



When art meets science:

A blueprint for successful format renewal

McKinsey&Company

When art meets science:

A blueprint for successful format renewal

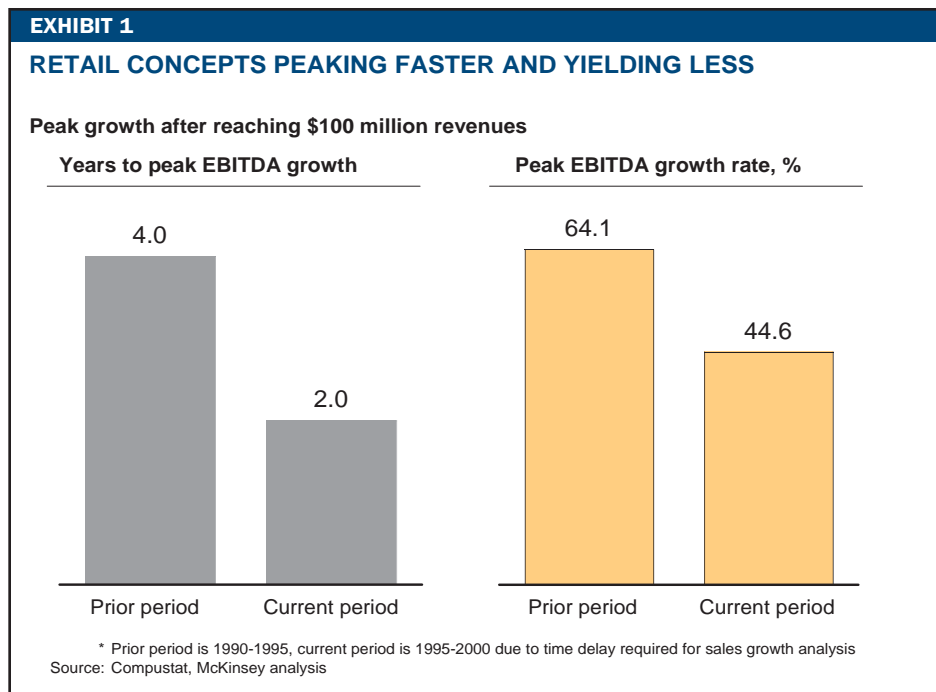
Format popularity comes and goes like runway fashions in today's retail environment, as concepts mature faster than ever before. Unfortunately, many retailers stumble and find that their renewal efforts are too little, too late, or too costly.

How can companies avoid this fate and sustain comparable store growth year after year? They must have both strong operating skills and very deep insights into what their customers want today, next week, and next month. They have to give their customers reasons not to shop competitors who will keep trying to win them over.

Accomplishing this is difficult. Retailers need to cut through the noise from their customers, stores, and organization. They must identify the precise mix of store attributes that have the greatest impact on customer behavior and still deliver positive capital returns. Capturing this blend requires significant discipline throughout the design and development process. Leading retailers have found a way to define the customer and brand sweet spots, design a format that delights, and deliver the promise efficiently and effectively, inside and outside the store.

INTRODUCTION

Format popularity comes and goes like runway fashions in today's retail environment as concepts mature much faster than ever before. In the early 1990s, new concepts reached top performance in approximately 4 years; by the late 1990s, it took just two years for new concepts to peak. After 6 years, many ran completely out of gas (Exhibit 1). Some of the strongest "growth" retailers in the mid- to late-90s, such as Wet Seal and Kohl's, are now working hard to stay relevant to their customers. Other high-growth retailers, which expanded rapidly over the past decade, are experiencing increasing difficulty in securing high-quality site locations. They are also looking carefully at their renewal efforts to improve their return on assets.



Some companies find that they cannot overcome the obstacle of too little renewal, or renewal that is too late. The statistics are not promising. Of the 26 retailers who had at least three consecutive years of negative earnings by 2000, over two-thirds either never returned to profitability or took more than 5 years to do so.

How can companies avoid this fate and sustain comparable store growth year after year? They must have both strong operating skills and very deep insights into what their customers want today, next week, and next month. They have to give them reasons **not** to shop at competitors, which will keep trying to win them over.

But accomplishing this is difficult. In our experience, companies need to cut through the noise from their customers, stores, and organizations. This is the only way they can identify the precise mix of store attributes (e.g., shopping frequency, basket size, and loyalty) that have the greatest impact on customer behavior. Capturing this blend requires much more than a fresh coat of paint and new fixtures. Decisions regarding the fitting rooms, flooring, adjacencies, and signage matter to customers and influence how they shop a store.

How does a retailer figure this out? The key is to use the right tools to predict what will positively and negatively affect various customer groups. By unlocking the handful of store, product, and service elements that are truly important to the most profitable customers, companies can more effectively build or renew a format that will accelerate sales and profit growth.

Taking three steps can help any company launch a distinctive, renewed format:

- 1) Define the sweet spots that marry consumer needs and brand strength,
- 2) Design a format that delights by investing in the elements that best shape customer behavior, and
- 3) Deliver the promise efficiently and effectively, inside and outside the store.

Throughout the process, both formal and informal customer insight combine with rigorous analysis to ensure that the substantial effort and investment will pay off.

DEFINE THE SWEET SPOTS

Isolating the handful of future customer shop occasions a retailer can and should own can seem like an impossible task. As a result, many retailers wisely experiment with format remodels. But even a try-it, fix-it approach will have significantly better results if the starting point is based on actionable

customer insights and supporting facts. An investment in sophisticated – yet actionable – market research is something we believe should precede any format renewal or new concept development effort.

But few retailers have taken this approach. We frequently hear retailers ask, “How do we figure out **exactly** what our customers want, even the small things that they don’t even know they want?” An answer to this perplexing question can only be discovered by melding art with science. The art is the strong, qualitative insight and intuition that comes from serving the same customer segments for years. The science relies on powerful tools and analysis that can quantitatively pinpoint the sweet spots.

Linking consumer insight to store and product attributes will start to unearth the few sweet spots that delight high-priority customer segments. While most retailers have strong intuitions and hypotheses about what such customers need and want, advanced market research can augment, focus and direct these impressions into the areas with the greatest impact. Such modeling can help companies pinpoint the specific store attributes that customers associate with the brand (e.g., rugged masculinity; the best fit you can get). We also find that retailers can determine which store, product, and brand attributes reinforce one another, and which actually conflict. For example, one company identified a set of attributes that collectively had several times more customer impact than an alternate set they had predicted would be superior. Sophisticated statistical modeling is often the only method that can reveal these interconnections.

These insights provide a foundation that companies can use to identify the customer segments they need to own. To gain these insights, retailers should augment existing consumer knowledge and store-level input with a short burst of qualitative and quantitative research. In a matter of weeks, it is possible to complete the picture and understand where various consumers shop, how much they spend, and why they prefer one retailer over another.

More research is often required if retailers are going to move beyond knowledge of what has happened to what is likely to happen. Traditional assessments identify historical purchase trends or customer satisfaction

levels. To shape consumer behavior, companies need to understand it now and predict its future course. A customer segmentation that examines attitudinal and life-stage needs for each purchase occasion gets to the heart of consumer behavior and can provide information that helps shape future actions (Exhibit 2).



These insights then help retailers make two crucial decisions: what brand assets do they need to emphasize and which dimensions do they want to become famous for. The research identifies the core properties of their brand and their competitors’ brands. It deepens knowledge about where their customers (and consumers not currently shopping their store) will allow the company to move and where they will not. For instance, does a value-based retailer have the credibility to offer more upscale fashion and design? Does a lingerie specialty retailer have the authority to sell bedding? A single misstep could adversely affect a retail brand for years.

But information is useless unless a company can translate these customer and brand insights into just a few store dimensions on which it will be distinctive. Traditionally, a retailer in high-growth mode has hit upon something unique. But over time all good concepts are copied. To stay

ahead, a market leader regularly refreshes its proposition to continue to satisfy customers. It presents a very compelling offer on one or two critical customer dimensions – price, convenience, experience, merchandise authority or service. Gaining insight into consumers from the beginning, and as a continuous process regularly to refresh a format can help narrow these choices. For instance, if high-priority segments shop at stores that offer complete solutions for their children, then merchandise authority and service may be the two critical elements. Translating these decisions into store tangibles is what occurs during the design stage.

RECAPTURING PROFITABILITY BY DEFINING CUSTOMER “SWEET SPOTS”

Over the past few years, a leading multi-category retailer had lost a number of shopping trips to discounters and specialty retailers. To win back customers and improve performance, it embarked on a journey to better understand who its valuable customers were, whether they could be won back, and, if so, whether they could be “delighted” profitably.

The company first examined its existing market research and gathered impressions from customer focus groups and closet walk-throughs. It then developed an in-depth survey that revealed new types of information that focused on behaviors and decision making. Questions included:

- *Who is our competition in our top 12 highly-shopped product categories? How much spending/share of mind do our customers give us versus our competitors?*
- *What key wear occasions do our core customer segments care about? What decision making processes drive core customers’ trips and spending, by category?*

The company used survey insights to find the “sweet spot” in the customer base. Surprisingly, only four of seven customer segments had significant upside potential. To gain greater share of spend in these four groups, the retailer had to excel on three shopping dimensions: style leadership, predictable promotional cadence, and convenience. Frequent promotions, which the company had been conducting, were not that important. In the eyes of the retailers’ best customers, less was more.

This level of insight was enlightening for the team and senior leadership. They had never had such a specific, actionable grasp of what it would take to win back the shopper. After years of internal debate, the retailer finally knew how to regain its authority with core customers and restore the confidence it had lost.

DESIGN A FORMAT THAT DELIGHTS

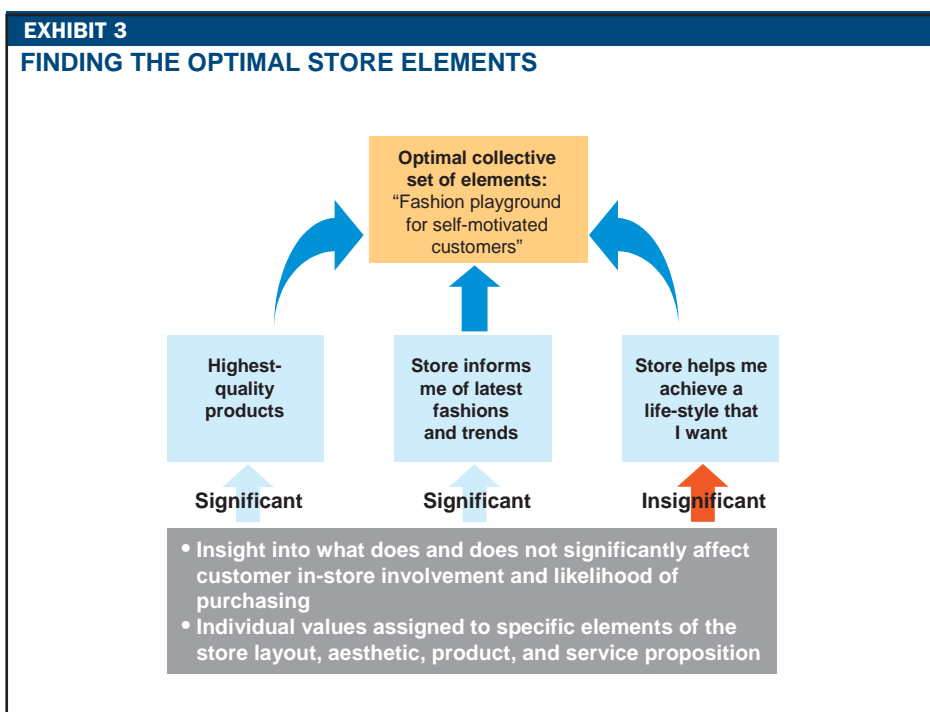
The “define, design, and deliver” renewal process enables retailers to translate their findings into actions by identifying and then implementing the specific combination of attributes and store layout that will maximize future profitability. In the design stage of this process, the strategy is converted into specific features and actions to maximize customer impact.

Retailers first translate the concept into store tangibles, which become the format. Layout, placement, adjacencies, and look and feel are all elements that need to be carefully chosen. Statistical modeling makes it possible to identify and analyze the attributes that most appeal to and influence priority customer segments. It is important to find specific “hooks and triggers” that draw customers into the store, keep them interested, and trigger their purchases. These devices can include critical store design elements like comfortable fitting rooms or well-placed signage and “key item” tables.

These tangibles all contribute to the overall “shoppability” of the store, an important – and often overlooked – factor. Shoppability is the cumulative effect of how the store layout, product display, and pass-throughs influence shopper behavior (Exhibit 3). A difficult in-and-out experience will affect how a customer views the store for all her trip occasions. Areas of the store with excess traffic are off-putting and those with very little traffic waste productive space (and can be off-putting as well). Simple observational research and input from store associates and managers can reveal critical store design elements and areas of the store which hinder or jeopardize purchases.

The path that a shopper takes often differs by the type of shopping occasion. For instance, a quick stop for an immediate need will have a short in-and-out spike with just a few stopping points. It is critical to place last-minute or

easily forgotten items (e.g., hamburger buns or stockings) in a convenient location for a fast and hassle-free transaction. For the seasonal or weekly stock-up trip, broad selection and displays that show how items work together are important. Without logical adjacencies and a pre-defined route, the customer could miss opportunities to fill her wardrobe or pantry.



After creating the format, many retailers then spend hundreds of thousands of dollars remodeling just one store. This may not be necessary. While many design elements may be aesthetically appealing, they are neither appreciated by the customer nor aid the sales associates. Most of the costs of renewal are locked in during the design phase – not in the construction phase – so in designing the renewal it is critically important to question content rigorously, and to design specifications that deliver the most value. A disciplined design process is called for, which incorporates practices such as target cost design that are prevalent in other design-heavy industries, such as the automotive industry. This tactic could be as simple as eliminating an expensive entrance vestibule in a warm-climate store or substituting attractive, lower cost (and possibly more unique) finishes and materials for premium ones. Many hotels

and spas have incorporated this into their recent remodeling efforts. They have shifted the investment into attributes that matter and reinforce the brand – Westin’s Heavenly Bed® , the club-like lounge area in the men’s section of the Willow Stream Spa, and so forth. Another expeditious but costly mistake is to take a “one size fits all” approach where every store in the network receives the original design package. This method typically wastes money. Obviously, some stores deserve more resources than others because they have a greater potential to pay back the capital investment.

The critical decisions of the design phase demand careful analysis of customer behavior. There are many elements that constitute the total picture of customer behavior, and a financial value can be assigned to each of them. With all the elements taken into account, various prototypical designs can then be evaluated for financial impact, using profitability metrics. With this kind of scrutiny, the savings can be quite large, as needless design features can be eliminated and reasonable payback from every store in the network can be ensured. Capturing this impact will be difficult, however, without the skills for implementing the renewal.

USING INNOVATIVE DESIGN TO WIN WITH BOTH EXISTING AND NEW CUSTOMERS

Five years ago, a U.S. grocer with dominant market share led its market on price and possessed a lock on convenient neighborhood locations. But as the population shifted and new neighborhoods grew, the company found that many customers were suddenly shopping at the nearby supercenter or new high-end specialty grocer.

The grocer embarked on an effort to design a new store concept that would win back loyal shoppers and draw in new customers who didn’t consider the store for quick trips. Extensive market research revealed three types of shoppers who craved quick-meal solutions. These segments valued different things in a grocery store, but their preferences were compatible.

However, none of their existing stores could please all three segments. The “something for everyone” approach would fall short. Energized by the need for a tailored approach for existing and new shoppers, a dedicated team devised a

prototype store. After several months of work, with extensive participation from the senior executive team, a new store design emerged.

The layout was unique. The store included a center core with easy-to-shop items like milk, juice, and fresh fruit snacks. Corner sections drew customers into specialized meal-solutions zones. Each of the individual elements would have been of interest in a regular grocery store. Collectively, they not only drew in customers, but triggered sales and return visits. The initial wave of redesigned stores outperformed the traditional stores by 30 percent. Many elements were quickly rolled out to the existing network and several other stores are under development.

DELIVER THE PROMISE

Most retailers remodel their stores every 5 to 9 years, depending on the pace of competitive change. Specialty retailers tend to renew more frequently, as a steady influx of new concepts rapidly dates formats. Recently, the wave of mergers and acquisitions is accelerating the pace and level of investment in remodels. For instance, Federated plans to rebrand and refresh many of the May Department Store banners. CVS is spending \$350 million reformatting 1,000+ Eckerd stores they purchased in 2004.

Regardless of the retailer's motivation, designing a new format is expensive – even for one store. It requires significant time and money to get inside the customer's head, build a format based on met and unmet needs, and then fine-tune that offering to ensure profitability. Revamping an entire network of several hundred or a thousand stores is another challenge altogether.

In our experience, companies that have successfully renewed their formats not only aggressively managed their remodeling budget, but simultaneously ensured that they had the organizational skills and mind-set needed for successful implementation. While this approach is challenging, the impact and payoff can be enormous.

The answers to the questions, “How many stores should we remodel a year?” and, “How much money should we spend upgrading each store?”, clearly

depend on a retailer's particular format and specific financial expectations from the renewal. The good news is that it is often possible to spend less than expected to deliver the desired impact. By setting the right scope and specifications and reining in costs, companies can often squeeze 15 to 25 percent out of a remodel budget.

Savvy retailers do this by ensuring that they have scoped the renewal to include customer-facing elements and eliminate or deemphasize elements with little customer impact. This could mean doing away with metal display cages that protect products but hinder access and inspection. Successful companies also ensure that their specifications include a clear definition of the minimum performance or functionality required to deliver the desired impact. They are then able to make the right trade-offs – setting lower wattage or material specifications for light fixtures that hang 20 feet above the customer, for example. For one retailer, this trade-off resulted in a very good lighting system for 65 percent of the cost of the original design (Exhibit 4).

EXHIBIT 4

LOWER COSTS WITH LOWER SPECIFICATION

Initial lighting element



- Glass and metal component parts
- Specifications exceed functionality requirements
- Complex mounting system
- Expensive maintenance

65% cost reduction

Final lighting element



- Plastic component parts; difference unnoticeable to the customer
- Product specifications meet functionality requirements
- Simplified mounting
- Easy and less costly maintenance

Sourcing is another important tool to reduce renewal costs. By aggressively sourcing both components and contractor services, leading retailers can reduce their renewal purchases by 10 to 30 percent. Finally, sound project

management skills must keep the project on time and on budget. Hard deadlines and penalties for delays or change orders are routine, and low-value activities like additional walk-throughs and duplicate inspections are avoided.

But even when retailers aggressively manage the time and money invested in a renewed format, the required organizational skills often trip them up. A fresh set of customers, an innovative store layout, and novel ways of providing customer solutions demand new capabilities and operating procedures. Doing things “like they’ve always been done” isn’t enough. Adding to the challenge is the fact that a renewal is a continuous effort, not a one-time reset. A shift in mind-set and clear performance expectations that drive continuous improvement are crucial if retail organizations are going to embed this approach into their culture.

In our experience, the following skills underpin any successful renewal. Retailers who want to succeed need to focus on these skills from the very beginning – and find ways to reinforce their commitment to them throughout the renewal process:

- Translate functional changes into specific actions that individuals need to take (and stop taking). These “guard rails” ensure ownership at the personal level but also prevent old habits from cropping up again. Everyone from the CEO to the frontline associate needs to buy into the change and know what they should be doing on a daily basis.
- Pilot the redesign to fine-tune the design and delivery. Everyone wants the remodel “out for the holidays.” In our experience, the payback will be greater if pilot stores are run and tweaked for several months (maybe even during the holidays). Best-practice retailers complete several rapid iterations that vastly improve the store’s shoppability and profitability. This discipline and patience can prevent the organizational pain of an excessively costly remodel, based on a poorly designed concept and hasty rollout.
- Manage the change through clearly defined and broadly understood performance metrics. Specifics like basket-size growth, average items per

basket, conversion rate, and customer traffic can provide tangible insight into how store-level activities affect the business. They also offer concrete evidence about which elements of the format are working and whether these items deserve their current level of investment.

- Treat the remodel like a complete makeover – one that affects the interior as well as exterior. The organizational transformation that needs to accompany the physical one is critical to success. The way the company gains consumer insights, the service delivery model, and the merchandise flow often need to be altered to deliver the new concept effectively – and to stay ahead of consumer tastes and competitive response.

DELIVERING CUSTOMER IMPACT AT LOWER COST

A high-growth, multi-billion dollar specialty retailer wanted to deliver a store that cost 25 percent less than previous builds or remodels. They had many stores to renew in the coming 5 years and wanted to get the most bang for their buck. To pinpoint the store areas that mattered most – the features for which the retailer would get credit – the company analyzed data on customer shopping behaviors and perceptions of the retailer vs. competitors. Features and finishes that mattered less became areas where the company could make substitutions or lower design specifications. For instance, carpeted floors were important. They reduced noise, made it clear where consumers could find certain products, and gave the impression of quality. Portions of the store, therefore, needed to be carpeted. Lighting was also critical to showcase the products properly. However, the retailer also found that it could install a better lighting solution for 25 percent less than the existing lighting package.

Store-level economic analysis revealed that each store could not sustain the same level of investment. Those with a stronger customer base and higher profit potential could justify more investment; others that were never going to yield the same financial returns would receive less. It was time to reevaluate the costs of construction and individual features. Where should the retailer cut back to deliver a “lighter” investment package? The company again used customer and store associate feedback to identify the minimum specifications that would deliver sufficient effect. As a result, the retailer gave the lowest-performing stores a remodel package that cost one-third of the package given to top performers – without reducing customer impact.

CONCLUSION

Format renewal is absolutely necessary for sustaining retail success and relevance. It must, therefore, be approached holistically. Many renewing retailers have relied too heavily, however, on their "art" – their insight and intuition. Companies that want to maximize their effect on their customers' future behavior, however, must use "science" – in the form of sophisticated research and analysis – as well. Exploiting these scientific tools will help retailers achieve the full potential of their art. Retailers must see renewal as a combination of internal and external change. By undergoing a rigorous format renewal process, retailers can identify and focus on the sweet spots in a crowded, undifferentiated marketplace. What they end up with is a format that draws in and delights customers, generates superior economic performance, and is continuously improved year after year.

Andrew Ross is a Principal in McKinsey & Company's Chicago office; Bart Sichel is an Associate Principal in the New York office; and Jennifer Schmidt is a Senior Practice Knowledge Specialist in the New Jersey office. The authors would like to thank Shannon Brownell, Chris Hsu and Amanda Matejak for their contributions to this article.

North American Retail Practice
August 2005
Designed by the New York Design Center
Copyright © McKinsey & Company
<http://retail.mckinsey.com>

McKinsey&Company