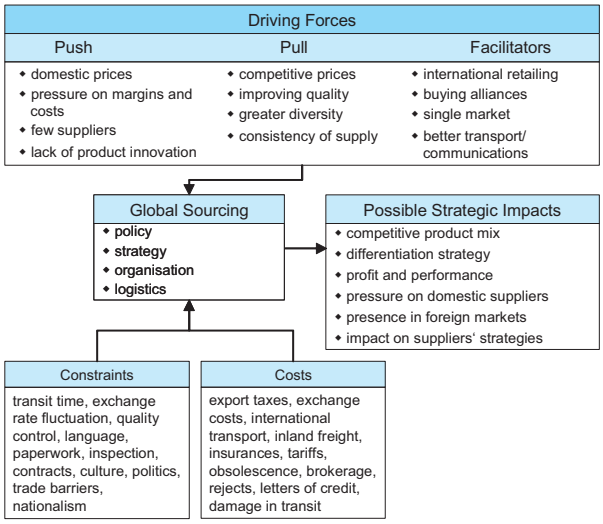
An important decision is to determine where the merchandise is produced and/or bought: local/national vs. international/global sourcing.

National and International Sourcing

International or *global sourcing* can currently be characterised as a megatrend in retailing. "A demonstrable reason for sourcing globally rather than domestically is to save money" (Levy/Weitz 2004, p. 442). Drivers of this tendency are tariff reductions on manufactured goods pushed by the *World Trade Organisation* (WTO) in the context of liberalisation of trade and the establishment of free trade zones like the *North American Free Trade Agreement* (NAFTA) or common markets like the *European Union* (EU). Retailers involved in foreign sourcing of merchandise can benefit from the cessation of tariffs in such zones. However, international sourcing costs must be calculated thoroughly: "Superficially, it often looks like retailers can get merchandise from foreign suppliers cheaper than from domestic sources. Unfortunately, there are a lot of hidden costs, including managerial issues, associated with sourcing globally that make this decision more complicated" (Levy/Weitz 2004, pp. 441-442).

Costs associated with global sourcing decisions are tariffs, foreign currency fluctuations, inventory costs, and transportation costs (see Figure 12.2). A more serious problem can occur if the vendor violates human rights. To avoid such problems, retailers require its suppliers to sign *codes of basic labour standards* and implement *auditing systems*.

Figure 12.2 *Costs and Benefits of Global Sourcing*



Source: Liu/McGoldrick 1995, p. 102.

Abuses of human rights and child labour are leading to the increasing importance of *corporate social responsibility* (CSR) in retail companies (Zentes 2006). Policing potential violations of human rights is easier when sourcing is closer to home (Levy/Weitz 2007).

Mode of Buying and Organisational Form

Individual and Cooperative Buying

A retail company chooses either an individual or a cooperative buying mode. In cooperative buying, a group of retailers (independent retailers, small chains as well as large chains) bundle their purchasing volumes to obtain volume discounts from suppliers. For example, the alliance *European Marketing Distribution* (EMD) comprises 16 buying groups and large chains across Europe (see Table 12.3). The main tasks of EMD are bulk buying, European-wide label offering, sales promotion campaigns, launches of new products and product ranges.

Inside and Outside Buying Organisation

Retailers must also choose whether to have an *inside buying organisation* or an *outside buying organisation*. This decision is closely connected to the mode of buying. In cooperative buying, the office of the buying group is involved in trend identification, product design and development, product sourcing, quality assurance, order tracking and delivery (Berman/Evans 2007).

Members of EMD

Table 12.3

Country	Member	Turnover in million EUR	Market Share in %
A	ZEV Markant	2,661	13.6
B	Delhaize Le Lion	3,900	17.0
CZ	EMD Markant	1,326	13.6
D	Markant	38,700	18.4
DK	SuperGros	5,663	31.0
E	Euromadi	10,637	15.2
FIN	Tuko Logistics*	1,631	14.3
GB	Nisa Today's*	7,200	8.8
GB	Musgrave/MBL	2,100	1.1
GR	Delhaize/Alfa Beta	935	10.4
I	ESD Italia	13,738	15.9
IRL	Musgrave	3,200	21.4
NL	Superunie	6,900	25.7
RO	Mega Image	98	15.9
S	Axfood	4,001	18.2
SK	EMD Markant Slovakia	450	8.5
	Total EMD members	*103,140*	*14.2*

* Figures from 2003.

Source: EMD 2006.

However, an outside buying organisation can also be hired in the case of individual buying. For example, within a category, all merchandising functions are transferred to a specialist who operates as a full-service supplier (e.g. a rack jobber, see Table 12.2). Another example relates to outside organisations specialised in global sourcing. They have buying offices worldwide and thus a better sense of foreign markets and merchandise sources.

Technological Form

Traditional and Web-Based Buying

Closely connected to the organisational form of buying is the question of whether to choose the web (Internet) as the basic platform for transactions, or rather traditional modes. *Web-based buying* means that an electronic platform is used to negotiate the purchase and terms (delivery date, quantity purchased, price and payment agreements, discounts, form of delivery), to run (*reverse) auctions* and to place orders.

Regular connections with suppliers through electronic data interchange (via the Internet or direct PC connections and other means) to transmit order data or to receive invoice data in the context of order processing and fulfilment is also used in *traditional buying*.

In this case, the Internet (or another technology) is the basis for *operational data interchange*, but not for the selection of suppliers and business negotiations. This remains a face-to-face process.

Multi-Channel Sourcing

The manifold instruments of retail sourcing are not applied in a standardised way for the complete product assortment, but, depending on the situation, in terms of a multi-channel system, subject to the requirements of the supply and sales markets. For the sourcing of some product ranges, it makes sense to use electronic media, but for others, there is no virtue in doing so, because, for example, there are no product standards. In addition, the question arises of whether a product should be purchased nationally or rather internationally when using electronic marketplaces. Requirements such as product quality and supplier reliability are very important for this decision.

The decision about cooperative sourcing also cannot be made unanimously over the entire product range of a company. Whereas this seems to make sense in many cases, e.g. for bundling demand or for using logistics services, cooperative sourcing may in fact be counterproductive and lead to price increases, for example in markets with an extremely low supply the emergence of surplus demand.

Competitive Advantages

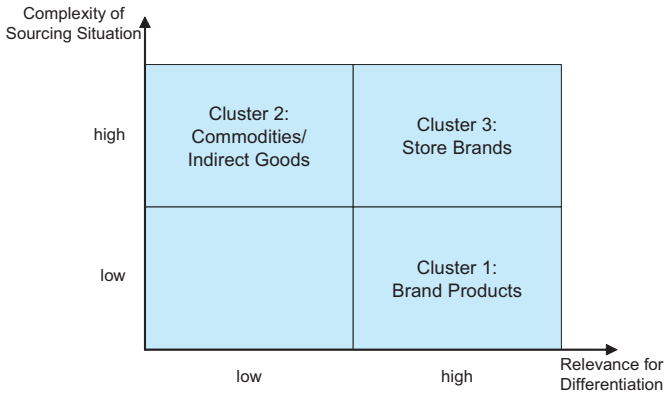
The sourcing conditions in retailing are characterised by an enormous number of articles and a high assortment dynamic. Nevertheless, the manifold situations can be simplified into three sourcing situation clusters resulting from the combination of the two dimensions "Relevance for Differentiation" and "Complexity of Sourcing Situation". Those two dimensions take into account the supplier market on the one hand, and the sales market on the other. From the *category management* perspective, the relevance for differentiation, i.e. the importance of a certain product for creating a distinctive image which differentiates the retailer from its competitors, aims at the relevance ("role") of a category or product group (see Chapter 8).

In simplified terms, the relevance for differentiation can be classified as "high" (e.g. categories in the "destination role" or in the "routine role") or "low" (e.g. categories in the "convenience role"). The relevance for differentiation is likewise influenced by the complexity of consumer needs which become manifest in sensitivity with regard to quality requirements (e.g. food safety), to product involvements ("high interest" vs. "low interest") and the continuity of needs (e.g. effects of fashion trends and seasonal fluctuations).

The *complexity* of the sourcing situation, which can be classified as "high" as well as "low", is also characterised by different influence factors. Questions within the frame of complexity of the sourcing situation, refer to the transparency of possible supply sources and the number of (potential) suppliers. However, the importance of the geographical displacement of suppliers (national sourcing vs. direct import) as well as the level of concentration and the productive capacity of suppliers (manufacturers), have to be considered in this context as well. This point of view creates three typical and empirically relevant sourcing situations which are described in more detail below (see Figure 12.3).

Sourcing Clusters

Figure 12.3



Source: Zentes/Bartsch 2002, p. 44.

Sourcing Cluster 1: Brand Products

Sourcing cluster 1 is characterised by high significance of the products for differentiating the retailer from its competitors, and at the same time by low complexity as far as the supply market is concerned. This situation is typical for many brand products which are often indispensable for the development of the merchandising competence of the retailer. Here, however, in most cases, only a few national or international providers (brand product manufacturers) with strong brands – often global brands – are available as suppliers. Furthermore, these are mostly categories with a high sourcing volume and a high turnover speed.

ECR Approach

It must be assumed that sourcing cluster 1 yields high potential for supply chain management partnerships, because the basic patterns of the ECR approach in the 1990s were based on this cluster. Accordingly, this sourcing cluster should currently describe starting points for continuing ("advanced") collaborative forms of supply chain management – such as VMI, CRP or CPFR – in order to obtain win-win situations (see Chapter 14). Traditional forms of electronic data exchange and newer web-based forms of cooperation are, in this case, an indispensable requirement.

Whereas, in this cluster, the supply market shows only low complexity, sourcing is generally very important, with regard to sourcing and sales volume (A and B products), gross margin, etc. Negotiations between manufacturer and retailer on price and other terms, whether traditionally or electronically, will not lose significance in the future. However, new fields of negotiation will emerge, such as logistics and inventory management. There will also be a trend towards assuming that personal interaction will continue to prevail in this field, even if the technological development of communication possibilities continues. Yet, obtaining *win-win situations* through collaborative supply chain and category management requires interaction between different functional actors on both sides, which goes way beyond the classical dyad of seller and purchaser (see Figure 12.1).

Sourcing Cluster 2: Commodities/Indirect Goods

In contrast to sourcing cluster 1, sourcing cluster 2 is characterised by low relevance for differentiation, but high sourcing complexity. In most cases, this is valid for a large number of articles, usually with low sales importance (C products), for which there is a multitude of suppliers generally scattered worldwide. There is normally no transparency with regard to potential procurement sources. Furthermore, the importance of brands is either not given at all or is low (anonymous products or labels, no real brands) and sensitivity to quality is also low. This situation prevails for commodities, but generally also for indirect goods, i.e. goods which are not sold, but used in retail operations. Examples are photocopy paper or laptops for the personal use of food retailers (like maintenance, repair, operating (MRO) goods of manufacturers).

Outsourcing

Because of the low relevance for differentiation, the question of a potential outsourcing of procurement arises in this cluster, for example by bringing in system suppliers. In general, these suppliers are responsible for the operative sourcing of a complete category in the sense of a classic *rack jobber* (see Table 12.1). Manufacturers who complete their own product assortment with additional merchandise, and wholesale companies can be considered as *system suppliers*. In this connection, the reduction of general procurement

costs, that is the reduction of purchases (at cost) and process costs, is a dominant target.

Sourcing Cluster 3: Store Brands

Sourcing cluster 3 yields high relevance with regard to both dimensions - the complexity of the sourcing situation on the one hand and customer-oriented relevance for differentiation on the other hand. For example, this situation applies to store brands for which retailing is largely integrated into the value-added chain, for example with regard to product development and supply chain management.

Value-Added Chain

This sourcing cluster offers important potential for increasing effectiveness and efficiency by extensively combining value-added chains, for example, in the form of collaborative product development or collaborative supply chain management. The potential offered by these characteristic forms should exceed the potentials of ECR partnerships in sourcing cluster 1, because their level of integration is higher. At the same time, the following dimensions play an important role: quality, speed of turnover, reliability and innovative strength of suppliers, together with high supplier complexity.

Conclusion and Outlook

Starting from multi-channel sourcing and the current strategic basic trends in retail sourcing, new responsibilities are increasingly emerging for traditional buying. There are also shifts with regard to the organisational relevance of various sectors. This results in changing requirements as far as future buyers are concerned.

In general, a consistent customer orientation is reflected in the company's organisation in such a way that marketing and sales gain influence, whereas the importance of buying tends to decline. On the other hand, the growing process orientation is reflected in the changing nature of annual retailer-supplier negotiations. Whereas price negotiations have so far been of prime importance within the frame of traditional buying, the importance of other terms – particularly conditions with regard to logistics and marketing, combined with a customer-oriented management of the supply chain according to the supply chain management philosophy – is rising with the transition of many manufacturers to purely net prices.

Within the context of optimising the synergy potential of retail businesses by bundling the volume of purchase across countries and sales formats, international purchasing organisations are increasingly emerging which coordinate

sourcing across the group or the company. In the course of international sourcing, the relevance of specialised knowledge in the field of quality assurance is also growing.

The introduction of e-procurement is also leading to an extensive change with regard to both organisational and personal aspects, and as far as the corporate culture is concerned. In this regard, the learning aptitude of the company as a whole is also relevant. Thus, it is generally necessary to organise or reorganise purchasing and sourcing processes in the context of electronic sourcing and to ensure compatibility with previous systems with the help of standards.

Further Reading

FERNIE, J.; SPARKS, L. (Eds.): Logistics and Retail Management, 2nd ed., London et al.

MOORE, C.M. (2005): The Anatomy of Retail Buying, in: BRUCE, M.; MOORE, C.M.; BIRTWISTLE, G. (Eds.): International Retail Management, Amsterdam et al., pp. 64-77.

Case Study: Kingfisher[1]

Profile, History, and Status Quo

Since the demergers of *Woolworth's* in 2001 and *Kesa Electrics* in 2003, *Kingfisher Plc* has undergone a transformation from a highly diversified retail company with general merchandise, electrical and DIY business to a "single-sector strategy" (Hirschkorn 2004, p. 45) with a strong focus on its core business of home improvement.

The London-based *Kingfisher* is currently generating 8 billion GBP in annual sales, which makes the company Europe's leading home improvement retailer and the third largest in the world after *Home Depot* and *Lowe's*. The group's main retail brands/store formats are:

1 Sources used in this case study include the web sites www.kingfisher.com and www.kingfisherasia.com.hk, information from B&Q's Direct Sourcing Office, miscellaneous annual reports and investor relations presentations as well as explicitly cited sources.

- *B&Q*
- *Castorama*
- *Brico Dépôt* and
- *Screwfix Direct*.

Furthermore, *Kingfisher* owns a 21 % stake in *Hornbach*, Germany's leading DIY warehouse retailer with about 120 stores across Europe. The formats are distinctive and offer different customer propositions. For instance, *Castorama* is a broadly-based, mass-market retailer with large stores stocking wide ranges of products, whereas *Brico Dépôt* is aimed at the serious DIY enthusiast, with smaller stores emphasising the building trade and renovation markets. *Brico Dépôt* concentrates on stocking large volumes and essential products and tools, but, unlike *Castorama*, offers only few decorative items and has no garden centres (Murphy 2006, p. 16).

In 2005, about 48 % of all sales were generated outside the home market, the United Kingdom, and the group operates nearly 650 stores in 11 countries in Europe and Asia (see Table 12.4 for an overview of the group's portfolio).

Overview of Kingfisher Plc (2005)

Table 12.4

Country	Retail Brand	Market Position	Number of Stores	Number of Employees
United Kingdom	B&Q/Screwfix Direct	1/1	322	28,700/1,450
France	castorama/Brico Dépôt	1	102/67	13,150/4,800
Italy	castorama	2	26	1,700
Poland	castorama	1	27	4,900
Spain	Brico Depôt	N/A	7	250
Ireland	B&Q	N/A	3	360
Germany	21 % stake in Hornbach	1	120	9,400
China	B&Q (controlling majority interest)	1	48	5,300
Taiwan	B&Q (50 % joint venture)	1	19	1,800
Turkey	KOÇTAŞ (50 % joint venture)	3	5	430
South Korea	B&Q	entry in 2005	1	N/A
Russia	B&Q	entry in 2006	1	N/A

In June 2005, the group acquired all 13 *OBI* stores in China and is currently in the process of integrating the re-branded *B&Q* stores. This action is strengthening the strategically important Chinese market.

Within the scope of the group's international growth strategy, potential country markets must fulfil a number of requirements such as a large and growing market, organic growth capability and the realistic ability to become the market leader or number two of the country's home improvement industry (Kingfisher 2004b, pp. 36-37).

Kingfisher's Buying Power Strategy

In order to be able to constantly offer the best value at the best price to its customers, *Kingfisher* has adopted a strategy which consists of harnessing the group's scale and international reach on the one hand and emphasising the international diversity on the other hand, especially in terms of store formats, brands, people and range development. The element of this strategy that strives for group-wide scales in terms of buying power is based on the following fundamentals:

- direct sourcing from local factories
- strategic supplier management (SSM)
- group buying in key product categories
- development of *Kingfisher's* store brands.

Direct Sourcing

Goals of Direct Sourcing

The group's aims in increasing direct sourcing are

- to develop direct relationships with manufacturers
- to exert greater control over the entire supply chain by removing agents and importers and
- ultimately to reduce costs, the benefits of which can be passed on to customers in the form of lower prices.

Direct Sourcing Offices in Different Countries

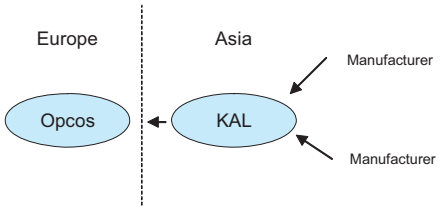
In 1994, the first direct sourcing office called *Kingfisher Asia Limited* (*KAL*) was opened in Hong Kong, complemented by a satellite office in Shanghai in 2000. The group currently owns direct sourcing offices in Milan/Italy, Warsaw/Poland, Pietermaritzburg/South Africa as well as an agency arrangement in India. The total amount of direct shipments totalled over 575 million USD in the fiscal year 2005, up 40 % compared to the previous year and boosted by a 44 % increase in *Kingfisher's* businesses outside the home market (Kingfisher 2006, p. 3). Direct shipments are expected to amount to 800 million GBP in 2007. In the fiscal year 2005, which ended in January 2006,

some countries achieved an enormous increase in direct sourcing, e.g. Italy, where direct sourcing was up about 200 % compared to the previous year. In Poland, the year-on-year increase in direct sourcing amounted to 300 %. At *Castorama France*, the participation in direct sourcing was up to 7 % in the fiscal year 2005, which equals a three-fold increase over the last two years.

With a share of 85 % of the group's direct sourcing volume, *KAL* is by far the largest overseas sourcing office and also *Kingfisher's* largest "supplier". Figure 12.4 illustrates the mode of function of *KAL*, with „Opcos" signifying "operating companies".

Mode of Function of KAL

Figure 12.4



Source: Kingfisher Plc 2004a, p. 9.

Tasks of Direct Sourcing Offices

The responsibilities of the direct sourcing offices comprise tracking supplier performance, negotiating prices with suppliers and ensuring the highest quality products. *KAL's* prime task is to source an increasing volume of products directly from manufacturers in the Asia Pacific region, while guaranteeing the reliability of suppliers and ensuring that suppliers conform to the group's quality as well as ecological, ethical and social requirements. Since its set-up in 1994, *KAL* has grown rapidly as the *Kingfisher* group has expanded across Europe. It now exports to subsidiary companies and strategic partners in France, the United Kingdom, Germany, Italy, Poland, Turkey, Taiwan and China. The main product categories that *KAL* supplies include heating & cooling, power tools, and garden leisure.

At *B&Q*, for example, direct sourcing is used in the case of high volume lines which are offered regularly, as well as one-off buys for promotions and events such as Christmas and Easter. However, certain kinds of products (e.g. paint) are not sourced directly at all, for technical and logistical reasons. For products which are not sourced directly, *B&Q* employs a variety of importers, manufacturers, agents, and sourcing companies. Importers are used especially if the risk of a very new and innovative product is too high for the company to bear.

Web-Based Reporting Tool

In 2002, a complex web-based reporting tool was implemented by *SAS Solutions for the Retail Industry* in order to track supplier performance. It was also intended to monitor the reliability of vendors, their on-time performance and ability to ship the full ordered quantities and deliver the agreed service and quality levels of goods. The technology provides access to information and data within seconds via the intranet in order to conduct comparisons or analysis.

Users can also drill-down and analyse data in various dimensions which facilitates fast feedback for forecasting and purchasing decisions. Furthermore, the technology is used at various levels throughout the company, including senior managers and merchandisers, i.e. the front-line people. The technology is strategically important because it can improve group margins even when sales are under pressure (SAS 2004).

As a means of strengthening its direct sourcing ambitions, *Kingfisher* established a quality control office in Indonesia in 2005 and plans to open a full sourcing office in Thailand in late 2006.

Strategic Supplier Management Programme (SSM)

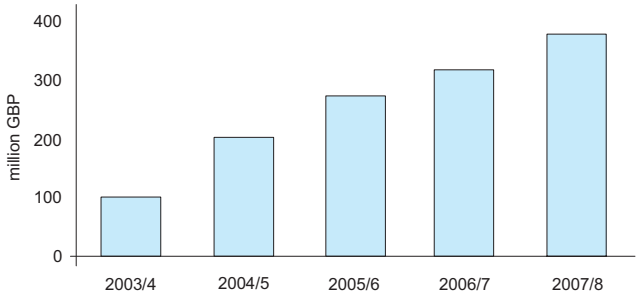
In 2003, *Kingfisher* established its so-called Strategic Supplier Management Programme (SSM). The core of this initiative relates to the scale of the group as Europe's largest home improvement retailer. This scale can be used to gain the best value and innovative products for the company. SSM is based on the group-wide Cost Price Reduction Programme (CPR) and aims to make *Kingfisher's* relationships with its suppliers closer and longer-term in order to ensure more innovative products and more exclusive ranges. The programme especially seeks to establish medium-term agreements and relationships with a limited number of key suppliers, especially local ones. Some successful examples are already evident: *Soudal*, a French business which has been supplying *Castorama France* with sealants, will now supply the whole group; *Hozelock*, a supplier to *B&Q* in the United Kingdom, is now supplying *Koçtaş* in Turkey.

When the programme was implemented in 2003, the group had about 9,000 different suppliers, the top 200 of whom accounted for approximately 60 % of all purchases. The SSM programme was expected to decrease the total number of suppliers to 5,000 with the top 200 supplying 70 % of all purchases. Two years after the implementation, the top 100 suppliers already accounted for 50 % of group costs of all goods sold.

The cumulative cash benefits from SSM are expected to reach 1 billion GBP within 5 years of the programme's launch (see Figure 12.5).

Estimated Cash Savings from SSM

Figure 12.5



The benefits are tracked monthly in order to ensure efficient controlling. Up to 75 % of the cash saved is re-invested in the following areas:

- competitive pricing
- instore service
- store modernisation
- new infrastructure and
- new stores.

In order to perform such controlling, each operating company currently has or is developing its SSM team consisting of expert staff who support the buyers. Among other responsibilities like operating common processes, these teams encourage and ensure the sharing of best practice within the group. Working closely with strategic suppliers, SSM teams have a long-term focus and look not just at the current year's product needs, but also at those of the next five years. They also help secure more innovative and exclusive product ranges for *Kingfisher* customers.

As a result of the SSM introduction, long-term agreements with suppliers now account for 32 % of *B&Q's* product buying by value and 7 % in *Castorama France*. These values demonstrate the future potential for improvements, resulting in the expected cash savings (see Figure 12.5).

Online Auctions

Online auctions for supply contracts are now being used in the United Kingdom, France and China, with two e-auctions in China resulting in 20 % cost savings. New supplier systems are being introduced; including an internet portal which enables manufacturers to share real-time information with *Kingfisher's* operating companies. Since the group discovered that many suppliers dislike online auctions, they need to be fully integrated in the group's SSM programme in order to tap the negotiating tool's full potential.

Kingfisher estimates that online auctions can and will be used not only for so-called commodity items in the future, but that the tool provides a much greater scope for exploitation.

Group Buying in Key Product Categories

Kingfisher tries to take advantage of areas in which consumer preferences are very similar and have converged across countries and cultures. Where standardised products can be offered, combined sourcing can reduce costs tremendously. These standardised products include:

- paint
- hard floorings
- power tools
- adhesives
- sealants (Murphy 2006, p. 19).

With group-wide buying activities in these categories, a group margin of about 40 % can be earned. All European companies including *Hornbach* are involved in group buying for these key products. The common buying processes build on the following policies, which were developed by *B&Q* and *Castorama* and have been adopted group-wide:

- buy from best-in-class supplier
- commit business to these suppliers with extended timeframes, agreed plans and targets
- continuously benchmark to monitor performance
- hold regular face-to-face reviews (Kingfisher 2005a).

Since *Kingfisher* stores sell a significant amount of timber as well as products manufactured from wood, the company implemented group-wide buying standards in 2005 in order to ensure that timber is sourced from well-managed forests certified by the *Forest Stewardship Council* (FSC) or equivalent schemes (Kingfisher 2005b, p. 11) and these are codified in its social responsibility report.

Store Brands

Functions of Store Brands

Whereas direct sourcing, the SSM programme and group sourcing are aimed at cost reduction in order to offer competitive prices, the development of exclusive store brands is an opportunity to contribute to value added. There-

fore, an avowed target of *Kingfisher* is to increase the share of its own brands in total sales, in order to reinforce trust and confidence in the brand, and to *differentiate the group from competitors* in the home improvement industry (Howard 2004b, p. 214). Furthermore, what makes store brands attractive to *Kingfisher* is the fact that the whole supply chain is controlled by the company, including product specifications and production costs. Therefore, *Kingfisher* can set a price which is in tune with the respective local market. According to the differing local market conditions, the own brand strategy is applied differently in various countries (Bell 1999, p. 17). In China, for example, where many big manufacturer brands are already available in the marketplace, but still account for only a small proportion of total turnover, emphasising store brands is very important (Howard 2004b, pp. 213-214).

Store Brand Product Categories

Around the year 2000, the store brand paint range *Colours* was introduced throughout the United Kingdom, at *Castorama France* and *Brico Dépôt*. Within three years, a 7.4 % saving of costs of goods sold could be achieved and the number of suppliers reduced by 50 %. Categories in the paint tender include an entry price level, coloured emulsions, masonry and gloss paint as well as decorative products. Currently, *Colours* is also being sold in China and Taiwan and launches are planned for 2006 in most of *Kingfisher's* other operating companies. Furthermore, new power tool ranges, under the brand names *Performance Power* and *MacAllister*, have been rolled out across the group. These store brands are sourced directly, mostly via *Kingfisher Asia Limited*. *Kingfisher* has been able to harness its supply chain knowledge in China and its experience with air conditioning sales in Taiwan and Turkey to develop new, low-cost store brand air conditioning systems which are sold under the brand name *AirForce* at *B&Q* stores in the United Kingdom and at *Castorama France* under the name *Bodner & Mann*.

In 2005, *Kingfisher's* group-wide cumulated own-brand penetration reached about 22 % of group sales (Kingfisher 2006, p. 3), up from 21 % in the previous year. The strongest growth of store brand sales was achieved in China, where the penetration rate increased from 0.8 % to 3.4 % in 2005.

The store brand penetration rate differs largely across countries and store formats. In Italy, for example, store brands currently account for 5 % of sales and in Poland, it is 3 %. At *Castorama*, store brands are about 15 % of total sales. These figures again show that the strategy allows for further improvements in the future.

In order to further accelerate store brand extension at *Kingfisher's* various formats, a group-wide transfer and sharing of people and skills is of great importance.

Summary and Outlook

For the financial year 2005, *Kingfisher* had to endure a 64.2 % drop in pre-tax profits from 647.7 million GBP in 2004 to 231.8 million GBP in 2005, although group sales were up by 4.7 % (Kingfisher 2006, p. 1) This decline is mainly attributed to falling sales and profits in the United Kingdom and France, as the DIY market experienced a downturn (Brand 2005, p. 10). In the United Kingdom, this downturn has its sources in higher interest rates, a weak housing market and is also affected by overall higher taxes and energy costs. As a response, *B&Q* UK has launched an action programme with the following objectives:

- reinforce price competitiveness
- reduce costs
- enhance customer service
- develop new product ranges and
- manage and develop store capacity (Kingfisher 2006, p. 2).

The SSM programme and an increase in direct sourcing are central and vital sources in achieving these aims, especially price cuts and cost reductions. Despite the downturn in the home market and in France, strong growth could be achieved with the group's international activities. Consequently, *Kingfisher* continues to pursue its growth strategy of expanding in developing markets such as Poland, China and Taiwan and establishing its presence in high growth markets, such as South Korea, where the first store was opened in 2005. In February 2006, the first *Castorama* outlet opened in Russia, where the group sees much potential for the home improvement market, due to a growing construction market and the country-wide need for extensive refurbishment of existing property; the group plans to open a further three stores during 2006. Poland is expected to offer some leverage for the Russian market, as it shares similar market characteristics and can transfer its expertise to the Russian *Kingfisher* employees.

Furthermore, a new format will be introduced in the United Kingdom in 2006: *Trade Depot* is solely aimed at the trade buyer; its main targets are thus small builders and trade professionals, e.g. plumbers or electricians. It stocks only 8,000 product lines compared to 15,000 in a *Brico Dépôt* and targets mainly industrial locations. Despite the differences in format, *Trade Depot* will also share a number of suppliers with other formats in the *Kingfisher* group in order to profit from the company's scale (Murphy 2006, p. 19). This aspect is consistent with *Kingfisher's* general key to pursue a successful international retailing strategy, consisting of "local marketing and global supply" (Bell 2004a, p. 279).

Local Marketing and Global Supply

Questions

1. Within the scope of the proceeding globalisation, global sourcing is becoming an increasingly important topic for retailers because it is a source of cost reductions. However, the limitations and risks of global sourcing must also be taken into consideration when determining the geographical scope of buying activities. Discuss the various advantages and disadvantages.
2. When it comes to global sourcing, Asia is becoming increasingly popular, and China in particular. What are the specific risks and challenges facing retailers buying from China?
3. Compare the option of direct sourcing (especially in geographically distant markets) with the use, for example, of wholesalers or importers to fulfil the buying task.

Hints

1. See section "Sourcing Toolbox" in this Chapter as well as, for example, Liu/McGoldrick 1995 for a discussion of the costs and benefits associated with global sourcing.
2. See e.g. Carter/Pearson/Peng 1997 on the risks associated with operating in China.
3. See e.g. Hoffmann 2006 for a brief discussion of the advantages and disadvantages of direct sourcing.

Chapter 13

Logistics – Physical Distribution

This Chapter considers the strategic role of logistics in retail management. It is concerned with those issues which form the context for restructuring logistical systems. There is also a discussion of distribution models for online purchases.

Logistics as a Core Competency

Traditionally, warehousing and distribution systems used by retail companies have been viewed as an operational instrument, delivering the goods at minimal costs. "Modern retailers, however, realize the advantages that can be derived from investment in such systems and view them as a trade-off between costs to the company and providing optimal service to the customer. As such, distribution and warehousing systems are an integral part of the companies' strategy and a major tool of competitive differentiation" (Bell/Davison 1997, p. 88).

Logistics Leadership

Competitive advantage through the warehousing and distribution systems means management control of the supply chain, i.e. logistics leadership (Zentes/Liebmann 2001, p. 201). For example, as one top manager of Swiss retailer *Migros* states: "It is our belief that we should control the logistics, and that logistics and the supply chain is a core competency of Migros as a retailer" (cf. Cuthbertson 2004, p. 175).

The *logistics management responsibility* of retailers is concerned with managing the components of the "logistics mix" (Fernie/Sparks 2004). The following basic components can be identified (see Figure 13.1):

- *Storage facilities*: These might be the stock rooms of the retail stores, warehouses or distribution centres.
- *Inventory*: The key question is the amount of stock to be held for each product.
- *Transportation*: Products have to be transported – by ship, truck, rail or plane – from the factory to warehouses or distribution centres (*primary distribution*) and from these places to the retail outlets (*secondary distribution*).

- *Recycling/reuse*: Over the last few years, retailers have become much more involved in reverse logistics operations. This means an increased return of packaging material and handling products for recycling and/or reuse. This trend towards *circulation* has been reinforced by the EU packaging directive (Fernie/Sparks 2004, p. 8).

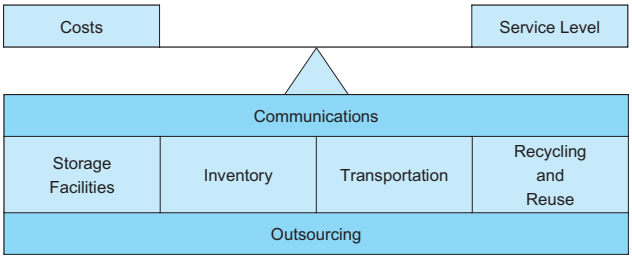
Communications can be regarded as a further basic component. "To get products to where retailers need them, it is necessary to have information, not only about demand and supply, but also about volumes, stock, prices and movements.

Retailers have thus become increasingly concerned with being able to capture data at appropriate points in the system and to use that information to have a more efficient and effective logistics operation" (Fernie/Sparks 2004, p. 8). The enhanced role of communications can be demonstrated by reengineering the supply chain: from a *push supply chain* to a *pull supply chain* (Bell/Cuthbertson 2004) (see Chapter 14).

Push and Pull Supply Chain

Managing retail logistics means balancing costs and service requirements (see Figure 13.1). In order to do this, retailers may outsource certain operational functions to specialist logistics services providers, while strategic functions are in most cases performed by the retailer: "Therefore, it is quite natural that we outsource very little of management control of the supply chain" (cf. Cuthbertson 2004, p. 175).

Figure 13.1 *Management Tasks in Logistics*



Source: Adapted from Fernie/Sparks 2004, p. 6.

Restructuring Logistical Systems

Increased Control over Primary Distribution

As a result of intensified competition, retailers have extended their control of the supply chain, both upstream and downstream. Upstream, that is from the warehouse or distribution centre to the manufacturer and downstream, that is from the warehouses to the retail stores.

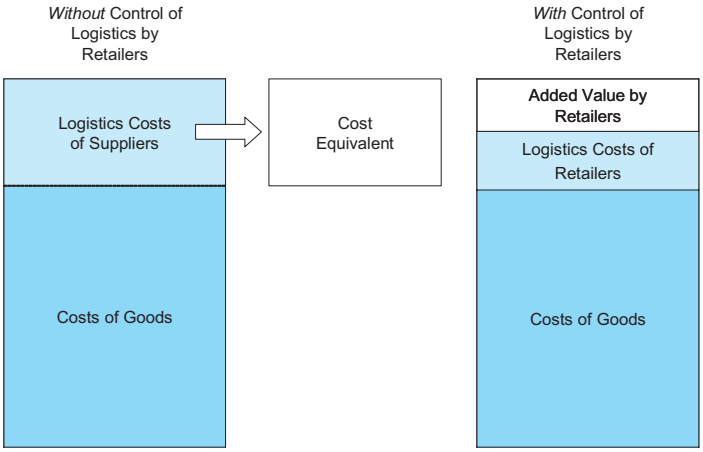
Many retailers have integrated primary and secondary distribution operations (Zentes 2006). They manage all transport operations (primary and secondary transport) and run them as a single "network system" (Fernie/Sparks 2004). This vertically integrated supply chain leads to a new pricing structure in the supplier-retailer relations: *factory gate pricing* (Ex Works, EXW).

Vertical Integration

Logistics not only constitutes a huge portion of the total costs, but makes an essential contribution to the commercial value. If the handling of goods by the retailers is more efficient, then retailers are creating added value (Prümper/Pohl/Thoms 2006) (see Figure 13.2).

Value Added Through Logistics

Figure 13.2



Source: Adapted from Prümper/Pohl/Thoms 2006, p. 819.

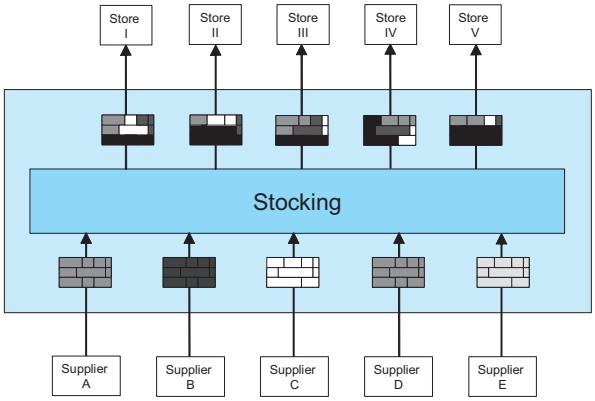
Rationalisation of Warehousing

Retailers have also increased their control over secondary distribution. They have restructured traditional (central or regional) warehouses in order to reduce inventory levels and improve the speed of product flow: "This has involved reducing order lead-time and moving to a more frequent delivery of smaller consignments both internally (between DC (distribution centre) and shop) and externally (between supplier and DC). This has greatly increased both the rate of stock-turn and the amount of product being 'cross-docked', rather than stored at DCs" (Fernie/Sparks 2004, p. 7).

Traditional Warehouse

In a traditional warehouse, goods are stocked, which is a very costly activity. Inventory is expensive and can become obsolete. Furthermore, there are many operations associated with the physical flow of products: goods-in, let down, picking, goods-out (Bell/Davison 1997) (see Figure 13.3).

Figure 13.3 *Structure of a Warehouse*



Distribution Centre

A *distribution centre* (DC) or transit terminal is intended to run stockless, in contrast to silos. The retailer can move from keeping stock to a *just-in-time* approach. The products needed in the retail stores are delivered to the "logistics platform" (by the manufacturers or collected/hauled by the retailer), bundled for the retail stores and transported to them. Ideally, no stock remains and the quantity delivered to the distribution centre is precisely that needed by the outlets. The job of the distribution centre is to partition the quantity delivered to the platform (usually on pallets) to the retail stores and to bundle the different products for each store (usually on pallets or roll cages).

Cross-Docking

In a pure cross-docking system, there is no partitioning. The products are delivered to the platform on separate pallets or in parcels for each retail store. The cross-docking process is reduced to the bundling of pallets or parcels for the various retail stores: "Cross-docking is a technique in which goods arriving at an RDC (regional distribution centre) are unloaded from the inbound vehicle and moved from the goods receiving area 'across the dock' for marshalling with the other goods for onward despatch without being put away into stock" (Whiteoak 2004, p. 143).

The logistical facilities of warehouses and distribution centres/cross-docking terminals are quite different. Warehousing is related to silos, whereas distribution centres/cross-docking terminals are related to "marshalling yards".

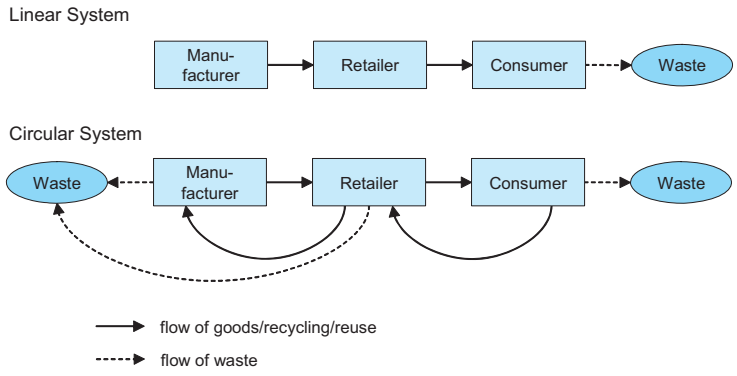
Integrating Reverse Logistics

The increased return flow of packaging material and handling the recycling and/or reuse of goods have become a major challenge in retail logistics (Cuthbertson 2004, p. 179). The integration of reverse logistics has extended the traditional linear flow of goods (see Figure 13.4). Recycling and reuse lead to a *circulation system*, in which retailers play an important role (Hertel/Zentes/Schramm-Klein 2005).

Circulation System

From Linear to Circular Logistics Systems

Figure 13.4

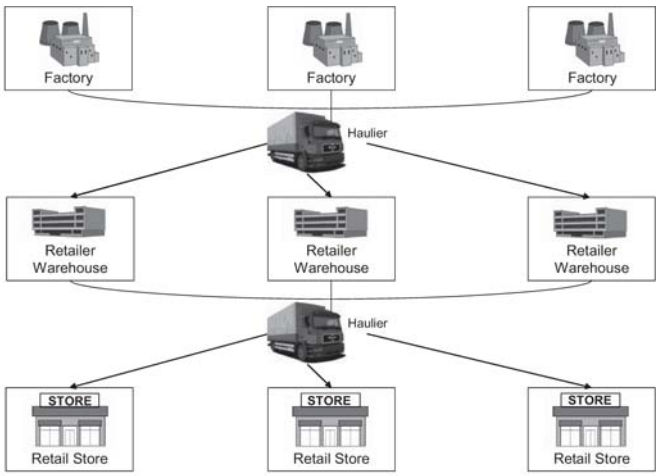


Outsourcing and Joint Physical Distribution

Consolidation Opportunities

As discussed earlier, retailers can outsource certain logistical functions such as transporting or warehousing to logistics operators. For example, by transport pooling the logistics services, providers derive benefit along and across many supply chains (see Figure 13.5).

Figure 13.5 *Consolidation Opportunities Along and Across Many Supply Chains*

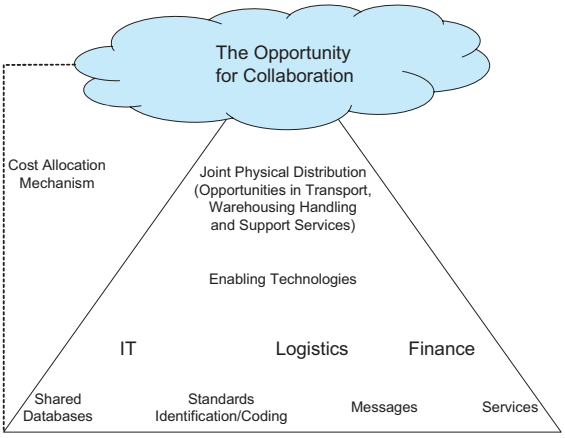


Source: Adapted from Whiteoak 2004, p. 155.

These consolidation opportunities can also be achieved by joint physical distribution systems (see Figure 13.6): "The broad principle here is that the greater the number of participants, the greater the synergy opportunities and the greater the chance of levering action within the logistics and network services provider community. […] A collaborative approach between manufacturers, their suppliers and customers is envisaged, aimed at optimising physical flows, executed via a community of service providers, working to common commercial principles" (Whiteoak 2004, p. 159).

Opportunity for Collaboration

Figure 13.6



Source: Whiteoak 2004, p. 160.

Distribution of Online Purchases

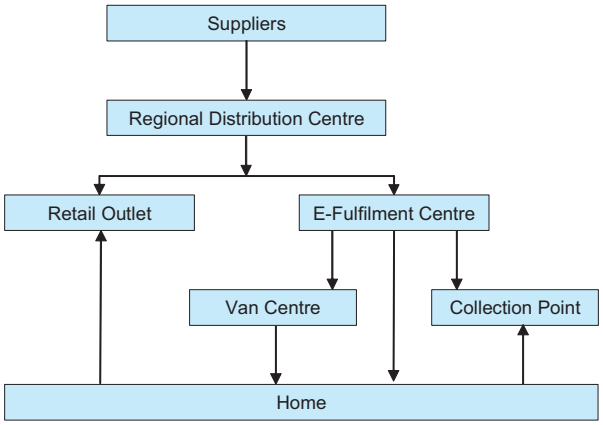
Online retailers providing a delivery service to the customer's home, especially grocery retailers, are faced with the greatest logistical challenges: "Over the past decade many e-tail businesses have failed primarily because of an inability to provide cost-effective order fulfilment. Several market research studies have identified delivery problems as a major constraint on the growth of home shopping" (Fernie/McKinnon 2004, p. 175). In store retailing (*bricks-and-mortar stores*), these "fulfilment activities" (picking, transport to home) are done by the consumers (i.e. they are externalised).

Fulfilment Problems

Traditional catalogue mail-order companies have long-term experience of delivering to homes. They can extend this experience to online purchases. For new players (pure players and multi-channel retailers) in web-based retailing (e-commerce), online shopping imposes new logistical requirements, such as new distribution centres and vehicle fleets. The greatest challenge of e-commerce is to solve the "last mile problem" (Fernie/McKinnon 2004).

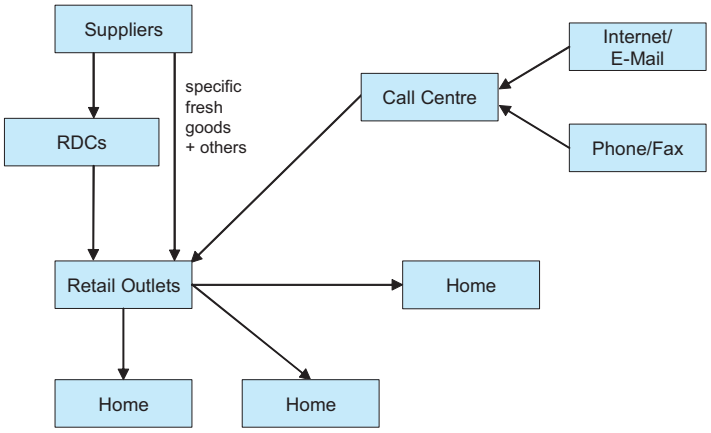
There are different logistics models for the distribution of online purchases. Figure 13.7 describes a delivery model of online purchases which is characterised by the integration of an *e-fulfilment* centre and a *collection point*, a possible solution for the last mile problem. A logistics model for store-based picking of online purchases is depicted in Figure 13.8.

Figure 13.7 *Delivery of Online Orders Via E-Fulfilment Centre*



Source: Adapted from Fernie/McKinnon 2004, p. 177.

Figure 13.8 *Logistics Model for Store-Based Picking of Online Orders (Grocery Distribution)*



Source: Adapted from Fernie/Sparks 2004, p. 20.

The delivery of online purchases of non-food items is often conducted via parcel networks.

Conclusion and Outlook

The last few years have produced many claims about *retail exchanges* (B2B exchanges): "Web-enabled market spaces that bring together buyers and sellers" (Sparks/Wagner 2004, p. 189) (see Chapter 12). Recently, radio frequency identification (RFID) has become the "hot topic": "RFID is a new technology that has the potential to revolutionise the retail industry" (Kalyanam/Lal/Wolfram 2006, p. 104).

RFID

An RFID system consists of a reader, a transponder and a computer network. "RFID readers are devices that send out radio signals on a continuous basis and look for a response from one or more transponders. A computer network transmits the information from the transponder. Readers can accept responses from many transponders at any given point in time. However, given the current state of technology, the transponders need to be within a particular range of the reader to make a connection. As of today, there are two types of transponders; active and passive. Passive transponders consist of a microchip that stores a digital code, and an antenna. When the antenna receives a radio signal from the reader, the transponder converts that radio signal into energy and then sends a digital code back to the reader" (Kalyanam/Lal/Wolfram 2006, pp. 104-105). Active transponders, which are more expensive, use their own source of energy (e.g. a battery) and therefore transmit more information. A number of different benefits can be derived from RFID technology (see Table 13.1).

RFID – Functions and Benefits

Table 13.1

Function	Activity	Benefits
Superior Alternative to Bar Code	• allows information to be read by radio waves from a tag without requiring line-of-sight scanning • allows virtually simultaneous and instantaneous reading of multiple tags in the vicinity of the reader • each tag can have a unique code that ultimately allows every tagged item to be individually accounted for	• boost of productivity due to faster scanning • accurate tracking (reduction of shrinkage, theft, out-of-stocks) • real-time stock location (increased availability, lower stocking costs, higher sales)
Bear Additional Information (passive read/ write tags only)	• can handle a variety of data attributes (e.g. sell-by date) • however, security issues relating to the interception of added data may occur	• provides product authentication due to difficulty of counterfeiting • decentralization of information
Allow New Applications (active tags ("beacons") only)	• conduct target/actual comparisons (e.g. temperature) • maintain records of data (e.g. date of manufacture, time spent in transit, location of distribution centre holding the item, name of the last person to handle the item, amount for which the item was sold, payment method used in buying the item, last date of service, warranty period) • localise goods via active tags	• generate cargo seals when filling containers • can automatically produce shipping manifest for customs • benefits from telematics

Source: NCR 2003; Intermec 2004.

However, there are a number of problems in RFID implementation, such as technology (e.g. scanning accuracy, size and data storage), costs (infrastructure costs), standardisation, and consumer privacy (Sparks/Wagner 2004).

Further Reading

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Case Study: Sainsbury's[1]

Profile, History, and Status Quo

The roots of *Sainsbury's Supermarkets* go back to 1869 when John James and Mary Ann Sainsbury opened their first small dairy shop in London. Today, it is the United Kingdom's longest-standing major food-retailing chain. The company is a leading UK food retailer with interests in financial services. The parent company *J Sainsbury plc* consists of *Sainsbury's Supermarkets, Sainsbury's Local, Bells Stores, Jacksons Stores* and *JB Beaumont, Sainsbury's* online service and *Sainsbury's Bank*, thus encompassing the business segments of supermarkets and convenience stores, banking services (established in 1997) and online shopping (since 1999). *J Sainsbury plc* is listed on the London Stock Exchange.

1 Sources used for this case study include various annual reports, preliminary results 2005/2006, press releases, the annual general meeting 2003, the web sites http//www.j-sainsbury.co.uk, http//www.j-sainsbury.co.uk/sid as well as explicitly cited sources.

Since the disposal of its US engagement in March 2004, when the 37 % share in *Shaw's Supermarkets* was sold to *Albertson's Inc.*, the company has focused on its core UK business in order to increase growth and strengthen its market position. *Sainsbury's* 153,000 employees serve over 16 million customers a week in 752 stores, of which 455 are main *Sainsbury's* supermarket outlets and 297 are convenience stores. For the financial year 2005/2006, group sales totalled 17.3 billion GBP, up 5.8 % from the previous year.

No. 3 in UK Retail Industry

Sainsbury's Supermarkets is currently the no. 3 UK supermarket behind its competitors *Tesco* (see case study *Tesco* in Chapter 11) and *Asda* (owned by *Wal-Mart*). Whereas *Tesco* is the clear leader with nearly 30 % of the market, the followers are very close to each other with roughly 15 % market share each.

Reform of the Distribution System: "7-in-3" Supply Chain Management Programme

Radical Supply Chain Reform in 2001

When *Sainsbury's* embarked on its radical supply chain overhaul in 2001, rivals "watched in utter disbelief" (cf. Watson 2005, p. 29). Since *Tesco* had first overtaken *Sainsbury's* as the country's largest supermarket in 1995, the former market leader had constantly lost market share. The reasons generally given include, apart from the increasingly competitive environment, *Sainsbury's* own complacent attitude and relying on its reputation as market leader instead of ensuring continuous improvement. Accordingly, the company was still operating with the same supply chain as it had 40 years ago. This outdated supply chain infrastructure was no longer capable of efficiently handling more than 2,000 suppliers, 35,000 product stock-keeping units (SKUs), 24 million cases weekly and more than 500 stores (Campbell 2003, p. 20). Not surprisingly, a benchmarking study conducted in 2000 revealed outdated systems and warehousing infrastructure as well as a supply chain-related cost gap of 60 million GBP between *Sainsbury's* and its best-practice competitors (Corsten 2005, p. 70). This is why, in 2001, under the new leadership of CEO Peter Davis, *Sainsbury's* started one of the "most talked about re-engineering projects ever undertaken by a supermarket retailer" (Campbell 2003, p. 20), a new "all-or-nothing" supply chain strategy. Four key areas were tackled through the new strategy which emerged from this exhaustive overhaul:

- network renewal
- systems and technology
- processes and partnerships
- people and culture (Sainsbury's Supermarkets 2001, p. 1).

When the proposals for the overhaul were first presented, the company's former supply chain manager estimated it would take seven years to complete. However, *Sainsbury's* management board, pointed out that there was no time to experiment and requested completion within three years. Hence the stretch-target "7-in-3" which gave the programme its name (Mitchell 2004, p. 32). Given the urgency, this radical "all-or-nothing" approach to rejuvenate the supply chain was chosen (Corsten 2005, p. 70). A reduction of the overall cost base by 700 million GBP within three years was targeted. Key measures for achieving this goal included:

Key Measures

- replacing the current depots with automated fulfilment factories (FF) and primary consolidation centres (PCC)
- an integrated management of transportation from the factory gate to the store back door
- replacing of core supply chain systems which were old and inflexible
- ensuring clear performance measurement by reorganising the supply chain structure and processes.

Key Principles

Furthermore, the following key principles were considered as the basis of the future distribution system: paperless, stockless, accurate, simple and automated where appropriate. Traditionally, so-called logistics teams had been responsible for managing the flow of information along the supply chain, whereas distribution teams had cared for the physical storage and delivery of goods. As part of the reform, these two areas now work as a single organisational division to achieve shared objectives and make the supply chain a truly seamless flow of products and information.

Reorganisation of the Distribution Network

During the 1960s, *Sainsbury's* had been one of the first retailers to centralise its distribution and to implement RDCs; about 1-2 % of the company's net profit margin could then be attributed to the resulting efficiency in retail distribution. However, as the distribution network had not been changed for 40 years, it was aging badly. As a result, a single store was sometimes receiving goods from as many as eleven different depots within a single day (Campbell 2003, p. 20). With the introduction of home shopping, the increasing variety of commodities sold, more changing consumer tastes and less predictable shopping behaviour, the need to manage this complexity efficiently had risen considerably. The "7-in-3" programme aimed at establishing a simplified and efficient supply chain/distribution network, providing for the substitution and supplementation of these RDCs with four types of distribution facilities, designed to increase the product flow (see Table 13.2).

Distribution Facilities

Table 13.2

Distribution Facility	Characteristics
Primary Consolidation Centres (PCCs)	• handling shipments from local suppliers • holding stock and replenishing fulfilment factories • link between local suppliers and RDCs
Fulfilment Factories (FFs)	• handling around 10,000 lines of high-volume commodities • handling waived deliveries to store on a round-the-clock-basis
K Line Depots	• specialist distribution centres • using highly-automated sorting systems enabling them to efficiently pick low volumes of a wide range of up to 16,000 slow moving and bulky products
Frozen Food Depots	• delivering products directly to stores

Source: Adapted from Sainsbury's Supermarket Ltd 2001, p. 3.

From RDCs to FFs

Additionally, 60 % of the prior existing facilities had to be closed (Tulip 2003, p. 52). The transformation of the entire supply chain was largely based around the new huge fulfilment factories which both receive goods and despatch them to stores. *Sainsbury's* change from predominantly stockholding RDCs to flow-through FFs has "involved moving from an infrastructure chiefly comprising conventional wide aisle racking to one combining automated storage and retrieval systems (AS/RS), pick conveyors and sophisticated sortation systems" (Baker 2004, p. 119).

Possible Flows Through the Supply Chain

Figure 13.9

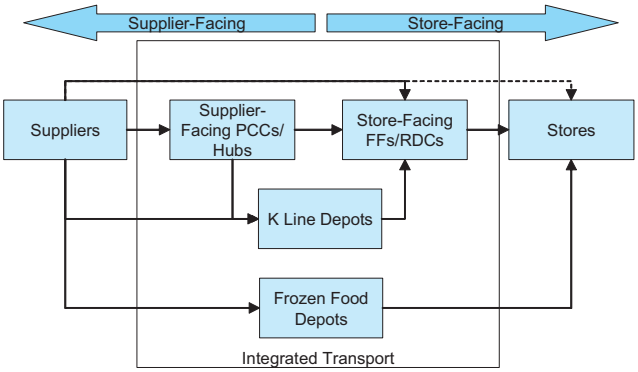


Figure 13.9 gives an overview of the possible goods flows through the supply chain, which is characterised as a supplier-facing network linked to store-facing facilities.

More than 95 % of *Sainsbury's* grocery goods are delivered from a distribution facility into the store and only 5 % are delivered directly from the supplier. This high degree of centralised distribution (see section "Rationalisation of Warehousing") ensures maximum control and hence efficiency. At the PCCs, stock from several suppliers is consolidated into full loads at a fixed cost per pallet, so that there is no minimum quantity for the individual suppliers. The products at the PCC, typically located within 30 miles of a supplier's production facility, remain the manufacturer's property until they are transported to their next destination. The concept is intended to increase their availability on the store shelves, develop closer relationships with suppliers and optimise, i.e. reduce, the number of vehicles used for transportation.

Automation

The automated distribution facilities, called the "fulfilment factory", the key part in the new distribution strategy, are each 65,000 m^2 in size and cost 70 million GBP to build and establish, with 27 million GBP accounting for mechanical handling equipment.

The rationale behind an automated facility is that economies of scale are increased, because fewer suppliers are able to deliver more volume and automated sortation and case picking entail greater accuracy and reduced costs. Automation means fewer touchpoints, so that goods are handled less. "This means we can get them to stores more quickly and fulfil orders accurately. The system is less prone to human error" (cf. Campbell 2003, p. 22). Inside each FF is a range including ambient, chilled and produce lines which serve over 70 supermarkets. The following were the objectives of their implementation:

- handle a variety of merchandising units as well as single items, cases, board and roll pallets
- receive goods throughout the day, with chilled products received in "waves" and sorted on receipt onto an automated sortation system
- typically serve over 70 stores and up to 150 local stores
- handle up to 2.4 million cases a week and 1.3 million single items
- have a sorter in operation for 20 hours a day
- have a vehicle leaving the site every two minutes (Corsten 2005, p. 71).

Since the weekly peak load is 2.4 million cases, each FF operates on a 24/7 basis. The so-called "mother depot concept" was also introduced at each FF which entails slow moving goods being cross-docked, so stores receive merchandise from only one depot. Prior to extending and automating the FFs, *Sainsbury's* used modelling technology to test projections. The resulting simulations revealed the advantages of certain warehouse design changes, identified potential site bottlenecks, helped to establish human resource requirements and set vehicle fill levels (Vega 2004, p. 20). Additionally, the retailer also used strategic distribution planning software to determine the optimum number and location of its distribution facilities. However, given the time pressure, the retailer refrained from testing the automation in detail in real-life circumstances. In order to comply with the automated and hence sensitive fulfilment factories, *Sainsbury's* set up a catalogue of the following criteria which the suppliers had to fulfil since September 2002, when the first fulfilment factory was opened at Hams Hall near Birmingham:

Technology Used for Simulations

Prerequisites for Suppliers

- achieve accurate traded unit bar code (TUC) compliance
- use correct pallet labels with a serial shipment container code with all products
- send advance shipment messages with all products
- achieve the correct pallet standards
- achieve timely delivery and order accuracy
- achieve data integrity by registering with the respective descriptor standards, established to manage a master file of all product descriptions.

Problems Resulting from Automation

Furthermore, suppliers were warned of possible renegotiations if they did not comply with these rules. However, since automated warehouses need near-perfect conditions in order to work properly and since the strict catalogue of rules led to confusion and annoyance on the part of many manufacturers, the actual performance of the FFs was lower than expected and entailed out-of-stocks and availability problems in the stores (Watson 2005, p. 29). Whereas the automation was expected to raise labour productivity and deliver store-friendly product sequencing to reduce replenishment labour at the store, the FF's sensitivity sometimes led to the opposite effect and manual assistance and intervention was required.

Outsourcing to Logistics Providers

In its attempts to optimise the supply chain, *Sainsbury's* does not operate every distribution facility by itself. Instead, only half of the distribution network are in-house operations; the major part of the remaining distribution facilities is managed by *Exel Logistics,* a third party logistics provider (3PL) specialising in distribution management. By having *Exel* manage strategically-located distribution facilities, *Sainsbury's* tries to increase supply

chain efficiency and improve the delivery service to the stores, even though the outsourcing of managing certain distribution centres was the cause of concern on the part of workers and the trade union (Sheppard 2005, p. 15).

Currently, *Sainsbury's* distribution network comprises 14 primary consolidation centres, four fulfilment factories (at Waltham, Haydock, Hams Hall, and Emerald Park), two K Line depots (at Stoke and Rye Park) and two frozen food depots (at Stone and Elstree) (see Figure 13.10). Additionally, a number of ambient, chilled, and produce RDCs are located throughout the United Kingdom.

Figure 13.10 *Location of Distribution Facilities*

IT Systems

Apart from the distribution network, the restructuring of IT systems and technology was a key issue of the "7-in-3" programme. *Sainsbury's* invested heavily in order to create a new, integrated solution replacing the old, outdated and fragmented information systems. For instance, the paper-based information exchange was replaced with a web-based real-time technology. Before the restructuring, the stock at distribution centres was only measured the day after. With the new IT system, current data is available instantly, providing the responsible people with minute-by-minute control of the nature and location of goods passing through the facility. The real-time data is the "backbone" (Campbell 2003, p. 23) of the new information system. The aim in creating the new end-to-end IT infrastructure was to ensure improved performance within the supply chain, due to a superior flow of information

and in order to control the use of resources (Corsten 2005, p. 74), to back up the automated depots. In order to implement this new technology, almost the entire IT function was outsourced to *Accenture* in late 2000, retaining an internal team of only about 25 employees (Clark 2004, p. 6).

Factory Gate Pricing

Factory gate pricing (FGP) has been one of the major developments in UK retailing in recent years, driven primarily by *Tesco*, but also *Sainsbury's*. Suppliers are asked to state the price of their products with and without delivery costs to the retailer's distribution facility. Hence, FGP "involves a retailer separating the transport costs that the supplier has imposed on products and looking for a cheaper way to transport the goods. This may mean the retailer using its own vehicles, or using a third party logistics provider to pick the goods up directly from the supplier — at the factory gate" (Davies 2004, p. 15). By taking responsibility for the primary distribution, i.e. collecting the supplies from the manufacturer (see section "Logistics as a Core Competency"), the retailer can optimise the use of his existing fleet, thereby realising competitive advantage as well as environmental benefits through the reduction of fuel usage.

Advantages of FGP

Additionally, *Sainsbury's* established a national transport service centre (NTSC) to optimise the effectiveness of its transport operations. This leads to greater efficiency and effectiveness, enabling *Sainsbury's* to save costs and reduce vehicle usage and kilometres travelled. The NTSC presents opportunities for reducing total truck distance through better planning of vehicle movements, whilst optimising truck fill. All trucks are equipped with a global positioning system (GPS) which helps to achieve this. In this respect, when it is beneficial to do so, collections of products from suppliers using *Sainsbury's* own fleet are organised, thus reducing the number of vehicles on the roads. In a typical week, some 800-900 of such collections take place (see also Figure 13.10 for a visualisation of this integrated transport system).

Making Sainsbury's Great Again

New Reform in 2004

In October 2004, Justin King replaced Peter Davis as CEO and introduced a three-year recovery plan worth 550 million GBP called "Making Sainsbury's Great Again". This was based on the outcome of the "7-in-3" programme. Despite the enormous 700 million GBP investment in the programme and being honoured with the Global Retail Achievement Award in the category Best in International Logistics and Distribution in 2004, and despite consensus that a reform of the distribution system was necessary, the actual per-

formance was not as good as projected. Especially the automated FFs did not deliver their performance potential, partly because they are easily disturbed by imperfect pallets. Furthermore, the ambitious programme has been criticised as wanting "too much, too soon" (Pendrous 2004, p. 8).

The new recovery plan is supported by the new advertising claim "Try Something New Today", stressing *Sainsbury's* heritage as a quality food specialist and seeking to exploit the growing customer interest in safe and healthy food. Whereas the "Making Sainsbury's Great Again" programme focuses primarily on creating an increase in sales, physical distribution and the improvement of the supply chain play an important role in achieving this aim, focussing primarily on reducing out-of-stocks and improving availability. A new supply chain director, Lawrence Christensen, was also hired, indicating the effort being made and the responsibility being taken for the optimisation of the existing distribution network. After problem identification, he sorted out the automated warehouses, drawing up an action plan to get the best out of what already existed, improving communication between the distribution facilities and *Witron* and *Siemens,* the companies behind the automation equipment. Furthermore, about 3,000 new employees were hired to manually sort products where needed, and distribution facilities were reorganised resulting in the closure of some and opening of other facilities. Currently, a "step change" programme across all of *Sainsbury* stores is being implemented to improve product availability on the shelves. Systems are put in place for deliveries, stock auditing and to make sure that the inventory management is efficient. Since the programme launch, the retailer has delivered five consecutive quarters of like-for-like sales growth. *Sainsbury's* also claims to have reduced its out-of-stock products by 75 % with availability now matching industry levels and to have cut the time it takes for stock to arrive at the store.

In an attempt to gain more control over its IT systems, the outsourcing contract with *Accenture* was terminated in October 2005 and the IT function made in-house again. The transfer of 470 employees was completed in April 2006 and cost approximately 63 million GBP. The company expects that future cost savings through regained control of IT processes and systems will amortise the investment in less than two years.

Summary and Outlook

Around 18 months after the introduction of the "Making Sainsbury's Great Again" programme, the company's controversial automated warehouses are now operating as originally intended. However, the retailer had to spend an exceptional 120 million GBP in writing off the initial automation equipment in 2004. A new transport management system is also being planned to create

a "central brain" for the entire transport fleet and for suppliers, to be controlled by *Sainsbury*'s. Plans to alter the current warehouse management systems are also being mooted. At their lowest point, Hams Hall, Waltham Point, and Rye Park were turning away 50 % of supplier deliveries. In October 2004, the fulfilment factories were each operating at a capacity of only 800,000 cases a week being picked and delivered and systems were breaking down regularly. However, FFs are now exceeding the targets of 2.2 million cases each. With the distribution network now working efficiently and a 5.7 % increase in turnover for the commercial year ended 31 March 2006 proving the success of the new initiative, the retailer is now planning to open new stores for the first time in many years. This is a sign of its confidence in the recovery and the now smoothly functioning supply chain.

Questions

1. As described, *Sainsbury's* supply chain comprises different types of distribution facilities. Why is this distinction normally used?
2. Factory gate pricing (FGP) is becoming increasingly popular. What are the reasons and motivations for this development? Which possible limitations and risks can be identified?
3. What advantages and disadvantages are associated with the outsourcing of physical distribution processes, also applied by *Sainsbury's*?

Hints

1. See Bell/Cuthbertson 2004 for a description of different supply chains which operate in terms of type of product.
2. See e.g. Fernie 2004a.
3. See e.g. Levy/Weitz 2007 for a discussion of logistics outsourcing.

Chapter 14

Logistics – Supply Chain Management and Information Management

In this Chapter, supply chain management is presented as a strategic approach for retail companies. With a focus on logistics activities, efficient consumer response is discussed as a collaborative approach to supply chain management. Information technology is a major enabler for supply chain activities. Therefore, the general principles of information management in retail companies, in the logistics context, are outlined.

The Supply Chain in the Consumer Goods Industry

Traditionally, manufacturers were the dominant forces in the supply chain in the consumer goods industry. With the trend toward *retail consolidation* and the emergence of large retailers, power in the supply chain has been shifting toward the retail level (Fernie/Fernie/Moore 2004, p. 198). Whereas manufacturers *previously* designed, produced, promoted and distributed their products or brands and retailers depended on their leadership, with this *power shift*, retailers have been able to exert pressure back into the supply chain. They have forced manufacturers to change their supply chain strategies and, for example, include tailored pallet packs, scheduled deliveries, continuous replenishment systems, etc. (Coyle/Bardi/Langley 2003, p. 6).

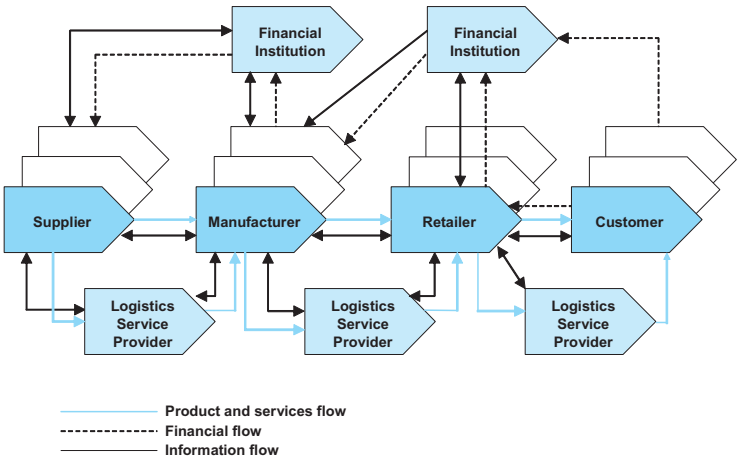
Retail Supply Chain

The *supply chain* in the consumer goods industry includes all parties directly or indirectly involved in receiving and fulfilling customer requests, e.g. manufacturers, suppliers, wholesalers, retailers, third party service providers (transporters, warehouses), and customers (Chopra/Meindl 2004, p. 4). Supply chains are dynamic and involve the constant flow of products, information and finance between the different stages (see Figure 14.1).

Flows in the Supply Chain

The first flow (*products and related services*) is one of the main elements in supply chain management. Traditionally, it is the major topic in logistics, because customers expect their orders to be delivered on time, reliably and damage-free. *Information flows* comprise, for example, orders, inventory, demand or sales data. These flows are important for replenishment and (demand) forecasting at all stages of the supply chain. *Financial flows* include the transfer of funds or cash between the supply chain partners (Coyle/Bardi/Langley 2003, pp. 18-19).

Figure 14.1 *Flows in the Supply Chain of the Consumer Goods Industry*



Source: Adapted from Hertel/Zentes/Schramm-Klein 2005, p. 51.

Supply Chain Management

Supply chain management is defined as the planning and management of all business activities involved in fulfilling customer requests, such as sourcing, procurement, operations, marketing and logistics management. It not only focuses on processes or functions within one particular company, but also includes *coordination and collaboration* with other parties in the supply chain (Stank/Davis/Fugate 2005).

Total System Efficiency

The main goal of supply chain management is to facilitate the *integration* of supply and demand management for the purposes of improving the performance of individual companies and the supply chain as a whole. The objective of supply chain management is thus to maximise overall value generated and it focuses strongly on *supply chain profitability* (Mentzer et al. 2001).

The Bullwhip Effect

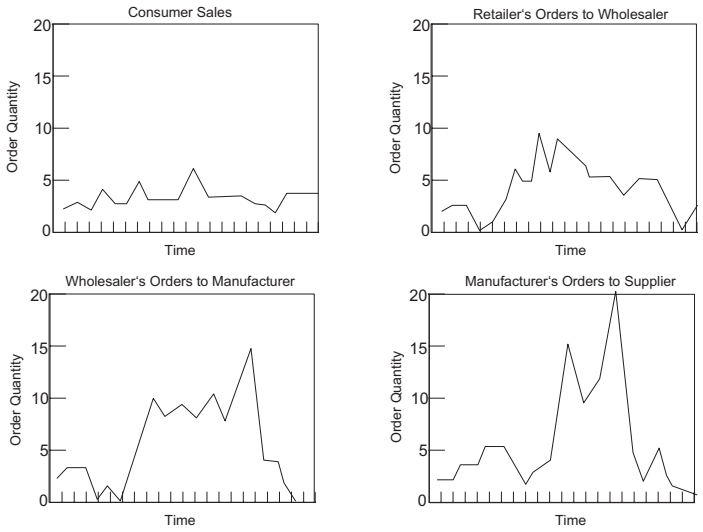
The fundamental idea of supply chain management is that all parties involved should coordinate their activities and collaborate, thus improving the profitability of all supply chain partners. If each value-added partner is

considered in isolation, *inefficiencies* in the supply chain can occur. They result mainly from the *isolated planning* of materials or order quantities along the value chain and are described as the *bullwhip effect*. This occurs when sales or order quantity fluctuations swing upwards through the various value-added stages, with the amplitudes increasing at each stage. The bullwhip effect results from the fact that customer demand is often unstable. Thus, each company in the supply chain must forecast demand. Because of incomplete information and uncertainties, forecasting errors are common and companies therefore usually carry safety stock in their inventory.

Moving up the supply chain from the consumer to the suppliers, each participant in the supply chain observes higher fluctuations in demand and therefore has a greater need for inventory buffers. If demand rises, supply chain participants tend to increase stock and orders. On the other hand, if demand declines, companies tend to reduce inventory stocks. The bullwhip effect is characterised by variations amplifying the further one moves up in the supply chain from the consumer to the suppliers (Lee/Padmanabhan/Whang 1997b; see Figure 14.2).

The Bullwhip Effect

Figure 14.2



Source: Lee/Padmanabhan/Whang 1997b, p. 94.

Uncoordinated Planning

The effect demonstrates how pervasive *inefficiencies* can arise mainly from delays caused by *uncoordinated planning cycles* (e.g. because of order batching, price fluctuations or the rationing of quantities by manufacturers), inconsistent and possibly out-of-date customer information or sales data (Lee/Padmanabhan/Whang 1997a, 1997b; Disney/Towill 2003). This then impacts planning and reduces the transparency of supply and material quantities beyond the specific value-added stage (Lee/Padmanabhan/Whang 1997b).

Information Sharing

The main approach to solving these difficulties is the implementation of comprehensive *inter-organisational information and planning systems*, developing an information flow in the supply chain which reduces inefficiency (Schramm-Klein/Morschett 2006).

Apart from information sharing, other *sales* and *marketing practices* in the supply chain, such as the price schedule offered by the manufacturers, frequency and depth of price promotion, demand forecasting methods, allocation rules in case of shortage, etc., are important (Lee/Padmanabhan/Whang 2004).

Efficient Consumer Response

Cooperation and Collaboration

The consequence of the problems encountered with isolated planning is that cooperation and collaboration among the supply chain participants are at the core of industry efforts to attenuate the bullwhip phenomenon. The concept of *efficient consumer response* (ECR) is significant in this context. ECR comprises a number of collaborative strategies and operating practices between retailers and suppliers that focus on fulfilling consumer needs better, faster and at less cost (ECR Europe 1998).

Push vs. Pull

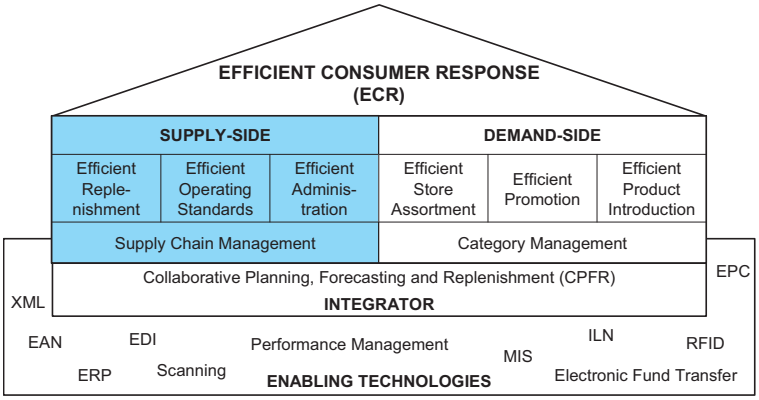
The ECR concept implies a shift from the traditional *push-oriented* view of the supply chain that relied on "pushing" merchandise through the supply chain, initiated and performed in anticipation of customer orders, to a *pull-oriented supply chain*.

Pull processes, in this view, are triggered by consumer demand and are executed in response to consumer needs. ECR is thus a demand-driven pull system that has an affinity to the concept of *just-in-time* (Kracklauer et al. 2004, p. 59).

Efficient consumer response is central to the development of concepts for exploiting inter-organisational potential through the structuring and control of value chains and offers a range of supply-side and demand-side-oriented concepts based on retailer-supplier collaboration (see Figure 14.3).

Efficient Consumer Response

Figure 14.3



Source: Adapted from Hertel/Zentes/Schramm-Klein 2005, p. 173.

Supply-Side Concepts in ECR

Whereas demand-side-oriented concepts focus on cooperation in marketing, supply-side-oriented concepts strongly emphasise *logistical issues*. Following the pull-oriented view, they relate mainly to the satisfaction of demand in terms of delivering the right products to the right destinations at the right time and in the right quantities ("4r") (Mollenkopf/Gibson/Ozanne 2000) throughout the supply chain at lowest possible costs. The emphasis is on *minimising logistics costs*, such as transport costs, in particular inventory costs, and costs related to asset commitment.

"4r"

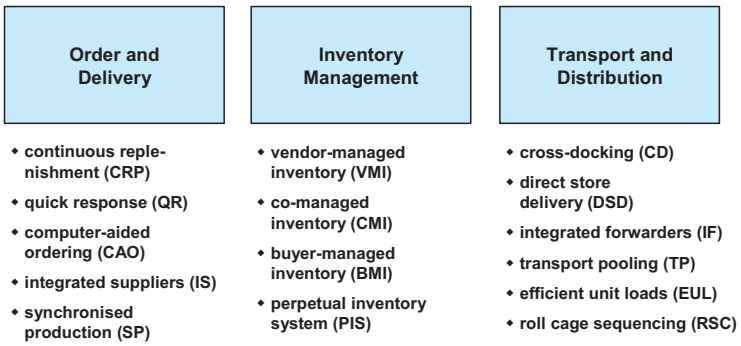
The main areas of collaboration on the supply-side are (Hertel/Zentes/Schramm-Klein 2005, pp. 185-186):

Supply-Side Topics

- *Efficient administration (EA)*: EA focuses on efficient administrative processes between the supply-chain parties. Very important in this context are electronic data interchange (EDI) and other technologies that enable, for example, process automation.
- *Efficient operating standards (EOS)*: The objective of these concepts is to enhance efficiency by establishing industry-wide standards.
- *Efficient replenishment (ER)*: The main goal of ER is to synchronise manufacturer and supplier operations with retail sales in terms of a *just-in-time* pull-oriented supply chain driven by retail sales.

In this context, various concepts have been established to increase efficiency and effectiveness in the supply chain (see Figure 14.4).

Figure 14.4 *Concepts in Efficient Replenishment*



Source: Adapted from Gleißner 2000, p. 169.

Order and Delivery

Continuous Replenishment

The superordinate concept in inventory management for ECR is *continuous replenishment* (CRP) which implies the continuous flow of merchandise based on consumer demand (i.e. retail sales). The fundamental idea is to transfer the just-in-time concept to retail outlets and thus reduce overall inventory at all stages of the supply chain (see Figure 14.5). Continuous replenishment systems require integrated information systems (e.g. EDI) that enable close to *real-time transfer* of sales and inventory data between retailer and supplier. This information transfer enables suppliers and retailers to *reduce lead times* in production and delivery.

Quick Response

Quick response (QR) is a specific type of CRP, and a concept which has been developed to accelerate product flows in the supply chain. The concept was developed in the *textile industry* to reduce replenishment lead times and is especially well suited to markets with *high volatility* in demand and a rapidly changing assortment. The main objective is to decrease the number of *overstocks* and of *out-of-stocks* in the fashion industry, which is characterised by a high number of product variants and short fashion cycles with low demand predictability and a high share of impulse purchases (Christopfer/Lowson/Peck 2004, p. 82). By allowing for *multiple orders* to be placed in the sell-

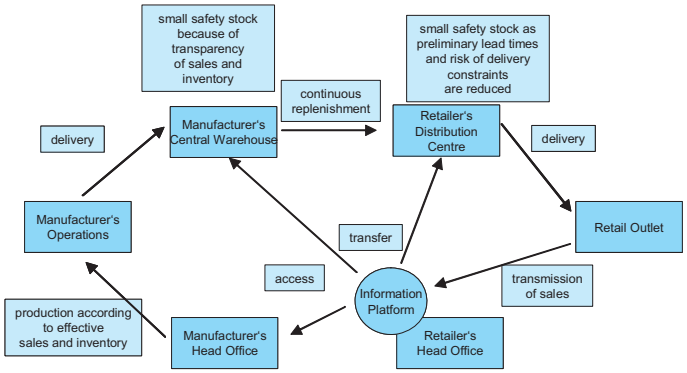
ing season, quick response enables a better match between demand and supply.

A manufacturers' *postponement* strategy is closely linked to this concept and refers to the delay of product differentiation until temporarily closer to the sale of the product (Birtwistle/Moore/Fiorito 2006; see case study *Benetton* in this Chapter).

Postponement

Continuous Replenishment

Figure 14.5



Source: Adapted from Swoboda/Janz 2002, p. 207.

Inventory Management Concepts

Inventory management strategies in efficient replenishment can be classified according to the party responsible for maintaining inventory levels in vendor-managed inventory (VMI), buyer-managed inventory (BMI) or co-managed or jointly-managed inventory (CMI).

The focus of attention is on *vendor-managed inventory*, which is characterised by the vendor being responsible for maintaining the retailer's inventory in the retailer's distribution centre or in each of the outlets (Lee/Padmanabhan/Whang 1997b). The main objective is to reduce out-of-stocks in the stores, and inventory in the supply chain, by centralising forecasting at the supplier and shortening of supply chain. For the retailers, VMI is sometimes associated with a loss of control in the supply chain.

Vendor-Managed Inventory

VMI requires a *continuous information transfer* between both parties in terms of sales and inventory data, and the vendor generates the orders (i.e. reverse

purchase orders). Under ideal conditions, inventories are replenished in quantities that meet the retailer's immediate demand, reducing *out-of-stocks* with minimal inventory (Levy/Weitz 2007, p. 285).

Buyer-managed inventories imply retailers maintaining the suppliers' inventory. They are thus inversely related to VMI. *Jointly-managed inventories* entail cooperation between vendor and retailer in inventory management.

Transport and Distribution

Several transport and distribution strategies are applied in efficient replenishment. They serve mainly to guarantee continuous product flows in the supply chain (see Chapter 13). For example, *cross-docking* allows for stockless distribution processes and transport optimisation. *Direct store delivery* (DSD) means that merchandise is shipped directly to the outlets and *transport pooling* helps to use transport capacities to the full extent (Coyle/Bardi/Langley 2003, p. 109).

Collaborative Planning, Forecasting, and Replenishment (CPFR)

Optimisation of Promotions

Collaborative planning, forecasting, and replenishment is a concept which integrates the idea of supply-side and demand-side concepts in ECR. The concept focuses mainly on *promotion processes* and thus relates primarily to HiLo pricing strategies that, in contrast to EDLP pricing strategies, are usually characterised by a high risk of running out of stock, because of high demand uncertainty (see Chapter 9). The main goal of CPFR is to increase *sales forecast* accuracy by joint sales planning by manufacturer and retailer, using all available data from both parties. Based on this forecast, production, delivery, warehousing and advertising are coordinated to achieve higher product availability and reduce inventory costs. Additionally, as information on customer behaviour is available simultaneously to all participants, reaction to sudden, unanticipated, changes in demand is possible (Kracklauer et al. 2004, p. 59).

Enabling Technologies

Supply chain management requires efficient information-sharing processes between the parties at each stage of the value chain. Many available technologies enable such information flows (Sanders/Premus 2005).

EDI

In order to facilitate an inter-organisational data exchange, *electronic data interchange* (EDI) and communication networks that enable instantaneous,

real-time information transfers such as Internet, intranet or extranet are necessary (Chopra/Meindl 2004, p. 63). Standardisation and automation are important to increase efficiency of such information processes. Other particularly important enablers of inter-organisational information exchange are, therefore (Hertel/Zentes/Schramm-Klein 2005, pp. 202-205):

- *Automated identification systems*: Important auto-id systems are bar codes, optical character recognition or RFID (see Chapter 13). They are based on coding systems such as global trade item numbers (GTIN) that identify each SKU (item) in the supply chain, the global location numbers (GLN) for identifying each participant in the supply chain or the serial shipping container code (SSCC) for identifying shipping units.
- *Communication standards*: Standardised message formats that can be processed by the IT systems of all involved parties are important for inter-organisational data transfer. Examples are UN/EDIFACT (United Nations Electronic Data Interchange for Administration, Commerce and Transport), EANCOM (a subset of UN/EDIFACT in the consumer goods industry) or GS1 XML, which is a more flexible message format.
- *Master data*: Master data are the basic data in information processing. They characterise each object in the supply chain, for example, each customer or supplier. Customer and supplier master data are usually company-specific whereas article master data are usually exchanged between the parties. Thus, standardisation in this field is very important.

Information Management

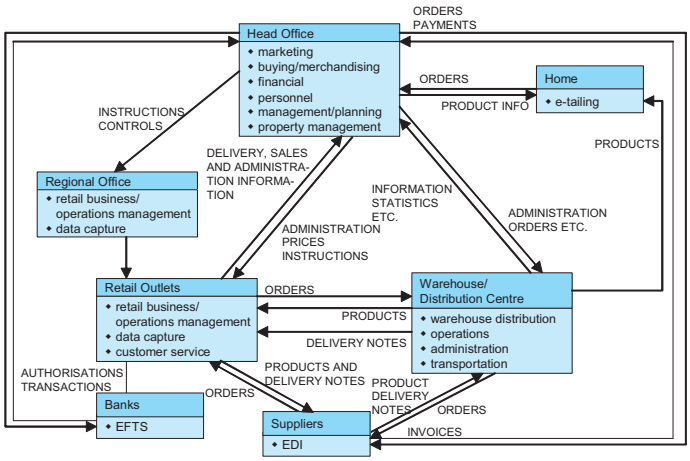
Information Transparency

As the *bullwhip effect* demonstrates, information availability is extremely important at all stages of the supply chain. For example, *suppliers* need information from the retailer on sales, inventory turnover, and feedback on competitors or on the level of customer returns. Information is also needed from consumers on attitudes toward the products, brand loyalty, willingness to pay, etc. *Retailers* need, for example, sales forecasts, information on product specifications, advance notice of new models, training materials for complex products, and information from consumers on their shopping needs, where else they shop and their satisfaction level with the retailer and the merchandise (Berman/Evans 2007, pp. 226-227). Retailers play a crucial role in collecting information on consumers, because they have direct contact with the customers at the *point-of-sale* and can collect information which goes beyond sales or scanning data and is important for marketing and logistics. They thus can act as *gatekeepers* in the supply chain who are able to control information flows.

Information Exchange

The above examples demonstrate the need for *information flows* between the different departments of the retailer (e.g. marketing and logistics), and also at an inter-organisational level (Schramm-Klein/Morschett 2006). The main information flows that are important in logistics are shown in Figure 14.6. In order to guarantee efficient and timely information flows and to reduce errors in information transmission, *information technology* (IT) plays a vital role.

Figure 14.6 *Information Flows in the Supply Chain*



Source: Adapted from Dawson 1995.

Store-Based IT

In a pull-oriented supply chain, the starting point for information flows is the retail outlet. Thus, *store-based IT*, especially point-of-sale systems that enable the *scanning* of *bar codes*, is of particular importance. Such point-of-sale systems do not only increase efficiency and productivity in the stores (e.g. faster check-outs), but, in terms of logistical benefits, enable the immediate recording of sales and a rapid flow of sales and inventory information. Also, orders can be automatically recommended or triggered (*sales-based ordering* (SBO)) (McGoldrick 2002, p. 15).

ERP and MIS

Also important are enterprise software systems such as *enterprise resource planning systems* (ERP) or *merchandise information systems* (MIS). ERP systems such as *SAP, Oracle* or *Microsoft Dynamics* integrate all data and processes of the retail company into a single unified system. They usually consist of vari-

ous components such as human resources, finance or logistics. In retail companies, particularly MIS, as integral part of ERP systems, play a central role. MIS such as *SAP for Retail* or *Oracle Retail* support all information processes related to product flows in the retail channel, for example, merchandise planning, ordering or inventory processes.

Data Warehouse

As illustrated, at all stages of the supply chain, data is important for *decision support*. The information (e.g. merchandise information, sales, customer data, or supplier information) is "stored" in huge databases that are referred to as *data warehouses*. This information can be accessed by different departments within a retail company (e.g. marketing, buying, or logistics) and serves as input for the various software systems such as ERP, MIS or *data mining* systems.

Conclusion and Outlook

In the past, suppliers and retailers were intent on minimising their own logistics costs. This optimisation at one stage of the supply chain often leads to additional costs at other stages, either for retailers or for suppliers. Recently, more integrative views on the supply chain have evolved, which has led to supply chain management and the various concepts of ECR.

Technological Improvement

Apart from this change to a more strategic view of the supply chain in terms of focussing on total system efficiency, *efficient information processing* is of central importance in collaborative supply chain management. In this context, new technological developments such as data warehousing, web EDI, RFID or Internet applications have added new dimensions to collaboration in the value chain and have enabled the various new concepts in supply chain management.

Further Reading

BELL, R.; CUTHBERTSON, R. (2004): Collaboration in the Retail Supply Chain, in: REYNOLDS, J.; CUTHBERTSON, C. (Eds.): Retail Strategy, Amsterdam et al., pp. 52-77.

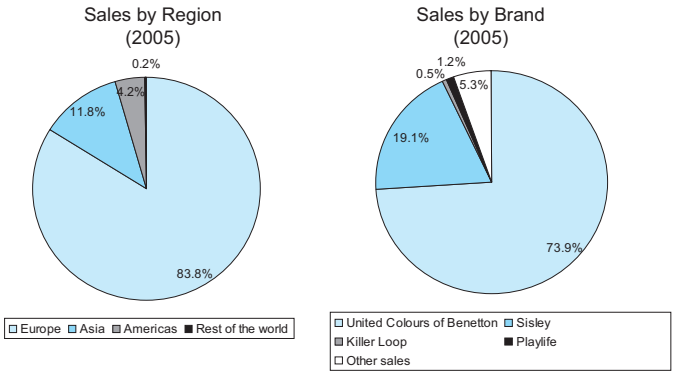
SEIFERT, D. (2004): Collaborative Planning, Forecasting and Replenishment - How to Create a Supply Chain Advantage, Bonn.

Case Study: Benetton[1]

Profile, History, and Status Quo

The *Benetton* group was founded in 1965 in Treviso, Italy, by Luciano Benetton and his younger sister Giuliana. At the time, Giuliana was working for one of the region's many textile artisans who produced woollen sweaters in traditional sombre colours and rather scratchy wool. Luciano worked as a wholesaler selling artisans' output to department stores. When his sister started sewing sweaters with more colourful and fashionable designs on her own, he was sure he could sell these designs. Their small-scale operation grew slowly at first, but, by 1965, they were able to open the first *Benetton* factory in the nearby town of Ponzano. Soon, their two other brothers, Gilberto and Carlo, joined the company and three years later, in 1968, the Benetton family opened its first clothing store in Belluno, followed by a second store in Paris a year later (Datamonitor 2005a, p. 6).

Figure 14.7 *Sales by Region and by Brand (2005)*



Source: Benetton 2006a.

The *Benetton* group is now present in 120 countries around the world with Eastern Europe, the Mediterranean (Spain, Greece and Turkey) and Korea being the areas of greatest growth. While more than 80 % of turnover is still

1 Sources used for this case study include various annual reports, press releases, the web site http//www.benetton.com as well as explicitly cited sources.

generated in Europe, the company is continuously strengthening its international expansion, particularly in Asia. The group produces around 115 million garments every year and generates a total turnover of around 1.8 billion EUR. Almost three quarters of sales come from the casual brand *United Colours of Benetton* (UCB). On top of that, *Benetton* also holds the fashion-oriented *Sisley*, *Playlife* leisurewear and *Killer Loop* streetwear (see Figure 14.7). In 2003, the sale of the sports equipment business and the strategic focus on apparel led to the group operations being divided into two business activities, which are managed separately:

- *apparel* which includes casual and sports clothing and complementary products such as accessories and shoes
- *other activities* which are composed mainly of the sale of raw materials, semifinished products, industrial and advertising services and income and expenses relating to real estate activity.

67 % of the group is held by *Edizione Holding S.p.A.*, the holding company wholly owned by the *Benetton* family. About 10 % is held by institutional investors and banks and the remaining 23 % belong to other investors. The founders are still active in the company management, with Luciano Benetton being the Chairman of the *Benetton* group and Carlo Benetton the Deputy Chairman.

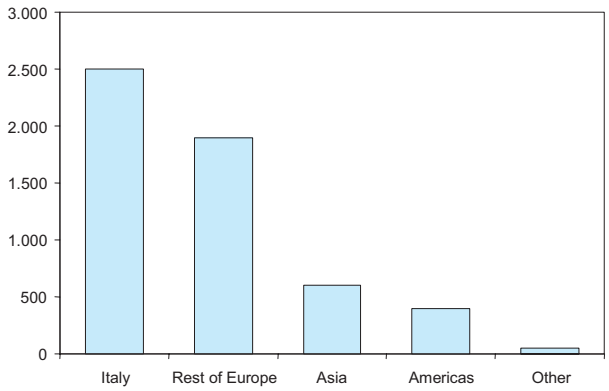
Retail Network

Benetton continued to open new stores in Italy as well as all over Europe. In 1979, *Benetton* opened the first store in the USA, where they also built a factory in 1986, the same year of the company's initial public offering on the stock exchange in Milan. Today, there are about 5,000 stores all over the world (see Figure 14.8).

Role of Sales Agents

Of special significance in the development and maintenance of the *Benetton* retail network, is the role of agents who act as intermediaries between the company and the shops. Each of the roughly 70 to 80 agents is assigned a large territory in which they are to supervise and encourage the development of *Benetton* retail outlets. They control and assign the contracts with store operators and minor investors in their respective territory and may also have an interest in a number of stores themselves. It is their responsibility to recruit and help train the individual store operators; they display the *Benetton* collection to shop owners in their regions and assemble orders for the initial stock and stock reordered during each season. In addition to their share of profits from the stores in which they hold ownership, agents receive a commission on the sales of goods by the retail outlets in their region.

Figure 14.8 *Geographic Breakdown of Benetton Stores*



Source: Benetton 2006a.

Franchise Retail Outlets

While *Benetton* sold through leading Italian department stores in the beginning, they soon began operating mainly with stores selling *Benetton* products exclusively. However, the company originally owned only very few of the stores itself. The retail function was traditionally carried out by an independent shop owner, who is closely linked to the company by a contract relationship, a licensing agreement similar to a franchise. *Benetton* then supports the retailers with services such as merchandising (Camuffo/Romano/Vinelli 2001, p. 46). Although they are fairly closely coordinated by *Benetton*, store owners are not required to pay the manufacturer a fee for use of its name or a royalty based on a percentage of sales or profit. Instead, they are expected to carry only *Benetton* merchandise, maintain a minimum sales level, adhere to suggested markups, pay for their orders according to a pre-set schedule, and develop a good understanding of the "Benetton way of doing things". In terms of store layout, the owners are supposed to maintain the distinctive *Benetton* features of small size, simple design, open layout and colourful displays (Davis/Devinney 1997, p. 221).

Re-Definition of Retail Strategy

For many years, *Benetton's* traditional approach of direct retailing entrusted to third parties was one of the company's most successful strategies. However, the aggressive market penetration of international competitors with retail outlets of a much larger average size required a redefinition of the retail strategy. In 2000, *Benetton* therefore began to enlarge its retail outlets wherever possible to enable the display of the whole range of *Benetton* products, including garments, shoes and accessories. Where such an expansion is not possible due to space limitations, retail outlets focus on a specific market

segment, such as men's products or knitwear. The third element of the revised strategy required the opening of large retail outlets on the main shopping streets and in the central shopping districts of big cities. These flagship stores are directly owned and managed by *Benetton* itself to allow an even more direct control of distribution channels, as well as rapid reaction to market changes. Through these own stores, the company can get closer to final consumers, obtain more information about them and reinforce its image (Camuffo/Romao/Vinelli 2001, p. 48).

Production Network

Network of Sub-Contractors

Benetton's manufacturing operations are based on its own factories in combination with a network of subcontractors. While most of its competitors are international retailers with basically no in-house operations, *Benetton* has always continued carrying out vital parts of the production process itself. The company generally outsources the labour-intensive phases of the production process, such as tailoring, finishing and ironing, but has always kept all strategic activities in-house, as well as operations requiring major investment. Activities that are therefore carried out by *Benetton* itself include weaving, cutting, dyeing, quality control on finished goods as well as quality control of intermediate phases and packing. With respect to the network of subcontractors, *Benetton* has always been known for its good relationships with almost 900 small and medium enterprises (SMEs) located mainly in North-Eastern Italy (Camuffo/Romano/Vinelli 2001, p. 47).

Production Poles

Along with the changes in the retail network, *Benetton* is now beginning to transform its production system by retaining its network structure, but changing the nature of the network. Again, unlike most of its competitors, the company is increasing its *vertical integration* upstream along the value chain. *Benetton* owns 22 factories operating the casual business, 15 of which are located in Italy and one each in Spain, Croatia, India, Portugal, Tunisia, Slovakia and Hungary (Datamonitor 2005a, p. 5). The production system is coordinated by a high-tech production pole in Castrette, Italy, not far from the headquarters at Ponzano, near Treviso. The facility was set up in the mid-1990s as a reaction to the increase in volumes which could no longer be handled by the existing production sites. The production pole at Castrette is among the most advanced in the apparel industry, especially since it is *Benetton's* policy to completely renew all production systems and equipment in production every five years. It is responsible for producing around 20 million items per year. The Castrette model – a large production pole coordinating numerous subcontractors – has been adopted on a smaller scale in the countries where the company has relocated to take advantage of lower labour costs (see Table 14.1). Foreign poles are composed of a subsidiary, which is totally or partially owned and directly managed by Castrette,

which coordinates the production activities of a group of SMEs. These small subcontractors are often set up and managed by former *Benetton* employees or Italian contractors. In order to ensure high quality, *Benetton* obliges its foreign production poles to focus on one type of product and to use existing skills, e.g. T-shirts are made in Spain, and jackets in Eastern Europe (Camuffo/Romano/Vinelli 2001, p. 47).

Table 14.1 *Benetton's Foreign Production Poles*

Production Pole	Headquarters	Workshop Locations	Benetton's Equity Share
Benetton Spain	Castellbisbal, Spain	Spain	100 %
Benetton	Maia, Portugal	Portugal	100%
Benetton Tunisia	Sahline, Tunisia	Tunisia, Morocco	100 %
Benetton Hungary	Nagykallo, Hungary	Hungary, Ukraine, Czech Republic, Poland, Modavia, Bulgaria, Romania	100 %
Benetton Croatia	Osijek, Croatia	Croatia, Slovenia	100%
Benetton Korea	Seoul, Korea	Korea	50 % (joint venture)
Egyptian European Clothing Manufacturers	Alexandria, Egypt	Egypt	50 % (joint venture)
DCM Benetton	New Delhi, India	India	50 % (joint venture)

Source: Camuffo/Romano/Vinelli 2001, p. 48.

In order to accelerate processes throughout the supply chain, *Benetton* has increased upstream vertical integration by consolidating its textile and thread supplies. 85 % is currently controlled by the company. This means that *Benetton* has the ability to speed up the flow of materials from raw material suppliers through its production poles to ultimate distribution from Italy to its global retail network (Fernie/Fernie/Moore 2004, pp. 187-188).

Products for a Global Market

Benetton's philosophy has always been to offer product lines on a worldwide basis that have sufficient breadth to accommodate the needs of markets in many countries. In addition to offering casual clothing, *Benetton* also licences its trademarks for products that are manufactured and sold by others. For this reason, there are also fragrances and cosmetics, watches, sunglasses, housewares and other fashion accessories on offer, which complement the *Benetton* product lines (Datamonitor 2005a, p. 5). The products have also experienced changes recently, which actually enforced the existing *Benetton*

product strategy. While *Benetton* used to offer a standard range in most markets, allowing for 20 % of its range to be customised for country markets, the company now allows a differentiation of only 5-10 % in each collection (Fernie/Fernie/Moore 2004, p. 188).

Supply Cycle

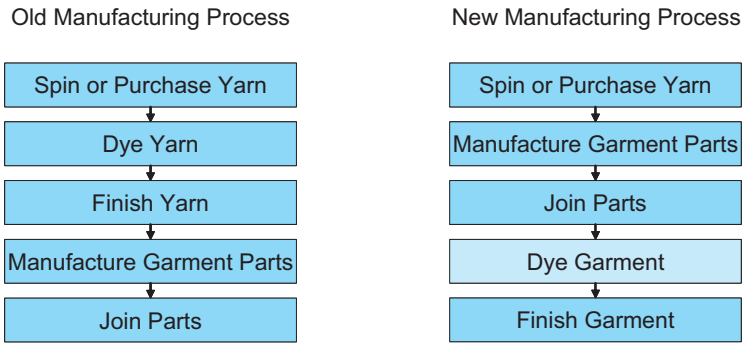
Textile Industry Characteristics

In the fashion industry, it is extremely important that new products be available in the retail outlets right at the beginning of a new season. However, the textile industry also has to cope with long production and distribution lead-times. *Benetton* therefore has to plan and produce a long time in advance, although it is never clear until well into each season which colours sell best.

Faced with this continuing problem, the company decided to partially reverse the production process in order to be able to receive rapid feedback from their retail outlets on the colours that sell fast. The traditional process of manufacturing knitwear consists of spinning or purchasing the yarn first, then dying and finishing it. After that, the garment parts are manufactured from the dyed yarn and finally joined to form the finished garment.

Resequencing: Postponement

Figure 14.9



Postponement

Instead of dying the yarn first, *Benetton* knits the plain wool into sweaters and postponed colouring the entire inventory. After an initial shipment of dyed sweaters went to stores, the company obtained reliable information about which ones were selling. They then dyed the remainder of their sweaters to more accurately meet demand for certain colours. This way, *Benetton* employed the concept of *postponement*, delaying the point of production differentiation until better demand signals could be obtained (see Figure 14.9).

Flexible Assortment

With the base collection for the spring/summer season arriving in the stores in January, *Benetton* requires its franchisees to commit themselves to specific orders through July, so about eight months before the start of the selling season. However, it also provides several opportunities for them to adjust the items actually presented to their customers. While production starts in July, from August to early December clients and agents can still specify the colours for up to 30 % of the woven items. These are held first in grey and the dying is postponed until the garment is finished. Throughout January, they are able to add a number of items to their spring/summer collection, the so-called *flash collection*, which is based on early customer requests for fabric-style-colour combinations not found in the store. The third part of the collection is the so-called *reassortment* which is manufactured and delivered later in the selling season, generally in March for the spring/summer collection. These orders are meant to fill in for items that have rapidly sold out. *Benetton* promises delivery in less than five weeks from the order date (Cazenove 2005, pp. 13-15). Starting in 2006, *Benetton* plans to further refine its just-in-time production, by moving away from two collections per year (spring/summer and autumn/winter) towards a *2+2+1* concept. The company is planning to break up the spring/summer collection into two parts, the autumn/winter collection into two parts and create a fifth collection comprising the base priorities or top sellers (see Figure 14.10).

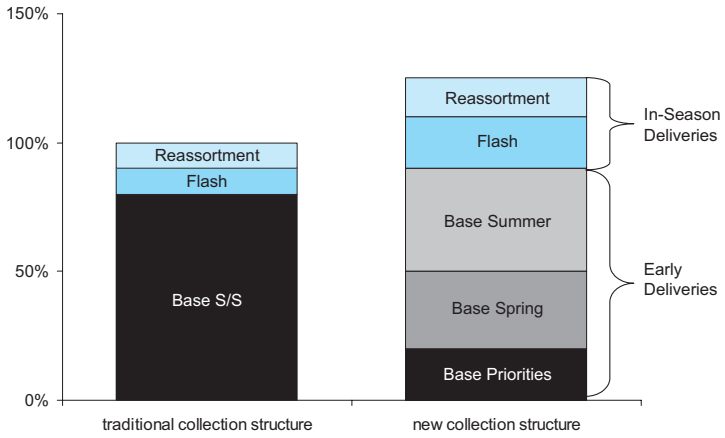
Before the postponement strategy was introduced, there were always too many garments with colours customers did not want, whereas the colours in demand were always sold out. The new strategy allows *Benetton* to be extremely responsive to rapid changes in customer demand for different colours in clothing and so also permits higher customer service levels (Waller/Dabholkar/Gentry 2000, p. 136).

Information Management

In order to ensure rapid reaction to consumer demand and fashion changes, a good and direct understanding of what is sold in the shops is crucial for the success of the *Benetton* model. While much information is obtained through the close relationship with the company's sales agents, one of the benefits of setting up the owned and directly-managed retail network is to obtain this direct understanding of market developments. In the past, based on the traditional IT system, *Benetton* used to receive only direct reports on sell-out data from selected stores.

Collection Development

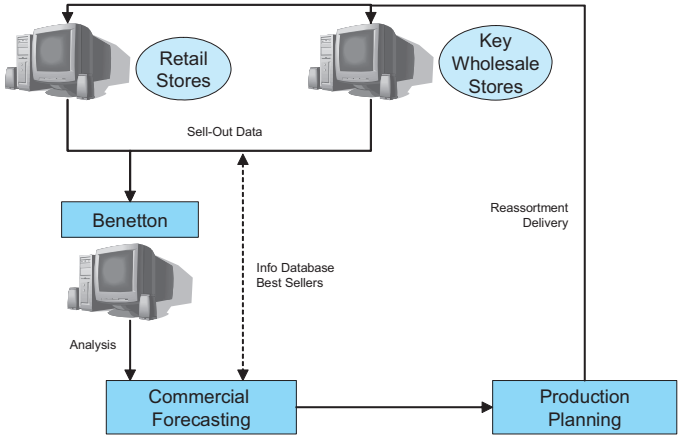
Figure 14.10



Source: Benetton 2006b.

Sales Data Intelligence

Figure 14.11



Source: Benetton 2006b.

Currently, however, further efforts at information gathering include the company's pilot project, in which a number of independent shops are linked to *Benetton* through its IT platform. The long-run objective is to obtain a good sample of all the different size shops that represent *Benetton's* retail network. As a first step, the IT network was installed in the shops that *Benetton* owns and manages, and as a second step, the system is currently being broadened to include third party stores as well. The company estimates that having 10 % of the approximately 5,000 independent shops feeding data into the IT platform will be sufficient to acquire a correct and accurate picture of the market and therefore to monitor consumer demand precisely (Cazenove 2005). Figure 14.11 gives an overview of how sales data intelligence is collected and processed at *Benetton* in order to optimally adapt the assortment in retail stores.

The high level of vertical integration that *Benetton* has always maintained allows the company to react quickly to market changes and demand fluctuation, which are common in the fashion industry. For the future, *Benetton* is planning to further optimise its demand-driven supply chain nationally as well as internationally, in order to remain successful in the increasingly competitive business environment.

Questions

1. Explain the difference between producer push and consumer pull supply chains as applied by *Benetton*. Explain and evaluate the role and value of information in managing the supply chain.
2. What are the particular challenges of supply chain management in the fashion industry? Describe and evaluate the role of quick response systems as applied by *Benetton* with regard to the textile apparel industry.
3. Critically discuss the role of power in the supply chain. What impact does the existence of a network of manufacturing subcontractors and a franchised retail network have on the quick response system? Take into account recent changes in the *Benetton* strategy.

Hints

1. See Bell/Cuthbertson 2004 for the different supply chain strategies in retailing and their respective prerequisites.
2. See Christopher/Lowson/Peck 2004 on characteristics of the fashion industry as well as on quick response strategies.
3. See Fernie 2004b on relationships within the supply chain.

Chapter 15

Controlling and Financial Management

The aims of this Chapter are to consider the relationships between retail strategy and performance, to review the ratios and tools of inventory/supply chain evaluation, profit/turnover evaluation and financial performance evaluation and to consider new conceptual frameworks.

Retail Strategy and Performance

Retailers develop their strategy for sustaining a competitive advantage (see Part II) in a market situation characterised by intensified competition. In such a situation, there is growing pressure on retailers to perform so that they must measure or evaluate their performance (Zentes 2004). Three different kinds of performance measures can be identified:

- inventory/supply chain evaluation
- profit/turnover evaluation
- financial performance evaluation.

The inventory (stock) of retail companies has an important influence on profits and financial performance. A large variety of ratios and performance indicators has been developed to evaluate how effectively retailers utilise their investment, for example, stock turnover or inventory turnover. To balance inventory level and out-of-stock conditions with regard to customer satisfaction and customer loyalty, new tools have been created such as performance measurement of the supply chain (Zentes 2004).

Profit and turnover evaluation are more specific in retailing compared to other industries, because of a huge number of articles (*stock-keeping units*, SKUs) and a large number of organisational units, such as outlets in a retail chain. This complexity leads to very specific turnover paths and profit paths in analysing retail performance.

The financial performance of retailers can be examined on the basis of the balance sheet, profit and loss account (P&L statement), and statement of cash flow. There is no difference in principle, in measuring the financial performance of the retail industry and other industries: liquidity ratios, return ratios, earnings coverage ratios, value metrics.

In addition to these tools, various other instruments have been developed for modern controlling, such as activity-based costing, benchmarking, Balanced Scorecard, etc. (Liebmann/Zentes 2001; Morschett 2004).

Inventory/Supply Chain Evaluation

With regard to *financial inventory control*, there are two main metrics:

- stock turnover
- gross margin return on investment.

Stock Turnover Ratios

"*Stock turnover* represents the number of times during a specific period, usually one year, that the average inventory on hand is sold" (Berman/Evans 2007, p. 488). This ratio can be calculated in units or in currency (e.g. EUR, USD or GBP). In computing stock turnover in currency, two dimensions can be distinguished: retail prices ("at retail") or purchasing prices ("at cost").

Different formulas can be applied (Berman/Evans 2007, p. 488):

$$(1)\ \text{annual rate of stock turnover (in units)} = \frac{\text{number of units sold during year}}{\text{average inventory on hand (in units)}}$$

$$(2)\ \text{annual rate of stock turnover (in retail prices)} = \frac{\text{net year sales}}{\text{average inventory on hand (at retail)}}$$

$$(3)\ \text{annual rate of stock turnover (at cost)} = \frac{\text{cost of goods sold during the year}}{\text{average inventory on hand (at cost)}}$$

In order to increase stock turnover, retailers can reduce inventory for slow-selling items ("stock reduced", see Chapter 12), buy in a timely manner ("stockless", see Chapter 12), apply collaborative planning tools and supply chain techniques, such as continuous replenishment (CRP) or vendor-managed inventory (VMI), and use reliable suppliers (Berman/Evans 2007).

Gross Margin Return Ratio

On the other hand, high stock turnover may result in the loss of volume discounts and in higher transportation charges. One way of controlling inventory investment and profit per unit is to compute *gross margin return on investment* (GMROI). This metric represents the relationship between gross margin and average investment at cost, by combining profitability and sales-to-stock measures (Berman/Evans 2007, p. 489):

$$(4)\ GMROI = \frac{\text{gross margin}}{\text{net sales}} \times \frac{\text{net sales}}{\text{average inventory at cost}} = \frac{\text{gross margin}}{\text{average inventory at cost}}$$

Profit/Turnover Evaluation

Profitability Ratios

Metrics from this group are designed to measure the ability of a retail company to achieve, sustain and increase profits (Dragun 2004a). Profitability can be measured by different indicators. One important relationship is between profits and sales (*margin ratios*); another dimension of profitability relates profits to capital. These so-called *return ratios* are discussed below within the context of financial performance evaluation.

Margin Ratios

"Top-level" indicators of profitability are (Dragun 2004a):

- gross margin in %
- net profit margin in %.

The *gross margin*, also called gross profit, is defined as:

$$(5)\ gross\ margin = net\ sales - costs\ of\ goods\ sold$$

"It is an important measure in retailing because it indicates how much profit the retailer is making on merchandise sales without considering the expenses associated with operating the store" (Levy/Weitz 2007, p. 166). Like other performance measures, this indicator can be expressed as a percentage of net sales:

$$(6)\ gross\ margin\ in\ \% = \frac{gross\ margin}{net\ sales} \times 100$$

The term *net sales* expresses the total volume of money (e.g. EUR, USD or GBP) after all refunds have been paid (Levy/Weitz 2007) (and after sales tax):

$$(7)\ net\ sales = gross\ amount\ of\ sales - costumer\ returns - customer\ allowances$$

The *net profit margin in %* relates net profits to sales:

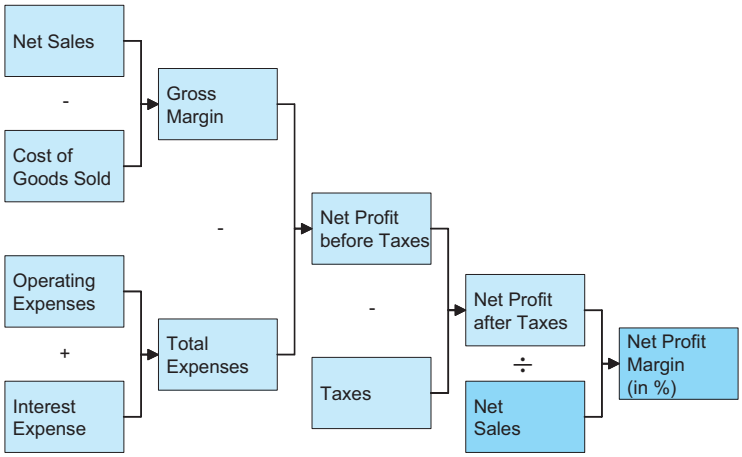
$$(8)\ net\ profit\ margin\ in\ \% = \frac{net\ profit}{net\ sales} \times 100$$

This "*bottom-line" profitability* is useful for comparisons across companies.

Profit Path

The different profit margin models or formulas can be illustrated by a firm's profit path (see Figure 15.1).

Figure 15.1 *Profit Path*



Source: Adapted from Levy/Weitz 2007, p. 165.

Expenses are the costs incurred by a retail company in the normal course of business. There are three types of *retail operating expenses* (Levy/Weitz 2004, p. 192):

- selling expenses
- general expenses
- administrative expenses.

Selling expenses comprise sales staff salaries, commission and benefits. *General expenses* include rent and utilities. *Administrative expenses* comprehend salaries of all employees other than sales personnel, operational costs incurred by buying offices and other administrative expenses.

Operating Profit Analysis in Retail Chains

As a simplified example of an operating profit analysis in retail chains, Table 15.1 provides a calculation of gross margin and operating profit for a retail store and the aggregation from the store level to the company level.

Operating Profit: Department, Store and Company Level

Table 15.1

Step	Position	Store A			Store B			Company
		Dep. 1	Dep. 2	Total	Dep. 1	Dep. 2	Total	
0	net sales	X	X	Σ	X	X	Σ	
	./. costs of goods sold	X	X	Σ	X	X	Σ	
1	gross margin	X	X	Σ	X	X	Σ	
	./. salaries	X	X	Σ	X	X	Σ	
	./. rent	X	X	Σ	X	X	Σ	
2	operating profit (department level)	X	X	Σ	X	X	Σ	
	./. other store level costs			→ X			→ X	
3	operating profit (store level)			→ Σ			→ Σ	Σ
	./. costs of headquarter							→ X
4	operating profit (company level)							→ Σ

Financial Performance Evaluation

Financial Ratios

To evaluate the financial performance of retailers, *financial ratios* can be applied. In retail companies, four groups of financial ratios are utilised (Dragun 2004a):

- internal liquidity ratios
- return ratios
- financial leverage ratios
- earnings coverage ratios.

In this Chapter, internal liquidity ratios and return ratios are discussed.

Value Metrics

The limitations of ratio analysis have led to the development of a new class of measures called *value metrics*. "The idea behind a value metric is simple and powerful: value is only created if the company generates return on capital exceeding the cost of that capital" (Dragun 2004a, p. 161). This relatively new approach will be discussed briefly and illustrated in the following case study.

Return Ratios and Return Path

These metrics relate profits to capital, in contrast to profitability ratios which relate profits to sales. A "top-level" indicator measures the efficiency of a company in utilising assets for profit generation: *return on assets* (ROA). This indicator is usually calculated on an *EBIT* basis (earnings before (b) interest and taxes):

$$(9) ROA^{(b)} = \frac{EBIT}{average\ total\ assets}$$

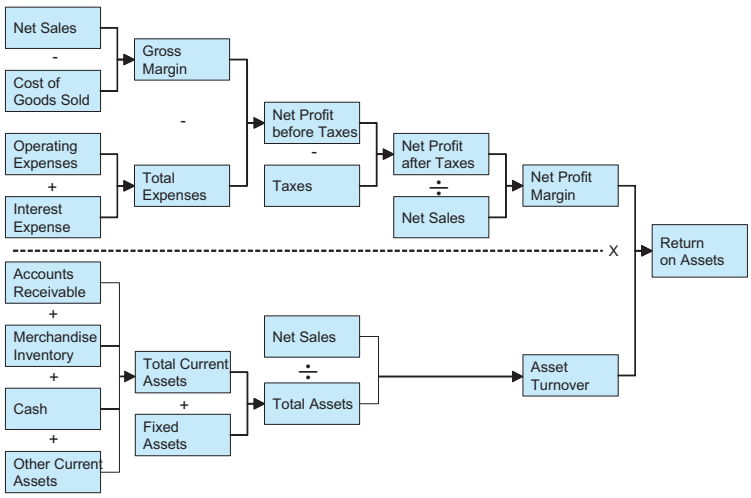
On an after-tax and after-interested basis (a), a second metric return on assets can be computed:

$$(10)\ ROA^{(a)} = \frac{net\ profit}{average\ total\ assets}$$

Other return metrics are *return on invested capital* (ROIC) and *return on equity* (ROE) (Dragun 2004a; Dragun 2004b).

The net profit margin model (Figure 15.1) can be combined with the *asset turnover model*, which yields *asset turnover* through dividing *net sales* by *total assets*. As a result, the *ROA path* can be derived (see Figure 15.2).

Figure 15.2 *ROA Path*



Source: Levy/Weitz 2004, p. 201.

Liquidity Ratios

Metrics from this group "measure the ability of the firm to sustain current and meet future obligations. Internal liquidity ratios usually compare the short-term asset such as cash and marketable securities with the near-term financial obligations such as accounts payable" (Dragun 2004a, p. 149).

The current ratio is one of the best-known liquidity metrics:

$$(11)\ current\ ratio = \frac{current\ assets}{current\ liabilities}$$

Other metrics from this group are (Dragun 2004a):

$$(12)\ quick\ ratio = \frac{cash\ and\ equivalents + accounts\ receivable}{current\ liabilities}$$

$$(13)\ cash\ ratio = \frac{cash\ and\ equivalents}{current\ liabilities}$$

$$(14)\ cash\ flow\ from\ operations\ ratio = \frac{cash\ flow\ from\ operations}{current\ liabilities}$$

Quick ratio and cash ratio are more conservative ratios, because inventories and some other assets included in current assets are not liquid enough (Dragun 2004a). Formula 14 integrates a cash flow perspective.

Value Metrics

Economic Value

These metrics measure the financial performance of firms by the ability to generate or to add *economic value*. Measures of economic value include market value added (MVA), which is a purely stock-market-based measure, and economic value added (EVA). Economic value added is computed according to formula (15) (Dragun 2004a, p. 162):

$$(15)\ EVA = net\ operating\ profit\ (after\ taxes) - WACC \times capital$$

The weighted average cost of capital (WACC) is calculated as a weighted average of the costs of debt and the costs of equity capital. The costs of debt are the interest expenses required to serve the debt. "For equity, the cost is the rate of return on common stock expected by the shareholders" (Dragun 2004a, p. 161). These costs are more difficult to calculate, because they depend "on the uncertain factors such as overall stock market risk, return expectations and the risk-free rate of return available to investors" (Dragun 2004a, p. 161).

Table 15.2 shows a calculation scheme for EVA.

Table 15.2 *Calculation of EVA*

	Component	Calculation
1.	Operating profit before taxes	
2.	Income tax expense	
3.	NOPAT (Net operating profit after taxes)	Item 1 – Item 2
4.	Capital	a = interest-bearing debt b = equity capital C = a + b
5.	Debt-to-equity ratio	$= \frac{a}{b}$
6.	Cost of debt	α (%)
7.	Cost of equity	β (%)
8.	WACC	$= \frac{a}{C} \times \alpha\ (\%) + \frac{b}{C} \times \beta\ (\%)$
9.	Capital charge	Item 4 x Item 8
10.	EVA	Item 3 – Item 9

Source: Adapted from Dragun 2004a, p. 163.

EVA and Supply Chain Performance

Supply chain performance evaluation can be combined with financial performance evaluation. Figure 15.3 illustrates the means by which supply chain management can improve value metrics such as EVA (Morschett 2004).

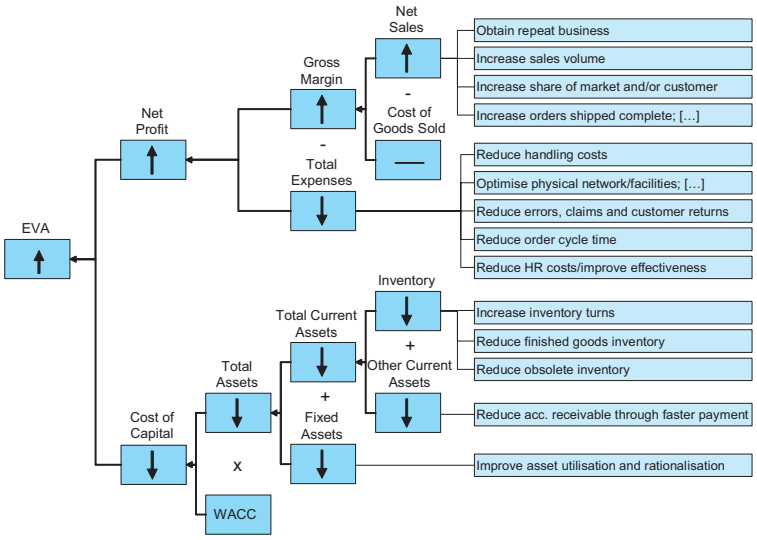
Conclusion and Outlook

Apart from the modern controlling concepts discussed here, approaches have been developed over the last few years in which the measurement of consumer satisfaction comes to the fore (for details see Zentes 2005). They enlarge the scope of functions of traditional controlling.

A new challenge for controlling is emerging from the increasing importance of corporate social responsibility (CSR) (Zentes 2006). The extension of the corporate goal system into ecological and social dimensions also requires advanced controlling concepts.

EVA and Order Fulfilment

Figure 15.3



Source: Adapted from Lambert/Pohlen 2001, p. 13; Neher 2003, p. 38.

Case Study: Metro[1]

History, Profile, and Status Quo

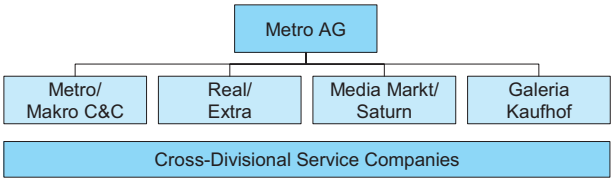
With net sales amounting to 55,722 million EUR in 2005 (Metro AG 2006, p. 34), the *Metro* group is currently fourth in the worldwide ranking list of food retail companies, directly behind the US *Wal-Mart* group, French *Carrefour* and British *Tesco* (see Table 5.1 in Chapter 5). The *Metro* group was created in 1964 when the first German *Metro cash & carry* market for commercial customers was opened. The *Metro* group emerged in its current form in 1996 after mergers with other companies and several portfolio adjustments. At the moment, the publicly listed *DAX* company concentrates on the four key business segments *wholesale*, *food retail* (hypermarkets/superstores), *non-food specialist markets* as well as *department stores*. These are organised in four sales divisions (see Figure 15.4). Since the IPO of the previous sales division *Prak-*

Four Business Segments

1 Sources used for this case study include the web site http://www.metrogroup.de, the annual report 2005, information of the department investment controlling/EVA analysis as well as explicitly cited sources.

tiker in November 2005, it no longer belongs to the group portfolio. The group will probably sell off its remaining minority stake in *Praktiker* after the holding period has run out.

Figure 15.4 *Metro Group's Structure*



Source: Adapted from Metro AG 2005b, p. 372.

Metro AG leads the group as a strategic management holding which is responsible, for instance, for determining corporate policy guidelines and the allocation of resources. The sales divisions are independently responsible for their respective operative businesses. They are supported by the so-called cross-divisional service companies which service the whole group with sourcing, logistics, IT, advertisement, financing, insurance, and catering (see also the case study in Chapter 2, which deals with one of the sales divisions, namely *Media Markt/Saturn*).

The company currently employs about 250,000 employees in 30 countries. More than half of the turnover of 55,722 million EUR in 2005 was made abroad. The internationalisation of the cash & carry concept contributes considerably to this success and generates more than 75 % of its turnover outside the domestic market (Bell 2004b, p. 222).

Shareholder Value Concept

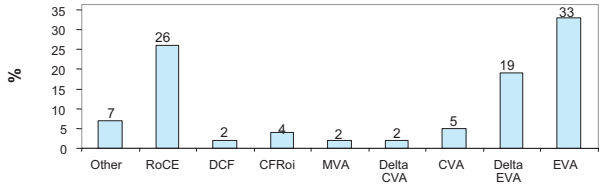
Within the framework of the internationalisation and liberalisation of capital markets, shareholder value for publicly listed corporations is becoming more and more important. Rational investors select the one investment of the multitude of possibilities with the same risk level from which they expect the highest returns on their investment (Stern/Shiely/Ross 2001, p. 3). Generally, there is a differentiation between investments in a company and capital market investments. As owners of a stock corporation, shareholders expect returns on their invested capital, in the form of distributed dividends

or rising stock prices. Furthermore, especially since the 1990s, the problem of measuring company value adequately became apparent through the high number of mergers & acquisitions. The basic principle behind the shareholder value approach is that the company's strategy is aligned with its owners' interests and that decisions are made in the context of their effects on the company's value. This approach is, amongst other factors, designed to counteract opportunistic actions on the part of managers.

Generally, the shareholder value concept results in the implementation of value-based management in the company. The value metrics are intended to counteract the deficiencies of the conventional performance benchmarks still often favoured, such as ROI (see Chapter 15) (Freeman 2004, p. 60) and to measure the actual value or value creation of a company according to the thesis „you can't manage and improve what you can't measure". Figure 15.5 gives a survey of shareholder value key data which was most commonly used by the German *DAX, MDAX* and *TecDAX* companies in 2003. Companies most frequently revert to economic value added (EVA) or delta EVA.

Shareholder Value Metrics in German Corporations (in % / 2003)

Figure 15.5



Source: Homburg/Töksal/Gödde 2004, p. 9.

Application of EVA at Metro Group

Computing EVA

Economic value added (EVA) is a measurement tool aimed at creating and increasing corporate value. The tool was developed by the consulting company *Stern, Stewart & Co.* in 1989 and EVA® is a registered trademark. The simple idea behind EVA is the fact that a company only creates value when the (long-term) earnings exceed the costs of all capital invested. One of the main reasons to use EVA as the company's principle financial goal is that it is

"the only performance measure to tie directly to intrinsic market value" (Bennet 1999, p. 3).

After the reorganisations of the *Metro* group in 1996, there were many different reporting, planning, steering and incentive systems within the group. For this reason, the introduction of a standard steering concept became necessary. In 2000, EVA was implemented across the entire group as the standardised steering instrument and is actively and externally communicated, especially to the capital markets and shareholders. The following targets are pursued with this measurement tool:

EVA Targets

- evaluation of all strategic and operative activities by their contribution to *Metro's* value added
- assistance in gaining competitive advantage and in strengthening *Metro's* market position in Europe and worldwide
- reconciliation of shareholder and stakeholder interests, e.g. securing the employee's jobs and simultaneously enhancing *Metro's* attractiveness to investors (Metro AG 2004, p. 3).

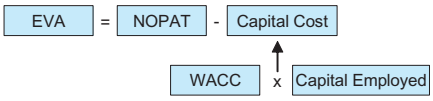
EVA Employed on all Levels of the Company

The group's steering system is an operational key figure measuring the annual success at different levels, such as the group as a whole, the sales divisions, cross-divisional service companies and individual stores. Thus, the value of individual investment decisions as well as strategic and operative planning and decision processes can be determined.

Furthermore, EVA is important for performance measurement and for the personnel incentive system. In this way, a standard language for all levels of the hierarchy and across all projects is created (Metro AG 2004, p. 7).

The basic economic principle that investment only creates value if at least the costs incurred are earned is reflected in the formula for calculating EVA (see also Table 15.2 for a detailed calculation of EVA).

Figure 15.6 *Basic EVA Formula*



Source: Metro AG 2004, p. 8.

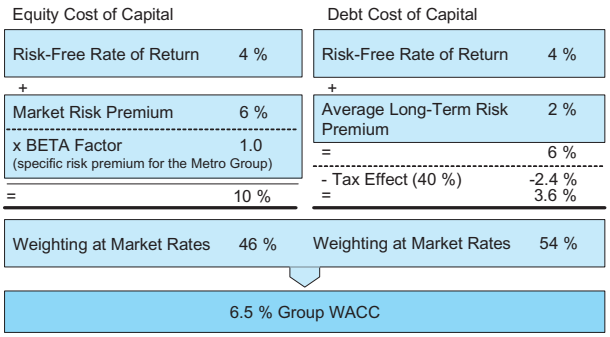
The formula components are the following:

- net operating profit after taxes (NOPAT) – operating profit before financing costs, but after having deducted the taxes on income
- capital employed – fixed assets and net working capital tied up during a particular period
- weighted average cost of capital (WACC) – calculated on the basis of the average cost of equity and borrowed capital, weighted by the company's capital structure. It reflects the risk inherent in an investment (see Figure 15.7 for the calculation of *Metro* 's WACC in 2006, which was identical to the value in 2005)
- capital cost – calculated by multiplying the WACC by the capital employed. It represents the expected compensation of investors for the capital they provide and for their investment risk (Metro AG 2004).

In the case of a positive spread between operative profit after tax and financing costs, a company generates value.

Calculation of Weighted Average Cost of Capital (WACC) for Metro Group in 2006

Figure 15.7



Source: Metro AG 2006, p. 30.

Country-Specific WACC

Equity cost of capital is determined on the basis of the capital asset pricing model (CAPM), which states that investors only invest in a company if they receive at least the return of a risk-free alternative plus a premium for their market risk which is weighted with a company-specific risk factor (Bühner/Tuschke 1999, p. 17). In the case of *Metro*, this BETA factor equals 1. WACC is normally computed once a year for each country in which the

group operates. In the case of high inflation, for example, it is recalculated quarterly. In 2005, the WACC values ranged between 6.5 % and 9 %. However, no sales division-specific WACC is computed.

Sources for Calculating EVA

The sources for the other data used to compute EVA are the income statement (for NOPAT) and the balance sheet (for capital employed). However, a number of adjustments have to be made in terms of the principles of materiality, continuity, practicability and comprehensibility, in order to eliminate distortions and to allow a reasonable calculation of EVA. Such adjustments (which can be grouped into the four categories of *fundamental*, *basic*, and *retail-specific* adjustments as well as those *subject to approval*) do not alter the external balance sheet and income statement. They are implemented in internal accounting in order to map the economic performance accurately and provide an incentive for value-creating behaviour via the incentive system.

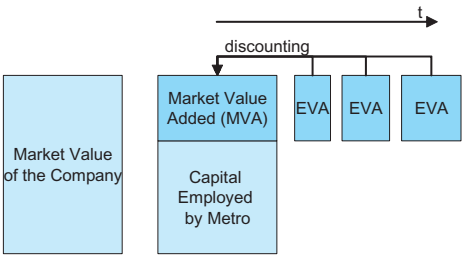
EVA Team

The appropriate definition of adjustments is one of the main functions of *Metro*'s EVA team, which is composed of staff from Planning & Controlling, Corporate Accounting and Corporate Human Resources. Other tasks include the calculation of EVA, clarification of specific questions relating to the different sales divisions, communication of EVA-related matters, calculation of bonus factors, documentation, and training (Metro AG 2004).

Concept of MVA

EVA is closely connected to the concept of market value added (MVA). A company's MVA represents the difference between its market value (stock market price multiplied by the number of shares issued) and capital employed. Today's MVA expresses the investors' expectation of the future success of the company, "in concrete terms their expectations of future EVA improvements" (Metro AG 2004, p. 9). Thus, MVA is the sum of anticipated future EVAs which are made comparable by discounting them to the present day for all sales divisions, investments and projects (see Figure 15.8).

Figure 15.8 *Relationship Between MVA and EVA*



Source: Metro AG 2004, p. 9.

Delta EVA

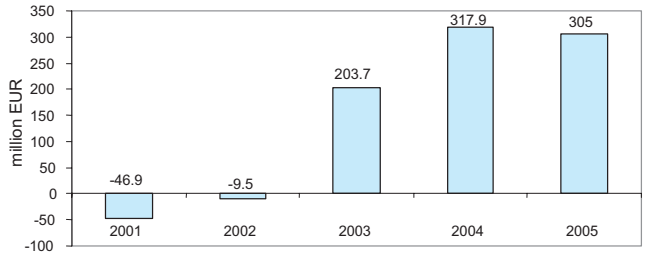
Since MVA is the present value of future expected EVA (Stern/Shiely/Ross 2001, p. 17), the stock price and consequently MVA, will only rise if expectations are exceeded. Thus, the dynamics of EVA are important. The absolute present EVA reflects past performance.

However, delta EVA measures the change in EVA compared to the previous year and only if the actual EVA improvement corresponds to the expected EVA improvement, market expectations reflected in the current MVA are justified and investors receive their full return (Metro AG 2004, p. 10). A positive delta EVA implies an improved ratio between NOPAT and capital employed.

Figure 15.9 illustrates the dynamics of EVA development for the *Metro* group as a whole, whereas Figure 15.10 represents the EVA for 2005 as well as delta EVA (the change in 2005 compared to 2004) for the four individual sales divisions.

Development of EVA at Metro Group: 2001-2005.

Figure 15.9



EVA at Metro Group's Sales Divisions in 2005

Figure 15.10

Sales Division	EVA (in million EUR)	Delta EVA (in million EUR)
Metro Cash & Carry	389	12
Real (incl. Extra)	-289	-124
Media Markt/Saturn	265	17
Galeria Kaufhof	-27	11

EVA as a Tool for Daily Corporate Management

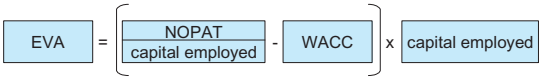
Assessment of Every Decision in Terms of the Contribution to EVA

The *Metro* group is dedicated to value-oriented business management based on economic value added (EVA). All operative, strategic and investment activities and decisions are assessed and evaluated in terms of their contribution to overall company value. For this reason, all decisions are made against the background of their contribution to the group's EVA and the increase in EVA from each individual decision contributes to the improvement of the complete EVA: "…every EVA improvement counts!" (Metro AG 2004, p. 10). Thus EVA has to fulfil the function of controlling resources so that capital flows into those fields in which the highest value enhancement can be expected.

Thus, the discounted EVA (see Figure 15.8) is forecasted for each potential project and every decision (Mengele 1999, p. 138). According to the rule that a positive EVA cash value increases, and a negative cash value reduces the value of the group's EVA over the long term, the calculated and discounted EVA values serve as decision factors for accepting or rejecting an investment. For this calculation, the WACC is also used as the „minimum return on the capital employed" (Metro AG 2004, p. 20). For each country in which the *Metro* group is active, an appropriate WACC is calculated (see Figure 15.7) in order to take account of different political and economical conditions such as inflation risk. However, the same WACC is used throughout the same sales divisions in different countries, for reasons of similarity of business areas and risk structures, as well as to facilitate calculation (Metro AG 2004, p. 14). In the financial year 2005, *Metro* group has invested a total amount of 2.1 billion EUR, equalling an increase of 394 million EUR compared with the same period the year before.

Investing in projects with a positive EVA cash value is one of the most important ways to increase a company's economic value added. By means of a simple modification of the formula for EVA calculation (see Figure 15.6), the three basic options for a company to improve EVA can be seen directly through the individual formula components (see Figure 15.11).

Figure 15.11 *Modified EVA Formula*



Source: Metro AG 2004, p. 15.

Three Possibilities of Increasing EVA

In order to increase the EVA value, the company can either *increase NOPAT*, which means raising the profit of previously existing businesses without additional capital expenditure, or *invest capital in projects the return rate of which exceeds the WACC.* Alternatively, it can reduce the so-called dead assets, which means *reducing the capital employed*. Measures to increase NOPAT are also referred to as *profit management* and those for the optimisation of already invested capital as *asset management*. Improving one of the three possible factors leads, ceteris paribus, to an increase in EVA.

Specific Measures

Specific measures for a NOPAT increase for existing business areas achieve higher turnover on the same floor space (like-for-like) by, for instance special offers, improved customer service or a more efficient cost management through process optimisation or the cost-effective employment of part- and full-time workers. Projects with a positive discounted EVA value can include the opening of new stores, implementation of product ranges or the development of sustainable competitive advantage through innovations. A reduction in dead capital employed can be achieved by optimising warehouse inventories with the help of special sales, increasing stock turnover through an improved product range, the sale of less relevant tangible assets or closing down unproductive sites (Metro AG 2004).

Risk Management

The company's risk management is also based on the steering instrument of economic value added. When deciding whether to accept specific risks, the *Metro* group's guiding principle is the sustainable increase in enterprise value. EVA represents the crucial benchmark for corporate success and is, in particular, an important criterion for investment decisions. Entrepreneurial risks are taken only if the concomitant risks are manageable and where the opportunities involved promise reasonable value added.

Performance-Related Remuneration and Incentive System

Employee's Participation in EVA

A carefully designed EVA incentive programme is seen as one of the most important steps in successfully implementing EVA as a group steering system (Stern/Shiely/Ross 2001, p. 147). At *Metro*, EVA is the basis for the variable component of salary. Thus, employees participate directly in the company's business success, which increases their identification with *Metro* group and enhances their awareness of opportunities and risks associated with all entrepreneurial decisions. Accordingly, employees ideally become "co-entrepreneurs" and "act as portfolio managers" (Bell 2004b, p. 223).

This measure tries to solve the intrinsic conflict "between the realization of an attractive return on investment and an attractive variable incentive for the employees" (Metro AG 2004, p. 21).

Mode of Function of EVA Incentive System

The EVA incentive system is implemented individually for each of the sales divisions with the help of the internal bonus bank system, which works as follows. The starting point for the calculation is the objective of expected EVA improvement (delta EVA). An employee's bonus changes with the realised delta EVAs each financial year. Where the anticipated and the real value of delta EVA correspond with one another, the individually agreed target bonus is granted. However, the bonus for the current fiscal year is only paid up to this value. If the target value is exceeded, the remaining difference is credited to the personal bonus bank. Each year, a fixed percentage is disbursed out of this bonus bank credit and the residue is carried forward. A negative bonus reduces the credit, but the negative credit has a lower limit. The bonus bank system is intended to smooth out annual expenditure and thus to create incentives also in the medium term (Metro AG 2004).

Management Level

There is also a link between remuneration and EVA concept at the management board level, which in this case is intended to reduce conflict between managers and shareholders (i.e. the company's owners) by rewarding managers for performance that increases shareholder value and penalising them in the converse case (Stern/Shiely/Ross 2001, p. 24). Within the *Metro* group, management board remuneration is linked by two-thirds to the performance evaluation via EVA, whereas only one third of the boardroom pay is fixed. The size of the variable, performance-based compensation results largely from EVA-based remuneration entitlements. Due to the bonus bank system, the full payout of EVA-based compensation entitlements depends on EVA factors in subsequent years. The development of delta EVA is the basis of the EVA-based remuneration system for members of the management board, just as for the staff. The EVA-based remuneration system is itself based on a comparison of delta EVA with a target set by the Supervisory Board's Personnel and Nominations Committee, taking into account capital market expectations of value creation. If the target is reached, an agreed bonus is paid in full (bonus factor 1.0). A third component of the remuneration of *Metro's* management board consists of a variable stock options plan (Metro AG 2005a, p. 15).

Summary and Outlook

Because of economic stagnation and the associated consumer price sensitivity especially in Germany, the retail industry is currently characterised by a high competitive intensity and difficult startup conditions. This trend can clearly be seen in the rapid growth of hard discounters in food retailing (see case study *Aldi* in Chapter 5) and as far as the *Metro* group is concerned, this trend is confirmed by the weakness of the hypermarket operators *Real*, the

only sales division (together with *Extra*) which was confronted with negative developments in the financial year 2005 as far as turnover, EBIT and EVA are concerned. This reveals the relevance of an effective performance measurement tool, also in the future in order to be able to evaluate decisions against the background of their contribution to the company's growth in crisis-ridden sales divisions. According to various reports, the *Metro* group will not sell the sales division *Real/Extra* and will counteract current difficulties with a quality assurance offensive as well as reduced personnel costs (Planet Retail 2006a). *Metro's* heavily pushed internationalisation, especially in East European or Asian markets, requires a relevant forecast of (expected) EVA in order to implement value-adding investments. These value enhancements are necessary for publicly listed companies, in order to satisfy shareholder desires for an increasing MVA, market price and dividends.

Questions

1. Apart from the *Metro* group, several other companies such as *Ahold* or *JCPenney* use EVA as a group steering system. Discuss the possible limits and risks of EVA as a group steering system.
2. What possible drivers or determinants can influence the economic value added in a company or contribute to its improvement?
3. Compare the EVA concept with another steering tool for value-based company management within the framework of the shareholder value approach and make a comparative analysis.

Hints

1. See Metro AG 2004 for details of the computation of EVA.
2. See section "EVA as a Tool for Daily Corporate Management" and Metro AG 2004 for examples of value drivers. Also take into consideration Metro's annual reports and press coverage for current examples of projects with expected positive discounted EVA net value.
3. See Stewart 1990 for a detailed analysis of the relationship between EVA and MVA.

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