Retail Operations

Six success factors for a tough market
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Introduction

The roll call of retail failure has become longer in the past few months. Many well-known retail brands in the UK and Europe have got into financial difficulty and changed hands in distressed sales or have been wound up and disappeared altogether. But, however bleak the consumer outlook may appear to be, the picture is not uniform across the retail landscape. Some retailers are weathering the storm and even prospering in the face of general downturn on the high street.

Undeniably, much of the impact we have seen has been the result of irreversible technological change and the rise of online shopping. Also, the government’s austerity measures have driven sharp reductions in discretionary consumer spending. However, our experience of working on many retail deals over the past five years indicates that some of the pain may be self-inflicted.

A successful senior executive in the grocery trade once told us: “The retail game is not complicated: all you have to do is understand what your customer wants to buy, offer it at a price they are prepared to pay and make sure it is available when they want to buy it”.

This maxim assumes that if you get this formula right, everything else will follow. And, in an otherwise benign consumer environment, that is probably true. Our view is that in the current climate, at the very least, retailers really need to get those three things right. We believe that retailers also need to focus on cost, capital expenditure, supply chain efficiency and integrating their online channel, to ensure that you can do those three things and be profitable. We have distilled these observations into six operational success factors, which we think help both retail investors and retail bosses in challenging or validating current practices and performance.
Complexity = cost ... simple operating models are lean

A grocery retailer we worked with a few years ago introduced huge efficiencies to the organisation by cutting its SKU count from 12,000 to c. 6,000.

A key driver of complexity in a retail environment is the number of unique Stock Keeping Units (SKUs) and the number of formats and fascias. Whilst offering a large number of SKUs may seem to be offering customers what they want, it adds cost to the operation. High SKU counts result in larger distribution centres, higher stock levels, more suppliers to manage, and more effort to maintain product availability.

A grocery retailer we worked with a few years ago introduced huge efficiencies to the organisation by cutting its SKU count from 12,000 to c. 6,000. This allowed them to eliminate national distribution centres and to reduce the total number of regional distribution centres, all without compromising service levels, or on-shelf availability. This was accomplished by changing the balance of A-brand and private label, and de-listing B-brands, whilst maintaining the perception of customer choice.

The same retailer eliminated fascias and size formats which were inconsistent with its core demographic and value proposition (re-branding certain stores and closing others). The removal of this complexity enabled a 50% reduction in central costs. Levers for headcount reduction included process simplification, consolidation of central functions and outsourcing of ‘non-core’ functions.

Another very successful food retailer takes this successful approach a step further, adhering strictly to a single-format model and a very small, targeted SKU range which is managed carefully to prevent ‘SKU-creep’.

This complexity reduction principle is applicable to general and fashion retail too. For example, a multichannel fashion and general retailer was underperforming its competitors post-financial crisis. One of the principal drivers of underperformance was a long tail of under-performing SKUs. This had come about due to undisciplined range and stock management and led to a large amount of slow-moving and aged stock, which in turn generated additional overhead. The combination of these factors was putting pressure on liquidity.

The retailer was able to improve this by improving range and stock management policies (e.g., ABC inventory management). This was accomplished without compromising customer range perceptions or lead time. The charts below illustrate the reduction in SKU achievable with negligible impact on margin, but with positive impact on cash and cost.

To support this complexity reduction in retail operations, warehousing and merchandising IT systems should be integrated and not reliant on human intervention to transfer information from one system to another.
Questions to ask yourself:

► Is the complexity of my range/format justified for the margin I am achieving?
► What additional central and supply chain cost is this complexity driving?
► How can I reduce complexity and cost without impacting my customer experience?

Source: EY analysis 2012
Staff are your biggest non-product cost ... and your biggest asset

Store labour is the largest category of controllable non-product cost for retailers. For this reason, major retailers have invested heavily in labour planning software to ensure that appropriate labour hours are deployed to support planned sales.

However, more important to survival in the current tough retail environment is labour flexibility – that is, not the total number of hours per week, but the distribution of those hours throughout the week. A major grocery retailer (‘Retailer 6’ in the chart below) achieved major improvements in labour flexibility by harmonising staff terms and conditions and aligning these with customer needs. This meant that stores had sufficient staff on the floor at non-overtime pay rates when needed on Bank Holidays and evenings, and were not overstaffed in quiet periods.

Although cost control and flexibility are important, store staff shape the experience of the end customer and enforce the store standards that, in turn, drive footfall and ‘on-shelf’ product availability. Retailers should therefore pay close attention to the satisfaction, engagement and pay-rates of store staff.

The grocery retailer we mentioned above drove through a major simplification in staff terms and conditions and reduced overall staff costs by one percentage point of sales. During the same period they kept staff churn below sector benchmark levels, reduced sickness payments and achieved 80% positive responses on staff surveys. This was achieved through better training, listening to staff suggestions and rewarding team performance.

Technology can provide opportunities to train and develop staff in stores. Short ‘eLearning’ modules delivered over the network allow staff to train during quiet periods in store. This also lowers the cost of training substantially.

Given their lower sales densities, fashion retailers find it harder to achieve the same store staff cost ratios as grocery retailers. However, some do better than others: ‘Retailer 1’ and ‘Retailer 2’ were very similar fashion businesses. However, ‘Retailer 1’ had significantly higher labour costs, driven by less sophisticated labour planning and control capability. This was a significant factor in its eventual collapse into administration.

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Questions to ask yourself:

► How competitive are my store staff costs and could I be more efficient in how labour is planned?

► Do I have the flexibility to put in store staff when I need them without incurring undue extra cost?

► Are my store staff engaged and how is a possible lack of engagement impacting store standards?

Source: EY analysis 2012
‘Fixed’ store costs should still be actively managed

Store overheads and costs (including utilities, rent and rates) are often treated as an uncontrollable fixed cost. It is often the notorious quarterly rent payment that pushes an ailing UK retailer into insolvency. These costs may be fixed, but they are certainly controllable in the medium to long term.

The best retail operations have strong (but not necessarily large) central property management functions that are responsible for central negotiation of rents and rates as well as utility, outsourced maintenance and other service contracts. These departments also actively manage these costs, for example, by implementing energy saving technology across the estate to reduce utility bills. A certain retailer we worked with, rolled out tablet PCs with 3G connections instead of a fixed network to reduce fixed store telecommunications costs.

Rent is usually by far the largest of these fixed occupancy costs and the best retailers devote resources to managing this cost, for example, by trying to negotiate monthly rather than quarterly rent payments, as well as lower rent levels to help liquidity. However, leverage to negotiate will vary: Store locations remain vital to the operations of a retailer and must be appropriately aligned to the customer base in order to maximise sales. This extends to both geographical distribution (where local demographics are key) and the pitch, either prime or secondary, within a given retailing area. Both will have a determining impact on the level of fixed costs incurred by a retailer, but more importantly, will strongly influence store revenue.

At time of writing, the prime Central London market remains good, with demand sufficiently outstripping supply to put upward pressure on rents. Demand also remains reasonable for a small number of other prime south eastern towns. Rents elsewhere, however, are still contracting or remain static. With institutional lease structures providing for ‘upward-only’ rent reviews, many stores have become ‘over-rented’ (rent above market rates). This represents a substantial additional fixed cost for many retailers, and therefore many are seeking to ‘re-gear’ their leases: secure a rent reduction in exchange for an extension of the lease term. The tenant’s negotiating position depends on the strength of the town and pitch in which the store is situated. Occupancy of low-demand secondary locations, short remaining lease terms and good tenant covenant strength will all give the tenant greater negotiating leverage, as the landlord will be keen for the tenant to remain in occupation.

The make-up of retail portfolios is likely to change further in the medium to long term as internet retailing gains an even greater proportion of market share (see our views on multichannel retailing below). This, combined with the current economic uncertainty, makes it essential that retail tenants have the flexibility to change and adapt to future market trends.

Prime retail units will typically be subject to leases in excess of 10 years, whereas landlords of secondary assets increasingly have to concede on shorter terms, in order to secure a tenant. Retailers should however ensure that leases do not unduly restrict their future ability to make changes to their estate, by placing onerous restrictions on the tenant in assigning the lease of a store (alienation clauses).

The nature of store portfolios must also be considered. Many retailers have a presence not only on the High Street, but also in out-of-town parks and shopping centres. The mix of these units will clearly be specific to the individual retailer but when expansion into different formats is pursued, flexibility is again vital in avoiding liquidity issues arising from unprofitable stores. For example, ‘Retailer 3’ in the chart below demonstrates the highest level of store overheads and occupancy costs in our group. This was driven by an ambitious expansion strategy, concentrating on upscale store locations. The sales densities achieved did not justify the costs, which was a factor in the financial difficulties it experienced.
Questions to ask yourself:

► How tightly am I managing store overheads and occupancy costs? Do I have the right mix of insourced and outsourced cost?

► Is there scope for me to ‘re-gear’ leases on underperforming stores?

► How flexible is my estate and does it offer the right mix to address future demand?
Supply chain is a core competency ... even if you outsource

Management of the retail supply chain is a key element of a retailer’s central mission of getting the right amount of product onto the shelves in a cost-effective way. Some of the most successful retailers have outsourced secondary distribution (warehouse to store) to third party logistics providers (3PLs). A high profile high street fashion retailer recently moved to a 3PL model, after problems with a new warehouse management IT system caused stock shortages, which resulted in a multi-million pound hit to the bottom line. This put the business under even more cash pressure at a time of soft demand.

However, outsourcing the operation of warehousing and/or transport doesn’t mean that you should outsource the overall supply chain competency in your organisation. On the contrary, the negotiation and management of 3PL contracts requires dedicated management skill and focus in order to keep availability up and distribution costs down.

A 3PL contract should be set up to reflect the key priorities of the retailer’s specific operating model e.g., in-store availability of key offers and seasonality. It should also make provision for the clear measurement of Key Performance Indicators (KPIs) and have a system of penalties and incentives for maintaining and exceeding target levels on KPIs such as Cost per Case and Picking Accuracy.

The best retailers do not surrender control or oversight of warehouse and transport operations but still maintain an integrated, constructive relationship with their 3PL. The best retailers do not surrender control or oversight of warehouse and transport operations but still maintain an integrated, constructive relationship with their 3PL that allows them to benefit from their expertise in day-to-day warehousing and transport operations. For example, in recent years there have been significant cost reductions to be had from new technologies such as voice picking and fleet telematics – both retailer and 3PL can benefit from their introduction.

Whether in-house or outsourced, efficient retail supply chain operations remain a moving target, with cost benchmarks continually moving downwards. The best retailers devote management resource to this area even in the current challenging market environment. The chart above demonstrates how even a moderately sized operator (‘Retailer 5’) is able to be competitive on distribution cost with larger players (‘Retailer 10-14’) due to the simplicity of its operating model and efficiency of its outsourced distribution.

From a technology standpoint, understanding and monitoring the end-to-end information flow is vitally important when considering supply chain systems. Retailers need to know where their goods are at all times.

Taking the time to develop end-to-end information needs reduces the design risk of the solution, whilst ensuring that the solution will produce the information needed to control the business.
Questions to ask yourself:

► How competitive are my distribution costs and are they moving in the right direction?

► Should I be operating warehousing and logistics myself or should I use a 3PL?

► Do I have the skills in place to manage my 3PL provider and drive continuous improvement?
Get the level of capital expenditure right

A key question is how much capex successful retailers should be spending in the current challenging environment.

The major component of retail capital expenditure (capex) generally relates to the fit-out of new stores and the refurbishment of existing stores.

A key question is how much capex successful retailers should be spending in the current challenging environment. New store and refurbishment capex need to be analysed separately to yield any meaningful comparison. However, it can be difficult to reach firm conclusions on this due to the different profiles and fit-out requirements of different demographics and sectors.

A comparative analysis of new store capex can highlight some interesting results. For example, the US operations of high street (‘Retailer 3 – US’) show a significantly higher new store fit-out spend than its European operations (‘Retailer 3 – EU’) or a competitor European high street fashion retailer (‘Retail 15’). This high level of spend was, however, not matched by a high contribution per square foot. As a result, the implied payback period of this spend is around four years on average, compared to other higher performing retailers, which show a payback in the range 1-2 years.

As mentioned above, these low returns on capital investment were a factor in ‘Retailer 3’s’ liquidity problems.

Refurbishment capex is the most difficult to benchmark, as it depends on the nature and size of the retail estate. Suffice to say, the common characteristic of the retail ‘survivors’ we have seen is that refurbishment capex is appropriately balanced against the demographic served, the cachet of the brand and the local competitive situation.

We have frequently heard from successful retail bosses that refurbishment capex does not usually deliver any immediate appreciable ‘pay-back’ in terms of increased like-for-like sales, but that neglect will lead to slow decline (and catch-up capex for an unwary purchaser). The answer is to keep to a sensible refurbishment cycle – and then to focus spend on the areas that have the most noticeable impact on the customer experience e.g., the changing rooms for a fashion retail outlet.

Retailers shouldn’t neglect IT capex either. One fashion retailer recently faced the prospect of ‘open heart surgery’ in replacing its core merchandising and supply chain systems simultaneously as both were over 20 years old and no longer supported. This introduced a significant execution risk to the organisation.
Questions to ask yourself:

► How can my return on new store capex be improved?

► What is an appropriate refurbishment cycle and spend for my existing estate and what areas should I focus spend on?

► Have I invested sufficiently in my retail systems to avoid the execution risk of simultaneous key IT system replacement or upgrade?
With the advent of ‘pure-play’ online retailers, traditional high street retailers have had to launch online channels to complement their existing business model. Some ‘bricks-and-mortar’ retail businesses have invested heavily in setting up online retail channels to gain competitive advantage, only for this new channel to remain autonomous from the core business. In the early days of online retailing this might have been due to a conscious decision not to divert management attention from core business operations. However, as online retailing has grown to be comparable in magnitude to traditional operations, this can result in wasteful and disruptive duplication of functions in areas such as marketing and supply chain.

One retailer we worked with had an online order fulfilment process that was not integrated with the warehouse management and fulfilment systems of the traditional business. As a result of this separation of the supply chain, the business began to lose track of its stock, resulting in an inability to fulfil online orders which, in turn, had a negative impact on sales.

Another retailer insisted on separate product strategies for its autonomous online and traditional businesses. This resulted in massive duplication across the supply chain with dis-synergies in everything from third party management to procurement.

Traditional retailers will need to recognise that they may need to make significant investments in IT when looking to become a multichannel retailer. This may well represent a step change from how they have operated before, with requirements for 24/7 reliability, availability and security of customer data. The best retailers are integrating their offline and online supply chains and investing in versatile supply chain systems and scalable, flexible online platforms.

This integration will impact not just systems, but also the physical estate, with online retailing increasingly becoming incorporated into the concept through ‘click-and-collect’ stores where customers can touch and feel physical merchandise before buying.

Questions to ask yourself:

► Are my online sales going to be bigger than offline in the near future? If not, why not?
► How can I integrate online and offline supply chain?
► What do my organisation and cost base need to look like in order to support my multichannel ambitions?
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